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Q4 2023 ESCO Technologies Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 16, 2023 / 10:00PM GMT

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Fourth Quarter 2023 ESCO Technologies Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. On the call today, we have Bryan Sayler, President and CEO; Chris Tucker, Senior Vice President and CFO.

And now I would like to hand the conference over to our first speaker today, Kate Lowrey, Vice President of Investor Relations. Kate, you now have the floor.

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

Thank you. Statements made during this call, 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, except as may be required by applicable laws or regulations.

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 Bryan.

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Thanks, Kate, and thanks to everyone for joining today's call. We appreciate each of you taking time to get an update on ESCO this afternoon. We had a very strong year, and I'm excited to tell you all about it.

With that, let me pivot to some summary comments on the business. We finished the year strong and as you saw in the press release, closed the year with record results on a number of measures. Sales, adjusted earnings per share, entered orders and ending backlog were all record levels in 2023. Sales grew by 11.5%, and adjusted EBIT was up 17%. So it was great to have double-digit growth once again for both sales and earnings.

As we've been saying for a while now, our key end markets continue to have favorable dynamics and as you can see -- you can see that coming through in the financial results. Also of note was full year orders exceeding $1 billion in 2023. This is a significant milestone for the company and with a record backlog of $772 million at year-end, we feel great about the outlook for ESCO going forward.

Before Chris gets into the financial details, I do want to offer some top-level commentary about each of the business segments. Starting with Aerospace & Defense, where we had a good year. Sales were up double digit as we continue to see good momentum in the commercial and defense aerospace businesses. We did see margin compression here again in the fourth quarter and that was driven by margin erosion on a number of space development contracts. As we went through the quarter, several technical issues arose on these programs, leading to increased cost estimates, which in turn reduced our overall profitability.

We are working aggressively to fix these issues and minimize the risk in the space business as we move forward. But on the bright side, we had very strong orders in Q4 in the A&D group with particularly strength from navy orders at Globe and VACCO. And overall, the outlook here remains strong, and we are positioned well to take advantage of the growth that we're seeing in both navy and aircraft markets.

Next is the utility group, which had an exceptional year in 2023. For the year, we had 23% sales growth and significant margin expansion. The core utility customer base continues to invest in infrastructure and our portfolio of businesses operating under the Doble umbrella are well positioned to capitalize on this trend. We are seeing broad growth across most product lines with protection testing, condition monitoring and off-line testing all delivering good growth.

On the renewables side, growth continues to exceed expectations. 2023 was a phenomenal year for NRG. We did see NRG orders a little softer in Q4, and that's something we're keeping an eye on. But this business still has high backlogs compared to historic levels and we continue to expect to see good growth in 2024.

Finally, I'll touch on the Test business, where we saw a sales decline in the fourth quarter. So overall, the business finished the year down by 3% as strength in Europe could not offset weakness that we saw in China. We've seen flattish results domestically as growth paused after last year's strength from power filters and Test and measurement projects.

The good news for Test is that we did increase EBIT margins in 2023 in spite of reduced sales. We do have some exciting news with an acquisition that we just closed in the Test business. As you saw in the press release, we just closed on MPE Limited this week. Chris has a chart on the MPE coming up, but has a real nice fold in for Test, and we expect it to enhance both the growth and profitability characteristics of the Test segment. We're very excited to welcome the MPE team to the ESCO family, and we're excited about what they bring to the company.

So to summarize, I would say 2023 was a great year. ESCO has had 2 consecutive years of double-digit growth in both sales and earnings. Even better is we don't think the growth is done. And as you'll see from Chris, we have a strong outlook for 2024. The company is performing well, and we're excited about our future.

So now I'll turn it over to Chris for some financial highlights on the fourth quarter of this year.

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

Thanks, Bryan. Everyone can follow along the chart presentation. We will start on Page 3, where we have the overall financial highlights of the fourth quarter. As you can see, we had a great quarter for orders with an increase of 39%, which resulted in record backlog at year-end. All 3 businesses had good order results with A&D being particularly strong. Sales in the quarter were up over 6%, adjusted EBIT dollars were up 3%, and adjusted earnings per share were also up 3%.

We will go through the segment details in a minute, but on the sales side, the Utility Solutions Group delivered exceptional sales growth, while A&D had more modest growth and the Test business was down.

Overall, margins declined in the quarter. 2 of the 3 businesses had margin increases, but declines at A&D led to an overall reduction.

Moving to Chart 4. We'll start now on the segment details, beginning with A&D. Starting with orders, you can see that they've increased significantly to over $177 million in Q4. Navy orders at Globe and VACCO were a key driver of the increase, but we continue to see strength from the aircraft component businesses as well.

On the sales side, organic sales were flat, and the CMT acquisition added 3 points of growth. Defense Aerospace led the growth, followed by navy and commercial aerospace.

Space sales declined significantly. The space decline is driven by margin erosion on a number of development contracts. This is the issue Bryan mentioned in the overview, and it is also the driver of the down EBIT dollars and margins for A&D in the quarter.

Outside of the space business, we saw some very good increases in profitability from the aircraft component businesses.

On Chart 5, we have the Utility Solutions Group. Orders were up 11% with the utility business at Doble driving the increase. The renewables orders at NRG were down in Q4 after the first 3 quarters experienced growth rates above 30%. Obviously, we'll continue to monitor the renewables business going forward, but we expect good growth there as we move into 2024.

Sales in the quarter were up over 22%. And as you see on the chart, the Doble protection testing product lines were the key driver.

On the renewable side, with NRG, we once again saw explosive growth, 69% in the quarter as the business reduced backlog after a significant build through the first 3 quarters.

The top line performance converted to nice margin expansion with adjusted EBIT up 200 basis points. This improvement was driven by leverage on the higher sales growth and favorable impacts from price increases.

On Chart 6, we have the Test business, where orders increased 9% compared to last year's fourth quarter. On the sales line, we did see a reduction of 8% as we continue to see weakness in China and also some softness in the domestic power filter sales. EBIT dollars declined nearly 6%, but the EBIT margins did increase from 17% to 17.5%, a good result on profitability given the drop in sales volumes.

On Chart 7, we have a few details on the MPE acquisition. This closed last week on November 9, and Bryan did preview this a bit, but a real nice tuck-in deal for the Test business. MPE is a U.K.-based business that specializes in electronic filters. These can be whole facility, filters or component filters embedded in military or other critical applications. The business has a good sales presence in Europe and the U.S. while adding high-margin component content to our existing Test platform. We're excited to have MPE on board and feel they will be a great addition to ESCO.

On Chart 8, we have key measurables for the full year. As Bryan mentioned earlier, it's another record year for us in 2023, and this chart shows that trend nicely. Orders increasing to up over $1 billion, sales up 11.5% to $956 million, a nice improvement in adjusted EBIT margins and adjusted earnings per share up over 15%.

Next is Chart 9 with the full year results by segment. The sales momentum in 2023 really came from the A&D and USG businesses, while Test was down slightly for the full year. For A&D sales, the key driver was commercial and military aerospace, which delivered 19% and 32% growth, respectively.

For utility, there was broad-based growth with condition monitoring, protection testing and renewables leading the way.

Lastly, for Test, the full year decline was driven by volume drops in China, which were not offset by strength in Europe.

On the margin side, USG led the way with a margin increase of 160 basis points. Test was also able to increase margins in spite of the reduced sales.

Lastly, A&D margins fell as strong performance from the aircraft component businesses was offset by challenges in the space business.

The last chart on 2023 is 10, where we have the cash flow highlights. The operating cash flow dropped to approximately $77 million in '23. Cash flow continued to be a challenge throughout the year. The biggest challenges were with the A&D business where we continue to see elevated levels of past due backlog. This tied up more cash and working capital and was the key driver of the cash decline in 2023.

You can also see we had unfavorable cash impacts from increased tax and interest payments during the year. Capital expenditures were down by approximately $10 million during 2023. You'll recall that last year, we had a building purchase at NRG, and that's the main driver of this year's decrease. Acquisition spending was up approximately $7 million with NEco acquired by PTI in fiscal 2022 and CMT acquired by Globe in fiscal 2023.

Lastly, as share repurchase, where we completed just over $12 million in buybacks this year compared to approximately $20 million last year.

The last chart is our 2024 guidance. You can see on the graph at the bottom of the chart that we've had 2 strong years of growth in '22 and '23, and the outlook for ESCO remains strong as we expect to deliver another double-digit earnings increase for 2024.

For sales, we expect an increase in the range of 7% to 9%. The sales growth forecast is balanced by business with A&D both projected to grow in the 8% to 10% range. The Test range includes the impact of the MPE acquisition. USG is expected in the 6% to 8% range, all solid numbers after 2 good years of growth in '22 and '23. You can see from the chart that we are projecting adjusted earnings per share growth in the range of 11% to 16% for a range of $4.10 to $4.30 per share.

This will be the third year in a row of double-digit growth in adjusted earnings per share for ESCO.

As is typically the case, we expect the business to ramp sequentially as we move through the year, and we expect Q1 earnings per share to be in the range of $0.64 to $0.70 per share.

That concludes the financial update. Now I'll turn it back over to Bryan.

Bryan H. Sayler *ESCO Technologies Inc. - President, CEO & Director*

Thanks, Chris. Since I touched on quite a few of my thoughts earlier in the commentary, I'd just like a couple more comments before we move into the Q&A. So you saw the numbers from Chris, obviously, a great 2023 and a strong outlook for 2024. The company is really operating at a high level, and we continue to have confidence as we look to the future. We serve strong end markets with well-established customers. We've got great teams, both here at corporate and out of the businesses around the world. This forms a powerful combination, and we're excited about what's next for ESCO.

Before jumping into Q&A with you, I do want to take a moment and say thank you to all of our employees. ESCO has racked up another strong year, and that's really a testament to the skill and tenacity of our employees. Our industries are growing and no doubt it helps to serve markets that have positive dynamics. But there's always challenges when executing inside the business, and I continue to be impressed by the commitment and dedication shown by our employees around the world.

I'd also like to thank our Board of Directors. We just finished up meetings over the last few days with the Board, and we really appreciate their support and commitment to ESCO.

It feels great to close out my first year-end as CEO and be talking about record results. But it's only because of the efforts of a number of people, including all of our employees and the Board. So with that, we can start with Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of John Franzreb from Sidoti.

John Edward Franzreb *Sidoti & Company, LLC - Senior Equity Analyst*

First to start in Test in China. Can you talk a little bit about how the demand profile has changed with ongoing weakness in China. Any thoughts about maybe resetting your footprint there or readdressing what you can do elsewhere with the capacity in China becoming available?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Sure. So listen, what we're seeing in China right now is it's -- we still have a fair amount of backlog there, but we're still having a hard time getting on job sites. So it feels like the construction industry over there is still a little bumped up.

New orders have been somewhat soft. We're still -- we still have a meaningful business over there, and we're still making money. We have not given any thought to changing our footprint at this time. We think we have an appropriately sized cost structure there for a business that could be quite a bit smaller.

The biggest challenge we have though is that we had an incredible year last year. So from a comparable basis, it really is a big deceleration. The good news, though, is that we have seen strength over in Europe. And unfortunately, it just wasn't quite enough to offset what we saw in China.

John Edward Franzreb ***Sidoti & Company, LLC - Senior Equity Analyst***

Fair enough. And just switching to A&D. Last quarter, you had some supply chain issues. So 2 questions in A&D. Have those all been resolved. If you said it, I apologize, if I missed it. But also given the backlog profile, is it going to require additional staffing as that continues to ramp up and those orders to -- suddenly orders continue to come in?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Yes. So as far as the supply chain issues, company-wide, the good news is we have resolved them almost entirely in the utility group. We're still having some modest issues in the Test group, but what we're really continuing to see is challenges is in our Aerospace and Defense Group, particularly out in Southern California. There's a couple of different components to that. One would be the material availability. That is improving pretty significantly.

The second piece being the outside processing, that has improved with longer lead times. The one that where I think we're still having some problems is on staffing our facilities with qualified personnel. Yes, I think we just were out there a few weeks ago. We went through the numbers, we're probably about 85% staffed at our facilities out there. And we're struggling with competition for labor. And so we need machines and we need a qualified assembly and test type people, so that's probably restraining us a little bit more than the material availability as of this time.

John Edward Franzreb ***Sidoti & Company, LLC - Senior Equity Analyst***

Okay. And just one last question, I'll jump back into queue. By my calculations, you had a real good free cash flow quarter for the fourth quarter. I know for the full year, it wasn't what you expected, but is there any reason we wouldn't -- couldn't go back to normal free cash flow conversion in fiscal 2024?

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

Yes, John, we are anticipating that '24, we would have a more normalized cash flow conversion. So that's obviously, something we're very focused on as we work all of our subsidiary plans, and that's absolutely what we're looking to do.

Operator

Our next question will come from the line of Jon Tanwanteng from CJS Securities.

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

Bryan, congrats on capping off a pretty strong year. My first one is just on energy. I was wondering what's driving the growth outlook there, just given the headwinds that we've seen publicized across the renewable sector. Is that just working down your backlog? Or are you seeing order strength in the pipeline?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Well, so we had an incredible fourth quarter in the prior year and first 3 quarters of this year. So we did see from an orders perspective, a little bit of deceleration in the fourth quarter. That does appear to be picking back up in October and November. So we're keeping our eye on it, but we're not overly concerned. As you see from the numbers here, we were able to kind of work down our backlog a little bit. It's more of a book-and-ship type of a business.

So having too much backlog can be a challenge there in terms of our ability to compete and deliver, but listen, that business is doing very, very well, and they've had incredible margin expansion in addition to the overall revenue growth. So we still feel pretty good about renewables in general. I think one thing that you see a lot in the news these days is discussions about electric vehicle and offshore wind markets kind of having challenges. We don't really have a lot of exposure to either of those markets. We're typically in the onshore wind and utility scale solar and those seem to be going pretty well right now.

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

Okay. Great. I was wondering if you could go a little bit more into the details of the space issues that you had in the quarter. Is it a onetime issue that you're facing? Or is it going to be sustained kind of what do you see in your near-term planning for that business?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Sure, sure. Well, so listen, the space business, first of all, it's a small part of our overall business. But we have a number of contracts that are for very complicated development programs. These are -- meaning we are doing effectively research and development to develop these things. Unfortunately, they were firm-fixed contracts, and we've had some technical challenges there that we're working through. We think that we have our arms around it, but there is a little bit more risk there because we do not have these projects completed. And until you've got it up on the test stand and you've actually got it to pass the test, you really can't declare victory.

What led to the challenge really, I think, is through the COVID moment, we've had some turnover in that business. We've lost some key engineers, we've had to hire new ones. And so we're going through a little bit of a learning curve there. But we do think that we're going to get through it.

The good news is the rest of the A&D segment and the rest of our business overall has been able to more than compensate for the challenges we've had in the space segment.

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

Okay. Great. That's good to hear. Can you talk a little bit more about MPE, the valuation that you paid for and the accretion you're expecting for next year?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Sure. Listen, MPE is a business that we've known for a number of years. They're very solid business. They build RF filters for electromagnetic pulse applications. As you know, that's one of the big growing areas that we're, kind of, targeting.

They have more -- what's attractive about it to us is that they have a broader range of products. So in addition to doing facility filters, which we do at ETS-Lindgren, they also have built component filters that go into military systems and other kinds of systems that require protection from electromagnetic pulse. That's becoming a big market now because as you look at some of the things that are happening in critical infrastructure, both in the energy space and data centers and that sort of thing, that's become more and more of an issue that people are trying to address.

What's interesting about -- so we did spend about $57 million for this business. We expect it to add about $10 million to $15 million of revenue for us in fiscal '24, and we're not really going to talk a lot about the margin other than to say that we think that it will enhance the overall margins for the Test segment. So we think it's going to be accretive both at the revenue line and at the margin line for our overall Test segment.

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

Yes. The other thing I would say, Jon, from an overall EPS perspective, we expect it to be -- it's incorporated into our $4.10 to $4.30 outlook, and we would expect it to be pretty close to breakeven. It could be some slight dilution or slight accretion based on kind of how the overall -- we don't have full visibility yet to what amortization will be in some of that. So -- and that -- when I say it'd be kind of close to breakeven from an accretion perspective, that would also exclude the onetime inventory step-up charges, we always kind of adjust those out. But so anyway, from an overall EPS perspective, we expect very little impact in the year.

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

Okay. But that's including the cost of either financing or what we're paying for it...

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Correct.

Operator

(Operator Instructions) Next, we'll have a follow-up from the line of John Franzreb from Sidoti.

John Edward Franzreb ***Sidoti & Company, LLC - Senior Equity Analyst***

Yes. I'm just -- I'm a little curious about what's behind the lower power filter sales that you saw in Test. Can you add some color on that?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Sure. There's a couple of factors there. So we have about -- so primarily, the biggest driver for that, I think for the last couple of years, has been in data center applications. That would be the 1 place where we think we might be seeing a little bit of a destocking effect. We had one of our customers that had bought quite a lot of filters last year. And we think that they're kind of working depleting their inventory this year. We think that's going to resume before too long.

Operator

(Operator Instructions) Our next question will be a follow-up from the line of Jon Tanwanteng from CJS Securities.

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

I just wanted to dig a little bit more into the strength that you guys saw in the USG business. Did you meaningfully outperform your internal expectations there and either Doble or NRG or did you pull anything into future quarters?

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Yes. We meaningfully outperformed our internal expectations, and we feel really good about that business going forward. All of the information that we have is that utilities are making substantial investments in their infrastructure. And we are -- we made a lot of -- as you know, we made a lot of acquisitions and a lot of organic product development over the last 6 or 7 years that has really positioned us in an almost an ideal way to take advantage of that kind of infrastructure build-out. And so yes, we think -- we feel like we've got a really good forward path there.

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

Yes. And Jon, I would say it wasn't the result of a pull-in or anything. We just saw demand strong as we came through the quarter. And obviously, you saw Q2, Q3 were also very strong. So we just kind of hit -- we kind of kept going that way, and that's what drove it.

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

Have your order run rates in that business been roughly similar to what you saw in Q4 heading into Q1?

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

I mean we're always going to be a little bit lower in Q1. But as Bryan said, I mean, you saw the full year outlook there, and I think we still feel good about the overall trends there in kind of the near to midterm. So yes, I think we're kind of, I would say, chugging right along.

Operator

And I'm not showing any further questions in the queue at this time. I would now like to turn it back to Bryan Sayler for any closing remarks.

Bryan H. Sayler ***ESCO Technologies Inc. - President, CEO & Director***

Well, listen, thanks for taking the time to (inaudible). We're very excited about our 2023 results, but we're even more excited about our outlook for 2024 and we look to talking to you in 3 months.

Operator

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

Christopher L. Tucker ***ESCO Technologies Inc. - Senior VP & CFO***

Thank you.