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ESE - Q2 2017 ESCO Technologies Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

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

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

## PRESENTATION

**Operator**

Good day, and welcome to the ESCO Second Quarter 2017 Conference Call. Today's call is being recorded. With us today is 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.

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

Thank you. Statements made during this call regarding 2017 and beyond EPS, EBITDA, EBIT, EBIT margin, growth, profitability, sales, cash flow, orders, success of new products, success in completing additional acquisitions, the results of recent 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.

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

Thanks, Kate, and good afternoon. Before I give my perspective on the quarter, I'll turn it over to Gary for a few financial highlights.

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

Thanks, Vic. When we laid out our detailed guidance for the beginning of the year, we noted that our quarterly earnings profile was once again back-end loaded from an EPS perspective. In that initial guidance, we also projected a more heavily weighted Q4 than previous years given the timing of several large projects across the company. As we sit here at the halfway point, the year is playing out a bit ahead of plan, and the quarterly profile we projected at the start of the year is being delivered as expected.

Moving on to the Q2 results. In February, Q2 EPS was projected to be in the range of $0.37 to $0.42 a share on a GAAP basis. And additionally, we indicated our GAAP earnings were impacted by some noncash purchase accounting charges related to our recent acquisitions -- when we described and quantified these incremental charges related to the inventory step-up at Mayday as well as additional or incremental noncash depreciation and amortization charges that were expected to be incurred as a result of our recent M&A activities.

As noted in the release, we delivered Q2 GAAP EPS of $0.43 a share, which beat the top end of our expected range. The better-than-expected earnings were primarily driven by the continued strength of our commercial aerospace platform as well as significantly higher Navy and space products delivered in the quarter, coupled with lower Corporate spending.

Westland and Mayday delivered a combined $15 million in sales in Q2 along with solid EBITDA contributions. I'll remind you in Q2 that we recognized the final piece of Mayday's noncash inventory step-up charge, which was approximately $1 million. And as you can see from the financial tables within the release, depreciation and amortization increased $1.7 million in Q2 compared to the prior year. So on an EBITDA basis, we increased our Q2 contributions significantly despite incurring the noted inventory step-up charge. Our Q2 '17 EBITDA increased 19% to over $25 million compared to Q2 '16 as adjusted.

A few other Q2 and year-to-date highlights include the continued strength of our entered orders and the resulting growth in our March 31 backlog, especially as noted in Technical Packaging and Test, where we recorded Q2 book-to-bill of 1.3x and 1.2x respectively. Doble also reported a favorable book-to-bill and Filtration's 0.9x is not of concern as this reflects higher sales at VACCO and Westland related to the runoff of large multiyear procurements of submarine projects coupled with the continued delivery of VACCO space components for the SLS program.

Year-to-date, I'm pleased to report that all 4 operating segments delivered a positive book-to-bill, which increased our backlog by $42 million or 13% from the start of the year. The strength of our orders and the resulting $375 million in backlog provides additional confidence supporting our outlook for the back half of the year.

Additionally in Q2, we delivered another strong quarter of cash flow, which brings our 6-month cash flow provided by operating activities to $37 million, which is well ahead of plan. At March 31, our net debt was $116.5 million with a very reasonable leverage ratio of approximately 1.5x. Given the solid position we're in at the halfway point, our EPS and EBITDA outlook for the balance of '17 remains consistent with the expectations communicated earlier.

We continually expect '17 EBITDA to increase between 21% and 23% and to be in the range of $122 million to $124 million compared to '16's adjusted EBITDA of $101 million. We remain well positioned to achieve our financial goals as we continue to see meaningful sales, EBIT and EBITDA growth across each of our business segments. And in the longer term, we expect to exceed the growth rates of our defined peer group and the broader industrial market in total.

Our Q3 EPS guidance is projected to be in the range of $0.46 to $0.51 a share on a GAAP basis. And as a reminder, this includes the quarterly impact of the incremental depreciation and amortization from M&A as communicated previously.

Now I'd be happy to address any specific financial questions when we get to the Q&A. And now I'll turn it back over to Vic.

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

Thanks, Gary. I also am pleased with our second quarter performance and with the way we were wrapped up the first half of the year. Our second quarter sales came in on plan, and we exceeded our internal targets on EBIT, EPS, cash flow and orders. As Gary mentioned, our current backlog level is the highest it's been in a number of years, especially in Test, which bodes well for meeting our commitments over the balance of the year. We continue to deliver on our results across the 4 operating segments, and I believe our 6 months results validate our strategy and demonstrate one of the major benefits of maintaining our multisegment business platform.

Given the diversity and strength of our end markets, it allows us to manage around the normal operational and project timing issues and provides us with several alternative paths to achieve success. Our results communicated today demonstrate what, I believe, we do best: collectively, our management teams continue to execute to plan and remain focused on delivering sustainable operational results. This gives us the chance to exceed expectations despite the normal business challenges that industrial companies face regularly.

Since Gary covered the detailed financials in his commentary, I'll focus my comments on the balance of '17. Given our guidance for the third quarter and by reaffirming our full year EPS expectations, it's obvious we're counting on a very strong performance in the fourth quarter. I'm confident in our ability to deliver these commitments over the balance of the year, supported by the strength of our current backlog and the detailed insight by program supporting this ramp-up in sales and earnings.

So here are a brief comments on the individual businesses. In Filtration, we continue to expect to deliver solid results in sales growth, EBIT and EBITDA contributions and cash flow. Mayday and Westland have several opportunities to provide further growth over the balance of the year as well as in the outyears, given the bid and proposal activities we're currently addressing.

Since becoming part of our Filtration group, we've had several current customers reach out to Mayday with new business opportunities, and they want to consolidate their supplier base. Based on the experiences with our legacy Filtration companies, these customers feel comfortable adding Mayday to their list of preferred suppliers.

Additionally at Filtration, we remain well positioned on several fronts, including the continued upcycle in commercial aerospace, growing opportunities in space, unparalleled technology on Navy submarines and surface ships, which are critical to our national security.

Our Technical Packaging group's outlook is solid, and as noted previously, we're making additional investments to add production capacity both domestically and internationally. With the recent acquisitions, we now have meaningful scale and market leadership positions across several growth markets and geographies, which allow us to address the needs of our global customers, in the medical, pharmaceutical and consumer markets. The opportunities we're addressing set us up nicely today and in the outyears.

Move on to Doble. We continue to see some easing of the spending constraints within the electric utility capital budgets, and we set our expectations around this view. The growth opportunities we're seeing today will be coming from our new products, such as the M series, doblePRIME and our DUC enterprise solution. Coupled with the strength of our software offerings, I remain enthusiastic about Doble's future.

In March, we hosted our 84th annual conference which as in the past was very well attended. The enthusiasm and continued loyalty demonstrated by our customers is outstanding.

At Test, our sales and operating performance gained momentum in the second quarter as we began shipping product for one of our large key customers. I was really pleased to see the favorable impact on the EBIT from the cost savings we implemented last year. As the year progresses and a strong backlog converts into meaningful increases in quarterly sales, we expect these higher sales to result in EBIT margins in the third and fourth quarter at meaningful higher levels than today.

On the M&A front, we're currently very engaged in several opportunities which provide confidence that we will add nonorganic growth this year to supplement our current outlook.

Wrapping up, I'm pleased with our second quarter and first half results, and I remain confident that our outlook for the balance of '17 remains solid. Our focus remains constant: to continue to improve our operational performance and execute on our growth opportunities both organically and through acquisitions. That's how we will increase shareholder value.

We'll be glad to answer any questions you have.

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**Operator**

(Operator Instructions). And I'm not showing any questions at this moment.

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

Okay. We'll thank you for calling in today, and we look forward to talking to you next quarter.

**Operator**

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