THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ESE - Q4 2016 ESCO Technologies Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 14, 2016 / 10:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Kate Lowrey *ESCO Technologies, Inc. - Director of IR*

Vic Richey *ESCO Technologies, Inc. - Chairman and CEO*

Gary Muenster *ESCO Technologies, Inc. - EVP and CFO*

CONFERENCE CALL PARTICIPANTS

Jon Tanwanteng *CJS Securities - Analyst*

Ben Hearnsberger *Stephens, Inc. - Analyst*

PRESENTATION

Operator

Good day, and welcome to the ESCO fourth quarter 2016 conference call. Today's call is being recorded. With us today are Vic Richey, Chairman and CEO; Gary Muenster, Vice President and CFO; and now, to present the forward-looking statements, I would like to turn the call over to Kate Lowrey, Director of Investor Relations. Please go ahead.

Kate Lowrey - *ESCO Technologies, Inc. - Director of IR*

Thank you. Statements made during this call regarding 2017 and beyond EPS, EBITDA, EBIT, EBIT margin, tax rate, one-time charges, growth profitability and revenue, operating margins, cash flow, orders, success of new products, sales, acquisitions, implementation of the Company's capital allocation strategy, results of recent acquisitions, corporate costs, and other statements which are not strictly historical, are forward-looking statements within the meaning of the Safe Harbor provisions of the federal securities law.

These statements are based on current expectations and assumptions, and actual results may differ materially from those projected in the forward-looking statements, due to risks and uncertainties exist in the Company's operations and business environment, including but not limited to, the risk factors referenced in the Company's press release issued today, which will be included as an exhibit to the Company's Form 8-K to be filed. We undertake no duty to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

In addition, during this call the Company may discuss some non-GAAP financial measures in describing the Company's operating results. A reconciliation of these measures to their most comparable GAAP measures can be found in the press release issued today, and found on the committee's website at www.ESCOtechnologies.com under the link Investor Relations. Now I'll turn the call over to Vic.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Thanks Kate, and good afternoon. I'm very happy with our results in FY16, not only with the financial results, but also with what we accomplished to better position the Company for 2017 and beyond. We did accomplish our financial goals, with the EPS coming in at $2.03 a share, with strong cash generation. We successfully completed some very difficult restructuring actions, while adding three new good fit acquisitions to our portfolio.

Bottom line, we accomplished what we committed to going into the year. I'm going to turn it over to Gary for a few financial highlights before providing you with my detailed perspective on 2016, and our outlook for 2017.

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

Thanks, Vic. At the start of the year, we identified certain restructuring actions, which we'd be implementing throughout FY16. We described and quantified these actions in detail, as well as identifying the annual cost savings anticipated once they were completed. These costs were excluded from our original guidance provided last November, and we described how we would present our 2016 quarterly and annual operating results on both an EPS as adjusted basis, as well as a GAAP basis.

As noted in today's release, we wrapped up these actions in Q4, and our team did a fantastic job completing this complex multi-national project on schedule and under budget. The Q4 pre-tax cost was $800,000 or $0.02 a share, bringing the total year pre-tax restructuring cost to $7.8 million, or $0.26 a share.

Given the restructuring distractions at Test and Doble, and the fact we faced day-to-day economic challenges across our industrial landscape, we're still able to deliver $2.03 of EPS as adjusted, which topped our earlier guidance of $1.95 to $2.02.

Highlight in Q4, we delivered $0.67 of EPS as adjusted, which beat the top end of our August guidance range, which we noted at $0.59 to $0.66 a share. This means we exceeded our internal earnings expectations in every quarter of FY16.

Turning to a few specific highlights noted in the release, I'm pleased to report that for the year, we increased sales $34 million or 6%, led by another strong year of highly profitable aerospace sales, which increased 9%. Our sales growth was also supported by our technical packaging group, where sales increased $35 million, driven by the addition of plastique, which added $22 million, and the strength of our legacy tech business, which contributed an additional $13 million in sales over the prior year.

Comparing 2016 to 2015, our gross margins increased, our SG&A was held relatively flat despite adding our acquisition partners, our adjusted EBITDA increased to over $100 million, our cash flow from operating activities came in at nearly $75 million for the year, with $41 million of that coming in during the fourth quarter, which is well ahead of plan.

Orders in 2016 remain strong at $576 million. Backlog entering 2017 is solid at $332 million. Net debt of $56 million, with a low leverage ratio on September 30, remains comfortable considering our recent M&A activities and share repurchases. Our significant credit capacity and current liquidity position us well for the future.

Looking at our capital allocation policy over the past three years, I am pleased to report that we've returned approximately $60 million to shareholders, through cash dividends of $25 million and $35 million in share repurchases. As noted earlier, we reported Q4 EPS as adjusted of $0.67 a share.

Comparing this to our August guidance, we increased Q4 earnings, primarily due to the exceptional performance of our filtration group, which delivered an EBIT margin above 25% for the first time in our history. I'm pleased to report that all operating units within filtration contributed meaningfully to these results.

The next-best performance in Q4 was at Doble, where they also meaningfully exceeded our August expectations, resulting from higher-than-expected software, services, and new product deliveries. Q4 Test came in below August expectations, due to the push-out of some chamber orders which impacted the related deliveries in Q4. I'm pleased to note that despite the lower than expected Q4 sales, Test still delivered nearly 13% of adjusted EBIT, which validated our expectations of the impact of its lower cost structure.

Corporate costs were higher in Q4, due to additional spending on professional fees, primarily related to our M&A activities, coupled with additional amortization expense for purchase accounting intangibles from these acquisitions. As we enter 2017, I'm confident that our current backlog and our expected order profile supports our outlook described below.

Turning to our 2017 guidance, in September we acquired Westland and on November 7 we acquired Mayday and Hi-Tech, which we will collectively refer to as Mayday going forward. Westland's results are included for the entire year, and Mayday's results will be included for 11 months.

We noted in the release that their reported operating results would be negatively impacted by an amount of GAAP-related non-cash purchase accounting items. We called out these items to help investors better understand the underlying operating results of Westland and Mayday, and to quantify the significant impact these charges have on our expected 2017 GAAP operating results.

Given the amount of M&A activity over the past 13 months, we decided to supplement our EPS guidance with our expectation of 2017's EBITDA supporting our EPS guidance. We feel that EBITDA more accurately presents the comparative operating results, given the impact of these purchase accounting items.

Management expects 2017 EPS to be in the range of $2.16 to $2.26 per share. This includes the negative impact of $0.08 of one-time charges for the acquired finished goods inventory step-up, and $0.22 of additional depreciation and amortization resulting from these acquisitions. Additionally, Management expects 2017's EBITDA to increase between 21% and 23%, and to be in the range of $122 million to $124 million, compared to 2016's adjusted EBITDA of approximately $101 million.

On a quarterly basis, 2017's EPS profile is expected to be back-half weighted similar to 2016. When comparing our guidance to last year, we're expecting meaningful increases in sales in filtration, and within technical packaging, from a combination of organic growth and the impact of the recent acquisitions.

Filtration continues to benefit from the strong commercial aerospace market, coupled with higher space sales at VACCO. Technical packaging growth is partially muted by a temporary slow-down in KAZ deliveries.

Test sales are expected to increase in the high single digits, with a projected EBIT margin near 13%, again reflecting its lower cost structure. Doble is expected to grow in the mid to high single digits, with EBIT margins of 26%. This comes despite our continuing and significant investment in new products and solutions, as well as an increased focus on international sales and marketing when compared to 2016.

Lastly, our corporate expenses will be higher in 2017 due to the additional non-cash amortization of identifiable purchase accounting assets. In closing, when you're calculating EPS, we are projecting a tax rate of approximately 35% in FY17, compared to 32.9% in FY16. Our share count is expected to remain approximately the same, at 26 million shares outstanding. I'll be happy to address any specific financial questions when we get to the Q&A. I'll turn it back over to Vic.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Thanks, Gary. I am really pleased, as I mentioned, with our 2016 results, from a lot of perspectives, mainly because of the way we accomplished the four major goals we set at the beginning of the year. We set EPS guidance goals that were aggressive and achievable. We set out to demonstrate we had consistent, predictable, and profitable businesses within our diversified portfolio. We identified post-restructuring EBIT goals for Test and Doble, reflecting the impact of the defined cost reductions. We set out on an aggressive yet disciplined acquisition strategy to supplement organic growth, while providing protection to mitigate potential economic softness across our end markets.

I believe FY16 was a success, given the fact we achieved each of our stated goals while delivering above-average shareholder value as reflected in our share price over the past 13 months. It was imperative at the start of the year that we accomplish these goals as a means to delivering the best and most profitable year in ESCO's history. I'm proud to say our collective Management teams came together to deliver operating results which exceeded our internal expectations every step of the way.

I'm pleased with the way our M&A strategy played out this past year, as we completed four acquisitions over the past 13 months. That's a huge accomplishment for ESCO, and I'd like to acknowledge the many contributors to this success. Additionally, I'm happy with the way the Test business restructuring actions were completed, given their complexity, the various geographies involved, and the magnitude of the costs being incurred. Our teams across the Company did a very professional job managing this process so successfully.

Since Gary covered the 2016 financial details in his commentary, I will share my thoughts on 2017. I remain confident that all of our businesses are in a solid financial condition, with known and quantifiable growth opportunities, and that we're well positioned to deliver our projected results in 2017 and in the out years.

As I commented during each of the past earnings calls, we're not immune to economic head winds that many industrial markets are facing today. With that said, I strongly believe the breadth and diversity of our end markets, and the specific niches we operated in, provide us with the protection to mitigate this pressure.

While we are not without our challenges, I like the position we are in across our various businesses, and I anticipate that we can achieve growth rates in 2017 and beyond that exceed those of our defined peer group, as well as a broader industrial market in general.

I'll provide a few specific thoughts and comments on individual businesses as we enter 2017. In filtration, this segment is expected to deliver solid results in sales, growth, EBIT, and EBITDA contributions and cash flows during 2017.

We're well positioned on several fronts, including the continued up-cycle in commercial aerospace led by the A-350; contributions from Westland and Mayday during our first year of ownership; growing product contributions in space on the SLS program; and unparalleled technology on Navy submarines and surface ships, which are critical to our national security; and to which we added further content with Westland. I'm confident that our future growth and margin contribution in filtration will be strong and sustainable.

Our technical packaging group's future remains bright, as we now have meaningful scale and market leadership positions across several growth markets and geographies. We're well positioned in this global market to provide highly engineered products to customers in the medical, pharmaceutical, and consumer markets. We are investing in plastique during 2017 by adding a medical clean room in the UK, and by expanding the manufacturing plant in Poland to capitalize on its lower cost manufacturing; and we're adding additional capacity for fiber packaging.

I am confident the opportunities we're seeing globally set us up nicely in 2017 and beyond. Since we're seeing more easing with our overall utility capital budgets, we are taking a cautious approach to our growth expectations at Doble until we see a clear opening in CapEx spending. However, we do see growth opportunity in our service and software applications, which helped mitigate the legacy hardware slow-down we've experienced over the past 18 months.

We also see solid opportunities for new products such as the M Series, DoblePRIME, and DUCe. As noted in past communications, we're increasing Doble sales and marketing efforts in the international markets to expand our global revenues. We expect the combination of our new offerings and the breadth of our software and solutions to provide growth.

At Test, the restructuring activities are complete. I'm pleased to see the cost savings materialize as anticipated. Our reduced cost structure and ongoing operational improvement initiatives support our earlier 13% margin expectations in Test. I feel good about the growth opportunities we have across all of our businesses as we enter 2017. I can see tangible avenues for additional growth in future years.

While still early in the integration process, I'm very pleased with the Westland and Mayday acquisitions. I was at Mayday last week, and came away quite impressed with the overall Management team, the manufacturing and quality control processes throughout the Company, and their well-defined growth outlook. I like our ability to enhance their growth through synergies and customer relationships where applicable.

Westland has out-performed our acquisition expectations in the two months we have owned them. Their leadership team, and the President in particular, are really strong and I'm happy they chose to stay on after the deal was completed. Both Westland and Mayday are great strategic fits, with EBIT margins near the segment margins in total, and both have good opportunities for growth. We remain disciplined during the purchase process, and paid less than industry averages on recent deals.

Commenting on my longer-term view for the business, we continue to see meaningful sales, EBIT, EBITDA, and EPS growth across the business segments, consistent with our previous communications. Acquisitions will remain a key component for our ability to meet our long-term growth targets, and we continue to evaluate additional opportunities. We certainly have the balance sheet capacity to do more M&A, and we have the Management bandwidth to handle this additional growth within our current operating infrastructure. But we will remain disciplined in our approach.

Wrapping up, we had a strong 2016, and our outlook for 2017 remains solid on nearly every operating metric. Despite our success in 2016, we're certainly not declaring victory. Our focus remains constant to continue to improve our operational performance, and to execute on our growth opportunities both organically and through acquisitions. I would now be glad to answer any questions you have.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Jon Tanwanteng, CJS Securities.

Jon Tanwanteng - *CJS Securities - Analyst*

Hi, guys. Nice quarter, and thank you for taking my questions.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Hi, Jon.

Jon Tanwanteng - *CJS Securities - Analyst*

How are you doing? Can take some time to talk about the customer or timing challenges that you mentioned with KAZ and the Test segment? Heading into Q1 is there a demand issue, or anything else going on? Second, do you expect to rebound as you had in Q1 and Q2?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

I think we will rebound in Q1 and Q2. Really, it was a single customer that we had anticipated getting a large number of orders from. Actually within this past year, they've continued to get delayed. We've been awarded the vast majority of those. We haven't received the purchase orders yet, but we anticipate getting those purchase orders -- I'm sorry, I was talking about the Test, I misunderstood your question. I'll go ahead and my finish my Test answer, and then I'll move over to the KAZ.

Jon Tanwanteng - *CJS Securities - Analyst*

Sure.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

With the Test business, we do anticipate getting those purchase orders in the next two months, and all that product would be delivered within the year.

As far as KAZ, we had a really strong year there this year. The flu season was not that bad, so they've got a good bit of inventory that they're sitting on, and we're going to be burning off -- they're going to be burning off a good bit of that in the first quarter. I think once we get through the first quarter, we will be back on track.

To put it in perspective, we're talking about $4 million or so of sales this year that we won't have in 2017. We think once we get into the second half of the year, and going into the following year, we will be back at full rate. It's just really an inventory management issue.

Jon Tanwanteng - *CJS Securities - Analyst*

Got you, that's helpful. Can you touch on the Saudi contract that you announced last night? Does that increase the quarterly contribution to you guys from National Grid, or is that just a continuation of the old one? Maybe to follow on, when do you think that could actually lead to a full hardware sale?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

We have already gotten some hardware sales as a result of that contract, but this is really very consistent with what we've had the past two years. We wouldn't anticipate any ramp-up as a result of that specific contract.

I would say that as we get into the second half of the year, one or two things are going to have to happen. They have talked about wanting to be able to do more of this work themselves, that being the customer. For them to be able to do that, it would require the acquisition of hardware to be able to accomplish that. The other alternative would be to have a mixture of continuing for us to provide that service going into the following year, and making some acquisition of equipment.

We don't know exactly how that's going to play out yet; but I don't think it's going to be coming up to the end of the year and we're done there. I think we've become a very integral part of what they are trying to accomplish, and I don't think we're anywhere close to being done. I think that will continue into the future.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, great. Then can you touch on just the overall exposure to military and defense spending as a percentage of your total? How can a new administration impact you either positively or negatively from a defense spending standpoint, and maybe secondly as a Company overall?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

I would say we have some exposure there. I would say it's certainly less than 5%, 10%, if you think about the submarine, probably less than 10% of what we have. If you look at our specific opportunities, I would say they're very solid, because the biggest content we have is on the submarines -- and don't see any change in that, really either a positive or a negative.

They potentially in the out years could ramp up from one submarine a year to two. That would have a big impact, but don't anticipate that near term. If you look at the aircraft program that we're on, we're in the F-35; that looks solid. We're on a tanker; that looks solid. The F-15, we continue to get orders on that. I don't think there's any huge up side or down side on the military side of the business.

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

Jon, just to put a number on that, it's about 15% to 18% of our projected 2017 revenue that's across Westland and VACCO on the submarine business, and then Crissair, PTI, and Mayday on the fighter jet side.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, I forgot about the acquisitions.

Jon Tanwanteng - *CJS Securities - Analyst*

Got you, thanks. Maybe just for the Company overall, maybe even on the infrastructure side on the grid spending?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

I'm sorry, I didn't understand the question.

Jon Tanwanteng - *CJS Securities - Analyst*

The improved infrastructure spending as a potential of a new government, and how that may impact Doble?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, really depends on what type of infrastructure is done. If they have a concerted effort to upgrade and to automate the grid, I think that's our best opportunity. If you look at products like the DUCe and like DoblePRIME. Certainly those enhance reliability. If we're talking about straight building infrastructure, I'm not sure that will really have an impact to our business.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, great. Thanks.

Operator

Ben Hearnsberger, Stephens.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Hi, thanks for taking my question. I wanted to look at the filtration segment. If my math is right -- and Gary, check me on this -- you're looking for 35% growth. But if I back out Westland and Mayday, I'm looking at mid-single-digit organic growth. Is that right?

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

That is correct. Yes, I think the aerospace business is going to be up and the space business is going to be up, but there's some industrial things within PTI that are probably closer to the softer side. Your math is pretty close.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay. Legacy filtration, digging into the aero pipeline, is it -- it sounds like it's ramping as expected. Is it above plan, below original plan? Can you speak to what you're seeing in your aero business?

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

Yes, it's pretty much on plan. It may be just slightly above plan, but not significantly. We have had a little better growth at Crissair what we had anticipated, so that does provide a little bit of upside for us.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay. Then switching to Doble, the guide for mid to high single-digit growth, and we're coming off a year where we grew 3% to 3.5%. I tend to think of this business as GDP-plus, and this is a little bit more optimistic guidance. Can you talk about is these new products contributing more than I can expected? Can you can walk us through where you're seeing success?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

The biggest thing, Ben, is software. We made an acquisition two years ago, three years ago, of ENNOSERV in Tulsa. We got a tremendous amount of traction with that software business. I would say that, in addition to additional service business, is where we're really seeing the growth. I do think that while we've had some softness on the legacy business side, we're starting to get some traction with the new products. It's a little bit of a mix, but if you look at year to year, the biggest improvement is what we're seeing on the software side.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay. Then I had one higher-level question. If you think about we're two years through a three-year plan you laid out a few years ago, the guidance suggests that you're on track to achieve that plan. Given that you've had success, and given where you stand today, if you look out three years from now -- and I'm not trying to force guidance here, but how do you think about the longer-term earnings potential of this business?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

I think we've got plenty of growth opportunity, as I mentioned in the closing part of my statement. We can add a lot to the business without adding a lot of infrastructure. We don't have to go do a lot to add to that. I think we should be able to continue to see the type of growth that we've seen over the past couple years.

If you look at it very broadly, I would say the organic growth is maybe a little softer than what we anticipated two years ago. I don't think that's a surprise to anybody. We've been a little more successful earlier in the process on the acquisition front, which I think is good. I think it shouldn't be lost on anybody that the acquisitions that we've made have been pretty profitable businesses that we've been able to get for a reasonable price.

As a result of that, I think that does help our growth potential. If you look back at some of the other acquisitions that we've made historically, I think we have a proven track record of being able to get people's margins up.

If you even look at Crissair, which is really a combination of two businesses, I would say we've more than doubled their profitability since we've owned them. I'm not saying we're going to double the profitability of businesses we bought, because they are much different businesses. But certainly, I think being inside of a Company like our, and having some of the expertise we have, we should certainly be able to drive the profitability of those businesses. Then the question's going to be what else are we going to be able to acquire going forward?

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay. Gary, how much capacity do you have for M&A at this point?

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

Total liquidity with the ability to up-size on our facility, it's about $500 million-plus, $525 million, somewhere in that range.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay.

Gary Muenster - *ESCO Technologies, Inc. - EVP and CFO*

We have a $250 million accordion sitting on top of our revolver that's specifically designated for if we were to do incremental acquisitions greater than the pool we've been playing in right now.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Great. Thanks for taking my questions.

Operator

(Operator Instructions)

Sorry, I was just going to say that we have no further questions. Please go ahead.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Okay. All right, thanks everybody. I look forward to talking to you on our next call.

Operator

Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone have a great day.