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ESE - Q4 2019 ESCO Technologies Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

Robert Paul McCarthy *Stephens Inc., Research Division - MD & Analyst*

PRESENTATION

Operator

Good day, and welcome to the ESCO Fourth Quarter 2019 Earnings 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 statement, 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 the amounts and timing of 2020 and beyond, revenues, EPS, adjusted EPS, EBITDA, adjusted EBITDA, debt, growth, profitability, ROIC, timing of the divestiture, tax rates, shareholder value, success in completing additional acquisitions 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 the 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 describe our fourth quarter and full year financial results in detail after my comments. So I'm going to take a few minutes to discuss the sale of our Technical Packaging business, and share our thinking around the strategic aspect of this divestiture.

5 or 6 months ago, we were not contemplating selling our Packaging assets as we saw a clear path for this business to expand its contribution within ESCO. Given their identified prospects for growth, we made some meaningful capital investments in 2019, both domestically and internationally to support this outlook. But given the robust valuations we were seeing in the market, coupled with our strong presence in the medical, medical device and pharmaceutical markets, we knew we had an attractive set of Packaging assets that would command a solid valuation if offered for sale, and yesterday's announcement of the transaction proved we were right.

After a thoughtful analysis of our options, we came to the conclusion that monetizing our Technical Packaging assets at a strong valuation, was strategically positive and financially prudent. This transaction makes a lot of sense for a lot of reasons. It allows us to delever by paying down our outstanding debt, which creates additional debt capacity and liquidity for future M&A spending in our other segments. The transaction also streamlines our business and simplifies our portfolio, which allows us to focus on our remaining core operating segments, both on organic growth and continued M&A around this core.

On a personal note, I would like to thank Randy Loga and the entire management team and the dedicated employees around the world, who worked so hard to make the packaging business a success, and I wish everyone all the best in the future with Sonoco.

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

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

Thanks, Vic. We wrapped up the year in a strong fashion compared to fiscal '18 by delivering solid top line growth, coupled with 9% growth in adjusted EBITDA, 13% growth in adjusted EPS, strong cash flow and record entered orders, as all these items exceeded our previous expectations set earlier. Similar to the past, our sales, adjusted EBITDA and adjusted EPS not only exceeded our expectations, but they beat the consensus estimate, driven by continued strength across all 3 core segments.

On a segment basis, Filtration sales increased 14% over prior year, or 11% excluding globe. This growth was led by our aerospace businesses, where sales increased $32 million or 19%, resulting from continued strong demand across our extensive aero platforms, both OEM and aftermarket and both commercial and defense. This growth was partially offset by VACCO's Navy business, which had lower sales in 2019 resulting from revenue recognition timing items on several large programs. Globe added approximately $9 million of sales in the 3 months that we owned them. Test and Doble both grew sales at better-than-expected amounts. And our renewable energy business decreased in 2019, which mitigated our USG sales growth.

Our 2019 adjusted EBITDA was $151 million compared to $139 million in 2018, and our adjusted EPS was $3.13 a share compared to $2.77 a share in 2018, which reflects 13% growth. These increases were accomplished through a combination of meaningful sales growth, a favorable sales mix, rigorous cost management, coupled with solid execution across the company and topped off with solid tax planning strategies. Additionally, I think the strength of our 2019 results continues to demonstrate the earnings power that we can generate at higher sales volumes and continues to support our multi-segment, multi-industry strategy.

Our cash flow provided by operating activities for the year was $105 million, which resulted in $224 million of debt outstanding, which reflects an extremely comfortable leverage ratio of 1.68 at September 30. Q4 cash from operating activities was $68 million, reflecting our strongest quarterly cash flow in history. This was driven by solid earnings, an enhanced focus on working capital management and strong cash collections.

I'm also really pleased with our entered orders, both in Q4 and for the year, where we set a record by exceeding $900 million of new business for the first time. It was also great to see how our order growth was spread nicely across the operating segments. This order level resulted in an increase in ending backlog of $92 million or 24% from the start of the year. This gives us some comfort supporting our fiscal '20 growth outlook.

Looking forward to fiscal '20, I'll provide a backdrop for our outlook that was detailed in the press release, and point out that all comparisons between fiscal '20 and fiscal '19 are done, excluding Technical Packaging from both periods. We expect to grow our top line 9% to 10% on a consolidated basis, led by Filtration, which is centered around 14% growth, followed by USG at 7% to 8%, with Test growing 4% to 5%. We expect adjusted EBITDA to increase 12% to 13%, with the corresponding margins, increasing nearly a full point. Noncash depreciation and amortization is expected to increase approximately $5 million, which negatively impacts projected EPS by $0.15 a share. We are projecting a 23% to 24% effective tax rate, which is higher than our 2019 rate, which I noted earlier, was favorably impacted by various tax strategies which generated both cash and earnings benefits, which we do not expect to repeat in 2020 at the same level. This higher tax rate differential negatively impacts 2020 projected EPS by $0.10 a share.

So when bringing all these together, we expect our 2020 adjusted EPS to be in the range of $3.20 to $3.30 a share when excluding the packaging business. This reflects a meaningful increase over the pro forma adjusted EPS of $2.95 a share for fiscal 2019.

So in closing, given our new and expanded credit facility and available liquidity, we are well positioned to effectively execute on our M&A strategy and support future growth, both organically and through acquisitions across our core businesses, all of this while remaining focused on ROIC and increasing shareholder value.

And with that, I'll turn it back over to Vic for a few additional comments.

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

Thanks, Gary. I'll update you on a few items that were in process when we last spoke. We officially moved into the new Doble headquarters facility last week, and everyone is really pleased to have this disruption behind them and have settled into their new offices. I'm really happy to have all of our Boston area employees in one location as I'm certain this will enhance collaboration and productivity and will certainly benefit our employee recruitment given its favorable location.

Also within USG, we continue to see solid progress and customer acceptance with NRG's Bat Deterrent product and given a strong support from all the stakeholders and the positive test results being documented, we see this solution as a growth opportunity for the company.

I'm excited about Globe's future as they're off to a great start. The fit with us is obvious, as synergies with a shared customer base are already paying off with expanded order flow.

As Gary mentioned, our aerospace and space businesses continue to see an uptick in order and sales activity, and I'm pleased to see the Block V awards on the Virginia-class subs being released, which will benefit VACCO, Westland and Globe.

Our Test business outlook for '20 is solid, and we expect to see continued order strength throughout the year. Among other end markets, 5G continued to gain momentum.

We continue to look for additional acquisitions to support our organic growth, and we plan to deliver on our commitments in both these areas to support longer-term growth objectives.

In closing, we remain focused on successfully executing our strategy, and we're planning for a successful 2020.

Now I'll be happy to take any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jon Tanwanteng with CJS Securities.

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

Gary, can you give us the adjusted EBITDA number and margins that you're working off of -- or basing the 12% to 13% and EBITDA margin expansion growth level for next year?

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

Yes. When we look at where we're looking to go, if we pro forma '19, is that what you're referring to?

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

Yes.

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

Yes, I would say it's about $139 million for '19. And then we're seeing the 12% to 13% growth off of that number, and that $139 million is what correlates to the $2.95 on a pro forma -- adjusted pro forma EPS for '19.

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

Okay, great. And then can you give us a bit more color in terms of the timing of your backlog? And the dip of your forecast in Q1 into Q2?

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

Yes. Let me do it from the bottom, and I'll refer to Vic, if he wants to talk about the business side of it. So one thing I want to make sure everyone is aware, is kind of what the profile of the year looks like, how we tend to have significantly back half-weighted years, it seems like every other year, this year; in fiscal '20, it looks a little bit more like fiscal '18. And so just to give you a couple of statistics to save you the math, in fiscal '18, in the first half of the year, we did about 29% of our annual EPS, which means 71% came in the second half. Fiscal '20 -- I'm sorry, fiscal '19 was a little flatter, we did 40% in the first half and 60% in the second half. And fiscal '20's cadence will look a little bit more like '18, where we'll have somewhere between 30% and 33% of our EPS, adjusted EPS will hit in the first half, which means 67% will hit in the second half.

So while the quarterly profile is back-end weighted, again it looks pretty similar to the achievements that we realized in fiscal '18 on that kind of weighting. And that's really just a function of the bigger programs we have across the Test business, across the submarine platforms. Doble has some things in the back half of the year on some larger projects that it impact that. Across the Aerospace business, it's usually a function of distributor restocking orders that come in, in fits and starts. So there's nothing really unique to this year, again, because we've done this profile in the past, and it's very achievable for us. So hopefully, that answered your question from a financial perspective. And Vic...

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

Yes, let me just add. I mean, I think the thing that gives me a lot of confidence is the backlog. We have -- grew the backlog pretty significantly over this past year. So it's -- these timing issues quarter-to-quarter frustrating, but that's how they are. I don't think there's any issue at all.

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

And then just a question on the backlog. How much of the backlog today is part of the packaging business that's just going to be divested?

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

I got to go back to the last page of the press release. So we had -- at the end of the year, we were at about $11 million.

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

Okay, great. And then finally, just what's in the M&A pipeline now? And is it appropriate to think about you guys relatively quickly replacing the EBITDA that you're divesting with other assets that you may be pursuing that are more synergistic with your USG and Filtration businesses?

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

It's certainly our hope. We are working a number of issues right now. I mean, the M&A pipeline is as full as it's been for us. I mean, it doesn't mean something's going to happen right away, but certainly, there are a number of really good opportunities that we're pursuing currently.

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

Okay. And finally, if I could, from a global and geopolitical risk standpoint, have you seen any changes in the risk or headwinds that might be out there or maybe from a large individual program standpoint?

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

Not really. I mean, I would say that we probably are far enough down the food chain where we participate, that's not really been an issue. We watch China closely just because we do some business there, particularly with the Test business, somewhat Doble, although not that much at Doble these days. But the Test business certainly we do have a location there, so that helps us a lot, and we're actually a net exporter rather than an importer from China. So we don't actually bring anything back here from our Chinese operations. So we don't have any tariff issues coming in this direction.

Operator

Our next question comes from Robert McCarthy with Stephens.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

Great. Well, first, I want to just go on record as saying this is a tremendous quarter, really good strength. And obviously, the divestiture activity, you should be applauded for the price you got. So I just want to make sure that I'm on record on that, okay? So with that being said, could we talk about the bridge a little bit? That was very helpful in terms of the incremental guidance, but maybe we could just kind of run through the math one more time to just kind of level set everybody where we are. Because fundamentally, the outlook looks -- remains very strong, right? But I want to just make sure I'm getting the bridging aspects correct.

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

Okay. And from a top line, obviously, it really just impacts the packaging business. So the results that we've included on that last page of the segment page of the press release, I don't have the pages numbered here, but you can see that from a revenue perspective, we're talking about $86 million, $87 million for the packaging business, and then we're taking out adjusted EBIT there of about $7.3 million, and there's about $4 million of D&A in that, so you add that back in. So that kind of what takes you down to the number that I referenced at about $139 million, $140 million. There's a little bit at corporate that goes away where we carry a little bit of amortization of some purchase accounting stuff. So that will reconcile you back to the $139 million, $140 million of EBITDA. And then so kind of stepping across, on the top line, we kind of referred to each of that as we level set, as obviously, Filtration's growing at a very solid amount. Obviously, Globe's in there for 12 months versus 3, but absent that, we're still growing in the high single digits there. So we're really pleased with that. The packaging business -- I'm sorry, the Test business, it's kind of at the higher end of our historical range with, kind of, in that 4% or 5%. And USG is getting a little of a rebound effect. The renewable space was soft, to be polite, in 2019. And so we're kind of at the bottom of the V, and it's just a matter of how wide the bottom of that V is, but we're seeing pretty decent growth there, as Vic alluded to in his comments on the bat deterrence situation and a few other new products we've put out. So that's going to be adding. It's the law of small numbers, but that's 8% to 10% growth in that business again, coming off of the base of the V. So does that help?

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

No, that's very helpful. And I was actually just, if you wouldn't mind, just indulging me in just walking through that bridge again, the EPS bridge, which is basically level setting as to what should be the comparable number year-over-year, which you did allude to. And then just highlighting the incremental tax and the incremental, the other adjustment, just so we understand what the bridge was at the outset?

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

Yes, it equates back to about, like I said, $2.95 a share. The tax rate, on a consolidated basis, was impacted. Our consolidated rate was lower because a lot of the tax strategies we put in place were incurred domestically. And so the rate that we level set for the packaging business, being excluded, is back to our statutory rate of essentially 23%, 23.5%. So as you look at that EBIT and you back that out and then you take a tax effect of what that would be, that should bring you right down to $2.95 a share. We try to keep it as simple as possible. Obviously, when we do discounts, hopefully, at the end of Q1, that -- when that closes, we will have a very comprehensive bridge in those financials. But hopefully, that gets you enough information to get you back to the $2.95.

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

I think the other things may be what you were talking about with the tax rate, and the number you referenced is about $0.15. And then the other thing was amortization of intangibles we will see another 10% -- $0.10.

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

Yes, year-over-year.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

No, that's very helpful. Now in terms of the cash and association with the deal. First of all, when do you expect to close on this?

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

Yes, I hope. We have 2 regulatory approvals, HSR, and then we have to get an approval in Poland because we both have operations there. And that one is a little bit unknown just because we've not done that before. But certainly, our target is to try to get this done by the end of fiscal year -- by the end of the calendar year.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

Okay. And then in terms of the cash generation of the existing Technical Packaging business, help us kind of square that circle? Because obviously, I'm concerned about the free cash flow generation, but it sounds like you're selling a business that has been a bit of a cash drain. So going forward, given what we're seeing, and actually, this will probably be pretty material benefit fundamentally and optically to your free cash flow generation?

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

Yes. And I think it will, Rob. And just to take that kind of conversion of the EBIT number I gave you at about $7.3 million, they generally run in the 85% to 90% conversion of cash. So in that case, that would be somewhere in the neighborhood of $5 million or $6 million this past year. But I want to point out, as Vic mentioned in his prepared remarks, during '19, we made substantial capital investments that we built on the facility, put some extrusion lines in place, which created value and we put clean rooms in a couple of places. So we made about 13 -- $12 million, $13 million of capital investment. So the packaging group in total is a negative cash, but it's because of that one-off, we're not going to spend $13 million -- we wouldn't have spent $13 million every year. And so that's the kind of way you ought to think about the cash when you're looking at '19 that give us a net negative...

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

And I guess, that raises the question around CapEx as a company for '19. You may not guide to that, but maybe, does that obviously govern that or inform what you think CapEx is going to be at the corporate level for '20.

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

Yes. I would say if you look at the CapEx of the cash, so you can take $13 million out of that right away because that won't repeat obviously because we don't know -- we won't own the business for the year. And I would say we had a couple of other kind of one-off things where we did some things on some facilities that won't repeat. So I would think if you started with what we reported, back off $13 million and then back off, maybe another $2 million to $3 million, that should give optics of generally what CapEx looks like as we step forward into '20.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

Do you expect core CapEx to be flat or to increase slightly? Or tough to know?

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

I'd say generally flat. We're very generous. We don't -- we do focus on ROIC. And if one of the operating guys brings us a plan to put some additional automation in, we're big fans of that because it improves efficiency. So I would say -- and again, you don't repeat these things. If we go to Crissair and put in a $1 million piece of equipment, there may or may not be another $1 million next year. We've kind of deferred to the operating guys there. So I would say if you held it flat, and I don't mean flat like we're constraining it. It's flat because we've been making a sizable amount of capital investments, both in the hard capital and the software over the past 5 years.

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

Yes. I mean, the -- one of the issues we're running into these days, and I think it's -- you probably hear this from our other companies that you cover and that you talked to just difficulty in finding qualified people, particularly machinists and test techs and things like that. And so we have been working very hard to automate as much as we can just because it's hard to find qualified employees. And so we're working outside of it, but yes, I agree with Gary, and we're probably kind of flattish on capital equipment because we have been fairly aggressive over the past several years.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

And help me on the filtration side. I mean, obviously, you had a very good quarter there, aided by the recent acquisition. But level set us to what your expectation is for acquired revenues for 2020? Because I think, well, I'm not a Math major, so probably, I just was laziness and slough, but my number for filtration was way off. And you really handily beat it, so maybe just any kind of color around acquisition contribution for 2020 would be helpful.

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

Yes. And really, what we do is we don't -- we have a lot of things in the works, as Vic said. We don't put those in because, obviously, the success rate is hit or miss. So just to give you the one that's in there, when we announced Globe in July, we pegged it at roughly $37 million in revenue on an annual basis. And so we did about $9 million in round terms, so if you use that $37 million for '20 because again, that's what we are guiding towards, so $37 million versus the $9 million is the net difference of $28 million, is what the acquisition growth would be in '20, and then the balance of it comes from a combination of the strength of aero, the strength of submarines, because the order profile is picking up, so some of the Block V and some other legacy things are coming through. So that's where the inorganic growth comes from, from a onetime pop.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

I guess, the last question, and then I'll take more other questions offline. Your guidance looks very sound. The backlog is there, you have great line of sight, you're executing well. Where is the biggest area of maybe incremental concern or opportunity, even just in thinking about your kind of forecasting? I mean, obviously, on the utility side, one could speculate that, obviously, off a low base with some of the concerns around alternative energy, you're well-positioned? And obviously, there's been, at least, on a top down view, a lot more interest in grid hardening and transmission and distribution investment. Now I know you don't do grid, you're a distribution -- excuse me, your transmission transformers more of that in terms of the spend and testing. But thinking about the prevailing environment, where could we see more upside surprise in '20 or more risk in terms of how you're thinking about the outlook versus something on the Navy side, where you probably have a pretty good line of sight.

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

So I would say the area if you're going to force me to have a concern, which I tried not to on days that we issue earnings, but they forced me to have a concern, really the capital budgets in utilities are always a little tenuous. And I think we're broad enough now between the number of companies that we own in that space and renewables and non-renewables and all of that, that I think we're going to be okay. I mean, we obviously, took a hard look and do a bottoms-up review of the forecast that we have in that business. But that's one thing that always the utilities come back also. But again, I think we're in enough utilities that it would have to be something dramatic to have a big issue there. But there's probably more risk there than some of the other businesses. I think the thing that we haven't gotten our arms around yet from an upside perspective is, with our Navy business, we're working really hard at Globe, obviously, to be successful on the surface oil treatment as they're off to a great start with that. I think there's more opportunities within the Navy because the vendor base within the Navy is not as robust, I think, is what a lot of people might expect or what the Navy would want. And so we've developed almost $100 million of business in that area now. So we're seen as a larger contributor, a larger vendor than we had been historically. And so we're looking for opportunities to take advantage of having Globe and having Westland and having VACCO, so we really think we can go to the customer and say, look, we're here. Our Navy business is part of a larger corporation, and we really want to be a big vendor for you, and so let's work together and figure out what else we can do for you. So I think there's some real upside there, but we just haven't had an opportunity to flush that out completely.

Operator

I was going to say, I'm showing no further questions in queue.

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

Okay. Thanks so much. We appreciate everybody's interest, and we'll talk to you next quarter.

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

Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.