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PRESENTATION

Operator

Good day, and welcome to the ESCO Third Quarter 2018 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 read the forward-looking statements, I'd 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 the amounts and timing of 2018 and beyond EPS; adjusted EPS; EBITDA; adjusted EBITDA; growth; profitability; sales; cash flow; orders; success of new products; success in completing additional acquisitions and benefits from recent acquisitions; DoD and commercial customer spending; and other statements, which are not strictly historical, are forward-looking statements within the meaning of the safe harbor provisions of the federal securities laws. 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 that 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 company's website at www.escotechnologies.com, under the link Investor Relations.

Now I'll turn the call over to Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Thanks, Kate, and good afternoon. Gary will discuss the financials in his commentary, but I'll set the tone today by noting that each of the 3 quarters year-to-date, we either beat EPS expectations or came in at the top end of our guidance, which gives me confidence that we'll wrap up the year in a solid fashion.

In addition to our earnings strength, I'm pleased to report that we're ahead of plan on cash flow and orders as well and remain active in the M&A market.

Now I'll turn it over to Gary for the details.

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

Thanks, Vic. As noted in the release, we did not call out any specific or unique onetime items impacting Q3 2018's operations, which means our GAAP and adjusted EPS are the same for the current quarter. I'm pleased to report that we again hit the top end of our previous guidance as our Q3 EPS came in better-than-expected across several financial metrics. As we've done all year, I'll focus my commentary on adjusted EPS and adjusted EBITDA as these are more relevant measures of our operating performance when compared to expectations and the prior year.

Before I comment on the Q3 details, I'll recap a few data points that we communicated during previous earnings calls. As you recall at the start of the year, and before anyone could estimate the impact of then pending tax reform, we set our original financial goals on a GAAP EPS basis and included a discussion of our expected operating performance, including EBITDA and, subsequently, adjusted EBITDA, which was expected to increase meaningfully over prior year. Then in our February release, we raised our GAAP guidance to $3.55 to $3.65 per share and communicated our adjusted EPS as $2.65 to $2.75 per share. We continue to support these ranges with our May guidance, and we are continuing to support these ranges today. We feel it's both prudent and conservative to maintain these expectations.

We also described the timing of several project-related items that were impacting the comparability of our first half compared to prior year's first half, and we discussed what was driving the increases in sales and earnings that resulted in our significant back half weighting this year. Hitting the top of our expectations for Q3 demonstrates that what we saw early in the year with our back half weighting is playing out as expected, which provides us with some support for the remainder of the year.

Now touching on a few of the financial highlights from Q3. Again, we recorded GAAP and adjusted EPS of $0.73 a share, which hit the top end of our guidance and was driven by another strong quarter reported by our Filtration segment as a whole and our commercial aerospace business, in particular. Within USG, Morgan Schaffer significantly outperformed earlier expectations and delivered an EBIT contribution north of 25%, and Vanguard continues to perform exceptionally well. Test and Technical Packaging met their profit plans for the quarter.

Looking at Q3 sales in total compared to prior year. Sales increased $21 million or 12% led by significant increases noticed -- noted within Test, which is up 20%; commercial aerospace, up nearly 15%; and USG, up 32%, including the contributions from last year's M&A.

Test sales were driven by its strong backlog conversion to sales, and the commercial aerospace sales increase was somewhat evenly distributed across Mayday, Crissair and PTI. This helped mitigate the lower industrial and automotive sales of PTI that we described at the start of the year, along with lower space sales at VACCO resulting from project timing.

Our adjusted EBITDA increased by 27% in the quarter to $35.1 million which, in turn, drove our EPS to the high end of our range. Also well above expectations was our year-to-date cash flow from operating activities, which was $54 million, or $63 million when you exclude pension contributions we made which are intended to reduce our ongoing operating cost on the frozen plan. This cash flow allowed us to pay down debt and reinforced our view that our significant cash-generating capabilities over the balance of the year as well as our existing credit capacity and available liquidity have us well positioned to continue to execute on our M&A strategy.

Entered orders were $201 million in Q3 and, coupled with the $388 million recorded in the first 6 months of the year, this brings our year-to-date order total to $589 million, reflecting a book-to-bill of 1.09 and increasing our June 30 backlog by $48 million or 13% from the start of the year.

So in closing, I feel that our current backlog and program delivery profile supports the outlook for the balance of the year. And when we get to the Q&A, I'll be happy to address any specific financial questions.

And now I'll turn it back over to Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Thanks, Gary. Continuing the theme from when we spoke last, I remain confident that all of our businesses are in a solid financial condition with solid growth opportunities and an ability to add and integrate future M&A opportunities.

Gary and I just completed our July board meetings at each of our operating units. And after being on site and seeing where we are positioned in our various end markets and understanding our growth opportunities, I continue to feel confident that we're well positioned to deliver our projected long-term growth objectives through both organic means and supplemented by targeted M&A.

As you know, our original plan anticipated a very steep back half of the year. And now having wrapped up the first 9 months as we have and given the strength of our orders and backlog and project delivery schedules, we see a path to the finish line.

Clearly, our recent acquisitions in USG are making meaningful contributions this year. And for the most part, their performance is ahead of our acquisition plan, which we established when we acquired the companies. As Gary noted, Morgan Schaffer and Vanguard are performing very well, and we continue to see additional sales opportunities from rationalizing our distribution channels and maximizing our sales efficiency across USG.

In Filtration, we expected a solid Q3 when we put our previous guidance out, and I'm really pleased to see us outperform on sales and margins and entered orders. Filtration-served markets remained strong. VACCO and Westland are benefiting from the Virginia and Columbia Class sub programs, coupled with an increase in overall spending on U.S. Navy programs, as well as build rates continue to accelerate.

PTI and Crissair are growing as commercial aerospace deliveries and overall OEM build rates continue to increase. And Mayday is expecting growth from manufacturing capacity increases and their entrance into the MRO market. Our Technical Packaging group's future continues to improve as a result of our scale, broader footprint and leadership position in several growth markets.

In USG, we continue to see growth opportunities across the global platform, including hardware, software and services. Our rep and distributor network rationalization and our recent cost reductions are showing meaningful results.

Moving on to Test. We had a very strong quarter evidenced by the 20% increase in sales over prior year. And we generally hit our Q3 profit margins by delivering a 13% EBIT margin. We continue winning new business in Test across a wide range of end markets, including in automotive-related and tenant test facilities, electric vehicle motor testing chambers in China and several large custom projects related to the developing 5G market. I continue to feel good about the growth opportunities we have across all of our businesses, and I see tangible avenues for additional growth in future years.

Regarding M&A, the pipeline remains strong, and we continue exploring opportunities, which will supplement the Filtration and Utility segments. Acquisitions remain a key component of our ability to meet our longer-term growth targets, and we have the balance sheet and management capacity to meet our goals, while remaining disciplined in our approach.

As we begin to look at next year, we will continue to focus on our growth initiatives as well as continuing to look for cost reduction and margin enhancement opportunities across the company. Our focus on the cost side is to leverage our asset base to improve our operating efficiency and, therefore, improve our margins, cash-generating capabilities and our return on invested capital. So our focus remains constant: to continue to improve our operational performance and to execute on our growth opportunities, both organically and through acquisitions, therefore, enhancing shareholder value.

I'll now be glad to answer any questions you have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Sean Hannan of Needham & Company.

Sean Kilian Flanagan Hannan - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

First, what I want to see, if I could start with this, is now that we're entering the last quarter here for you folks, and I think that, if I sense correctly, you've been seeing some pretty good consistency in general around how your business demand is materializing and really kind of hitting through in that conversion through the top line. So I wanted at this point to get a little bit more of a perspective, not guidance, but early-stage viewpoints into how are you thinking about the continuity of the momentum you're seeing into '19. How should we think about any changes? Or are there viewpoints around your organic growth rates as we particularly apply to a '19 scenario? Or any other thoughts that may supplement that and, particularly, our modeling as outsiders?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Sure. So it's -- we don't have our plan put together for '19 yet, so I have to talk in pretty general terms. But certainly, we think that now that we've got some of these acquisitions incorporated, we've gone through some of the rationalization of the rep network and how we're going to market, we've made some changes there, we think we will start to see some benefit of that in '19, and we -- it's been pretty good so far. I mean, honestly, the integration effort's gone as well as could be expected, I would say. But it always takes some time to get reps trained. And we had some rationalization of that where we've had some that we parted ways with, some that we kept, and so we've had to do some retraining. I'm talking primarily in the USG side here. So I think we'll get a little pickup from that next year as a result of having everybody in-house for a full year and people understanding the products and getting familiarity with selling those. Beyond that, I think we'll continue to see solid growth in the aviation market. Those are strong markets. I think the MRO work that we're doing at Mayday in Texas has started to pick up. It's always a little harder start than you anticipate it's going to be, but we're really starting to see some traction there as well. So I'd say, overall, as we go into next year, we'll see the type of growth that the end market supports, and that's probably kind of mid-single digits, I would say. Hopefully, we'll get some kind of one-off projects, which we do from time to time, which will provide some additional growth to that as well. But again, we're not quite through the end of the year yet, but we're in the process of forming those plans together.

Sean Kilian Flanagan Hannan - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Okay. That's helpful, Vic. And then you touched on some of the efforts that have been [key] in terms of the integration. And as I specifically think about, say, a Vanguard or Morgan Schaffer and so forth, perhaps, you or Gary, can you give us some viewpoints around as you made those acquisitions and thought about where can you influence margin production out of those businesses and either, ultimately, where you think you could get them to or the pace of being able to get there, can you share some color on where do you feel that you stand? And has anything changed? Do you feel that maybe you might be able to squeeze out even better margin out of some of those acquired businesses? Or maybe has the pace either been a little bit faster or slower? Some viewpoints around that would be great.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

So let me answer that. The -- what we see in Vanguard and Morgan Schaffer in particular are actually better than what we anticipated going into this, so I think that's [related]. I think the game there is really more of a volume game, and then we've started to see some of that. Because, again, one advantage of being able to take a smaller business, they were very successful businesses, but now they've got a much larger distribution network, and so we think the real benefit there is going to be able to accelerate the top line for those businesses because they're already pretty profitable. I mean, certainly, we're going to work together with those businesses. I think they bring a lot to the table. We bring a lot to the table.

And we'll work together to see if we can do some things differently there. Also, with the addition particularly of Morgan Schaffer, that allowed us not to do some development -- well, actually, with both of those businesses, to do some development, which we had planned to do in the out years to kind of replicate some of those projects. So you have some kind of avoided cost there and also just the ability to have the engineering teams work together will provide some efficiency there. Manta, I think, we will be able to get those margins up some. Their margins aren't equivalent to what we're seeing in some of the other businesses in USG. I think that it's just a matter of helping them with the manufacturing efficiencies as well as I think we'll be able to grow their top line as well.

Sean Kilian Flanagan Hannan - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Okay. And then last question here. The -- if I -- a lot of times, I'll still really kind of look at a combined scenario, Filtration and Tech, in terms of assessing some of the bookings you have here. But in general, that has -- that came through the quarter really strongest, I think, in about 2 years. And so anything to incrementally read into that beyond how much may be relevant, say, for this next quarter? Obviously, it's a very seasonally strong quarter, but any more perspective around that would be great.

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

Well, I'll take that one, and Vic can add some color around kind of the business, and I'll go through the numbers here. The nice part within Filtration is all of our individual operating units had a positive book-to-bill which, obviously, bodes well. So to Sean's question, there's not really any individually significant catalyst that drove that. We didn't book the next 5 years of Virginia Class, so there wasn't any extraordinary one-off items, so that's really a good positive. And the fact that it's spread across the applications is really well. So if I had to pick one thing to call out, in the Airbus A350, they buy -- instead of buying every month, they buy once or twice a year, 12 months in advance kind of thing. And the distributor restocking orders, they don't come in every month. And so I had to really dig down deep to pick out 2 things that had slightly above-average contributions. And one is we had little higher level of A350 orders, which we'll deliver over the next 12 to 18 months because they try to buy about a year ahead. And the distributor stocking orders, which normally happen about this time of the year, tended to be higher. And I think that's supported by the build rates that you see around that. So it's not extraordinary, but it's really great from our side to see all 5 of those units getting an uptick in the quarter. And our hope is that we replicate that as we go forward. But a lot of that is just the general buying patterns of the customers, but we're very pleased with it.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes. The only thing I would add is I don't think you can read too much into one quarter. Just like with the sales, I mean we always have project timing, whether it'd be entered orders or big projects. And particularly, when you got kind of a big half in the second half of the year, you can have some projects that shift from third quarter and fourth quarter or vice versa. So I think, obviously, quarterly results are important, but I think we really have to look at our business kind of on a full year basis.

Operator

And our next question comes from the line of Drew Lipke of Stephens.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Just first on -- or maybe to follow up on that last question in Filtration, can you talk about some of the trends that you're seeing in commercial aftermarket? I know many aftermarket-exposed peers are posting pretty robust growth right now. Theoretically, I would think you would get a mix benefit from there as well. So can you just talk about the trends that you're seeing there, maybe the visibility that you have as we look out over the next couple of quarters here in aftermarket?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

I'd say the trends are good, the visibility's tough. I mean because where we're kind of at, on a Tier 2 or Tier 3 basis, we don't always get as much insight as we'd like to see in 2 quarters out. But I'd say the trends are good. Particularly, what we're seeing at Crissair, what we're seeing at Mayday, those are kind of more quick-turn businesses. And so I'd say we're seeing a little more pickup there than maybe some of the other companies where they're very program-driven. But the OEM business does seem to be picking up, it seems to be solid. We also had some of that PTI as well. If you kind of look at VACCO and at May -- or at Westland, not as much, just because those are really kind of project-related businesses. But where we have aftermarket, I'd say good trends but not as good a visibility as we'd like to have. And that's nothing new.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Yes, okay. And with Embraer E2, I know that's an important platform for you, how do you think about the Boeing partnership? I mean, on the one hand, it greatly helps the sales outlook. On the other hand, Boeing is talking about supply chain synergies and cost reductions there. Just be curious to hear your thoughts on that partnership.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, I mean, I think it's too early to tell. I mean it's such a big deal. And the devil's in the details, as you say. I'd say, we probably say from more positive than negative. I mean, there's always a lot of discussions about consolidation of suppliers and cost reductions, but those things take a lot of time. And sometimes, they make a big difference. Sometimes, they don't. But I'd say our early view is more positive than negative.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Okay. And then I apologize if I missed this earlier, but what's the proper tax rate we should be modeling here for the year for the fourth quarter for -- implied in guidance?

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

Yes. I'd say as you look at Q4, I'll put it somewhere in the range of 24% to 26%, and we did get a positive impact in this quarter. And I'd say we have -- everybody says they got a great tax department, but I think ours pays for itself multiple times over. But I think after tax reform, there's some strategic things we're doing to lower that rate. It's $25 million operating cost, and I think we're doing a couple of good things. But those are onetime things that's not going to be replicated. So I'd say, on a go-forward basis, pick the midpoint of them, say, 25% could be the right way to think about it for Q4.

Operator

And our next question comes from the line of Jon Tanwanteng of CJS Securities.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Vic, I might have missed this at the beginning, but how does the M&A pipeline look over the next 3 to 6 months? Are there opportunities there? And where are you focusing? And are valuations reasonable?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Okay, you hit a couple of them there. I'd say valuations are always tough. I think we work really hard to try to get businesses before they get into an auction. And if they get in an auction, they get a little bit higher, but I think we still are pretty disciplined about that. Pipeline looks pretty solid, we have a couple of things we're currently looking at, and a number of things that we understand are coming to market in the not-too-distant future. The Farnborough Airshow was a couple of weeks ago and, of course, we had a good representation there, and we had an opportunity to speak with a lot of folks, the investment bankers, primarily, that we're looking at bringing business to market. This is always a little bit of a slow time just because it's summer, but we've got insight in a number of things that are either active right now or be coming out after Labor Day. But yes, I'd say it's pretty robust. And continuing with that -- what I mentioned in my comments, I mean our primary focus really is in the Filtration business and in the USG space.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Got it. And from a longer-term perspective, how do you think of inorganic growth over the next 3 years as part of your growth strategy? Are you where you want to be from a portfolio standpoint? Or do you want to be more concentrated or broader in any of your business to hit those targets?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

I'd say all the businesses right now are good, solid businesses. They have slightly different growth rates, but I'd say not dramatically. I mean, what we do see with some of our businesses is -- particularly like with the Test business, we may have a larger program that will come in that will accelerate the growth rate for a year or 2. But I'd say that our businesses are all in a decent spot. Organic growth is never as good as you like it to be. I mean -- and so that's something we spend a lot of time working on. And interestingly, I've been having a discussion with our board last week and now with division presidents on what we could do to accelerate that organic growth rate. I mean, we've, obviously, had some good opportunities with acquisitions. We think we'll continue to do that. But obviously, you get a better return by having a strong organic growth rate, and we're focused on that.

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

And Jon, one thing I'd add to that is on the inorganic side, because you kind of asked the question do we plan on M&A growth rate perspective, and I'd say, back to the conversation on multiples, we obviously are prudent in how we look at ROIC and that sort of thing. And as we look at deals, I'd ask you to kind of think of the reverse end of it as to debt, I don't see a situation here where Vic or the board or myself will be feeling comfortable levering up to 4 or 5x. That's not the deal. So you're not going to see us buying a $500 million or $600 million company anytime soon because the inverse of that is the debt side. And so I think what we've done in the past, picking up $20 million, $30 million, $40 million revenue companies is what we're really good at. And that doesn't mean that if something comes on to market for $100 million, we won't go get it. But I would say, if you just kind of think of it in that perspective as you model out inorganic growth, it would not be awkward to add $25 million or $30 million a year when deciding your model for M&A. And that kind of fits our sweet spot, if you will. Is that helpful?

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Great. That's helpful, yes. And then finally, just on -- was there anything that pushed out of Q3 into Q4 from a project standpoint? And so what was the size and impact?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, we had a little bit both at Doble and the Test business that we thought was going to happen in the third quarter, it got pushed to the fourth quarter. It's -- I kind of alluded to that earlier. I mean, when you have some project-driven business, those things do fluctuate from quarter-to-quarter. Apparently, customers don't pay as much attention to our quarter-end as we do. So sometimes, things move around a bit.

Operator

(Operator Instructions) Our next question comes from the line of Liam Burke of B. Riley FBR.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Vic, you mentioned the growth out of the USG business was 32%. You highlighted the strong performance of acquisitions. How did the -- how was the organic growth contribution to the segment this quarter?

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

Yes. I think, Liam, if you look at it in the mid- to high-single digits for this quarter, that would be fair. So if you put it somewhere, 6% to 8%. And here's just kind of a general reminder, we had Morgan Schaffer and NRG for half, essentially, half of Q3 last time. And then so what happens is, as you go forward, part of our strategy, as Vic mentioned, relative to the aggregation and the rationalization of the supply chain, what happens as time goes on is you start to lose a little bit of visibility into where the products are sourced relative to if the distributors carry enough of Vanguard or something like a Manta product here and there. We keep -- generally, keep track. But you're going to start to see over time kind of a blended conversation as we go to -- our go-to-market strategy is kind of a OneCo, if you will. And so I think we still have visibility very clearly now because, again, we're tracking it for this first year. But I think as you get into Q4 and you get into '19, that conversation gets a little more blurred because of, for instance, using the online monitor, and we buy a Morgan Schaffer dissolved gas analyzer that goes into our prime products that we'll get to record the sale for that kind of thing. So that's just one example of products that kind of changed their name, if you will, as you go across. So it's a really long answer, but I just want to make sure that we reinforce the fact that our goal is to make USG look like USG as opposed to the individual components, we will continue to share specific commentary with you folks until it becomes a little bit less relevant. But I'd say for now, if you thought of 6% to 8%, it'd be a fair number, but then it's going to get a little muted going forward.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And still on USG, you had nice sequential order growth, you highlighted new products. Is there any particular market or business that saw a nice uptick in new product adoption?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

I'd say the biggest -- the 2 biggest things that we're seeing a little pickup in is our DUC product, which we talked a bit about historically, and then the in-line systems that we're selling to customers. I mean, over time, as you know, most of the products we have kind of have to take the transformer offline, do the test, put it back online. And ideally, utilities will have sensors in line all the time, measuring all the pieces of equipment. Obviously, that's a very expensive proposition, but we are seeing more and more adoption toward that. And so it is -- and that's one of the reasons we really were interested by Morgan Schaffer because that dissolved gas analysis is such an integral part of that online analysis. So I would say those are the 2 areas where we're seeing the most kind of new product growth, if you will. In addition to that, we're continually working to upgrade the products that we currently have because technology changes. We have things that we've had in the field for 10-plus years, and you just need to continually, in a business like that, upgrade those products. And so we have a good product road map to upgrade those core products while, at the same time, deploying new products like online monitoring and like the DUCe.

Operator

And I'm showing no further questions at this time. I would like to turn the call over to Mr. Vic Richey for closing remarks.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Okay. Well, thanks to everyone, and I look forward to talking to you at the next call.

Gary E. Muenster - *ESCO Technologies Inc. - Executive VP, CFO, Principal Accounting Officer & Director*

Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.
