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ESE - Q3 2017 ESCO Technologies Inc Earnings Call

EVENT DATE/TIME: AUGUST 08, 2017 / 9:00PM GMT

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*

CONFERENCE CALL PARTICIPANTS

Ethan Jeremy Potasnick *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

Jonathan E. Tanwanteng *CJS Securities, Inc. - Research Analyst*

Liam Dalton Burke *FBR Capital Markets & Co., Research Division - Analyst*

Shaun P. Nicholson *Segall Bryant & Hamill, LLC - Associate Portfolio Manager and Lead Portfolio Manager*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESCO Q3 2017 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 2017 and beyond EPS, EBITDA, adjusted EBITDA, growth, profitability, sales, charges, 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 operation 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 Form -- 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, CEO and President*

Thanks, Kate, and good afternoon. Before I give my perspective on the results and provide an idea of our preliminary outlook for fiscal '18, I'll turn it over to Gary for a few financial comments.

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

Thanks, Vic. In May, we projected Q3 EPS in the range of $0.46 to $0.51 a share, and we delivered GAAP EPS of $0.49 a share and adjusted EPS of $0.51 a share when normalizing for a few nonrecurring charges. The $0.51 hit the top end of our expected range and was primarily driven by the continued strength of our Utility Solutions Group. Doble once again outperformed expectations, with strong sales of new products such as DUCe and better-than-expected software and solution sales. PTI and TEQ also exceeded expectations. And Test, while coming up short on sales due to a customer-related project and construction timing, delivered a 13% EBIT contribution despite the sales shortfall, which I believe confirms our earlier profit margin expectations resulting from its lower-cost structure.

On an adjusted EBITDA basis, we significantly increased our current year contributions compared to the prior year as our Q3 adjusted EBITDA increased nearly 10% to $28 million, and our year-to-date adjusted EBITDA increased nearly 14% to $79 million.

Another highlight is the continued strength of our entered orders and the resulting growth in our June 30 backlog, which is up $53 million or 16% from the start of the year. I'm pleased to report that all 4 operating segments generated a positive book-to-bill year-to-date, which resulted in a consolidated book-to-bill of 111% through June.

On the cash flow and debt front. Despite the spending on acquisitions, we continued delivering solid cash flow, which puts our June 30 net debt at $216 million with a very reasonable leverage ratio of 2.2. We remain well positioned to achieve our stated long-term financial goals as we continue to see meaningful sales and EBITDA growth across each of our business segments, and we expect to exceed the sales and earnings growth rates of the broader industrial market in general.

Moving on to the balance of the year. When we provided our detailed guidance at the beginning of the year, we called out several factors that would be impacting our GAAP EPS, such as noncash purchase accounting inventory step-up charges and additional amortization of intangible assets. We also noted that our original EBITDA expectations were in the range of $122 million to $124 million, which was expected to result in an increase of 21% to 23% in '17 over the $101 million of adjusted EBITDA recognized in 2016. This EBITDA range resulted in GAAP EPS of $2.16 to $2.26 a share. Supplementing that original GAAP EPS, we called out $0.30 of inventory step-up charges and additional depreciation and amortization, which negatively impacted GAAP EPS.

The favorable aspect of completing Mayday, NRG and Morgan Schaffer during the year is the sales, earnings, cash, adjusted EBITDA and ROIC contributions they provide on a full year basis. The negative aspect of doing these deals at various interim periods throughout the year is the significant amount of noncash and onetime charges that must be recognized on a GAAP basis, coupled with the acquisition fees and costs. We called out these charges and costs to provide better visibility into the adjusted operating results in Q3 and year-to-date as well as to quantify their impact on the year in total.

Even though we had a significant amount of M&A activities and related onetime items identified in the current year, the bottom line is that our current outlook for '17's adjusted EBITDA is consistent with the range we provided at the beginning of the year. While recognizing that our adjusted EBITDA is consistent with the start of the year, our GAAP EPS, which bears all of the M&A costs, purchase accounting charges, acquisition costs and fees and other nonrecurring charges as described in the release, is now expected to be in the range of $2.05 to $2.10 a share. The recent acquisitions, coupled with our outlook for organic growth, driven by our substantial order backlog, certainly positions us well as we enter 2018.

In closing, while certain onetime charges had a negative impact on our '17 GAAP EPS, our adjusted EBITDA remains very strong and, again, is consistent with our earlier expectations.

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

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

Thanks, Gary. As noted in the release, I'm very pleased with the way our M&A strategy has played out this year. Mayday, NRG and Morgan Schaffer have each brought along strong operating results, a solid and well-defined growth strategy and, most importantly, top-notch management teams truly committed to our vision and values. The integration is going very well, and I'm really impressed with how quickly our new partners have embraced their expanded roles within our organization.

While it is not an easy task to move from being a privately owned company to a public company, given all that is asked of them from a reporting, planning and compliance perspective. I've been impressed with how quickly and professionally our management teams have adapted to this new environment. Mayday has brought us an array of new aerospace products and services and has introduced several additional market opportunities for expanding our growth. Mayday's on-time delivery, customer service and customer-recognized manufacturing quality awards are a complement to our existing aerospace offerings. Becoming a part of the larger platform, including our other aerospace businesses, has afforded Mayday additional bid and proposal opportunities.

Mostly, I'm really excited about our NRG acquisition as it provides an immediate and scaled entry point into the fast-growing renewable energy market. Clean renewable and sustainable energy is a $300 billion-plus per year global industry, with approximately 600 gigawatts of new wind capacity and 700 gigawatts of solar capacity are coming online over the next 10 years.

NRG also expands our global reach and provides cross-selling opportunities capable of accelerating USG's growth over the next few years. I'm pleased with NRG's initial results. And after spending time with our management team at the global wind energy conference in San Diego a few months ago, I see a real opportunity to further expand NRG's strong and capable product and solution offerings around wind and solar.

Morgan Schaffer has been our -- on our acquisition screen for several years as I've always considered them to have the leading expertise in dissolved gas monitoring or DGA equipment. For many years, the global utility market has recognized Morgan Schaffer providing the most accurate and premium DGA equipment and related software and services for monitoring the health of mission-critical oil filled transformers. Morgan Schaffer not only fits strategically with Doble, but also complements NRG by offering capable solutions supporting renewable energy generation. With Doble, NRG and Morgan Schaffer joining forces, we now have a world-class solution offering that I'm confident will create additional market opportunities to enhance our corporate-wide growth strategies and further our ability to create additional shareholder value.

On the M&A front, we continue to explore additional acquisitions, and I'm encouraged by the opportunities for additional near-term nonorganic growth. We continue to look at opportunities to further our USG offerings and to expand our Filtration segment's product line with complementary acquisitions clearly aligned with our current portfolio.

As with any acquisition opportunity we evaluate, we will remain disciplined in our approach and continue to maintain our focus on generating attractive returns.

Since Gary covered the financials, I'll only supplement the numbers with a brief perspective. Doble continues to perform above expectations and again delivered strong results. A few products, especially the DUC, are gaining strong market share. The DUC is one of the few proven or validated solutions that utilities have to meet the stringent NERC and CIP compliance requirements. Our software solutions along with increased services are contributing to Doble's success as well. And I'm excited about the pipeline of additional offerings we will be introducing over the next 12 to 18 months.

I'm especially pleased to see Test delivering 13% EBIT in the third quarter despite its lower sales. We've been working for quite a while on its cost structure, and I'm feeling more confident each month that we dialed this in correctly. The sales slip is timing related as the backlog and significant order book support our near-term outlook.

We are somewhat at the mercy of a few large key customers who are installing our technology and continue to be a bit behind their own schedule, which obviously impacts our delivery and installation schedules. While we had to lower our GAAP EPS for the full year given resulting purchase accounting items; other nonrecurring costs; and certain product pushouts, which impacted Q3 and 4, I'm confident that this is merely a stackup of various onetime items, which hit us in a very short period of time. Given the diversity and strength of our end markets, we will manage around the negative impact from the acquisition-related and purchase accounting charges as well as managing around the normal operational and project timing issues. Thereby providing us with several clear alternative paths to achieve success.

So wrapping up, I'm pleased with our Q3 results as well as our M&A successes, and I'm confident that our near-term growth outlook remains solid. Our focus remains constant: to continue to improve our operational performance and execute on our growth opportunities, both organically and through acquisitions, as this is how we will increase shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from John Tanwanteng from CJS Securities.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - Research Analyst*

Can you quantify the revenue impact of the delays and pushouts that you're seeing? How much came out of Q3, and how much is pushing out of the year into 2018?

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

Well, at the Test business, it's about $6 million or $7 million moved out of Q3 into Q4, but it kind of just pushes that same amount out of Q4 into the first quarter of next year. So from second half of the year, it's about $7 million, I guess, in round terms would be a fair assessment in Test. And then at Plastique, we had about $0.5 million moving out of Q4 over in Europe as a customer timing thing, and then maybe about $1 million at Mayday just based on some customer requirements that they wanted after September 30 than before. So in round terms, you could magnify that $10 million out of Q3 into Q4, and I would stick with the $7 million or $8 million from Q4 into next year.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - Research Analyst*

Okay, great. That's helpful. And then just on Morgan Schaffer and NRG, how much accretion do you expect from those 2 in 2018 when you get past these onetime costs? Are there revenue synergy opportunities, cost synergy opportunities? Just help us understand what you expect to get out of these acquisitions.

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

The numbers are rounded, John, and I'll let Vic talk about the synergies and what he sees on the market side. So just to remind you on relative size, Morgan Schaffer is about $25 million in U.S. dollar currency in revenues, and NRG is about $45 million. And the -- both of those margin contributions, what we're seeing is in the mid-teens. So I think NRG right now has some opportunities going forward that are greater than the past. So I'd be comfortable putting them at 16% to 18% and then Morgan Schaffer kind of in the 13% to 15% based on some things there. So if you do that math, and hit it at 35% tax in the 26 million shares, you'd be able to get what the EPS -- the GAAP EPS is. And the good point is both of the -- both of those entities do not -- look, the inventory step-up does not repeat. It does hit Q4, which is another impact to the way we reflected the guidance because there is another carryover there. But -- then we go into '18 clean. So all you'll have there is the incremental depreciation and amortization. So we'll again talk about '18 on an EBITDA basis, but they're both extremely profitable. So I'll defer to Vic on the -- what he sees in the synergies.

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

Yes. So the thing I would say is, particularly with the -- with Morgan Schaffer, we've been able to consolidate the direct network and distributors. And so we're able to share some there. So that would help. And I think it would also help with the volume side and as well from a revenue generation just because Doble obviously had a larger sales force out there, and I think we'll be able to push more product. I'd say we -- it's hard to quantify at this point. But we know something there. We just don't know exactly how much. The other thing is that we were already buying equipment from Morgan Schaffer to put in one of our products. So we'll get a little pickup there. And then the other thing, there was some product development that was underway at Doble that we now won't have to do. And so that's -- we're still in the process of quantifying how much all that is. So I think the way I would look at that is -- kind of take what Gary talked about because that's a -- it's a given because we've got them for a full year. And so then we're still trying to define how much upside we'll accrue to that as well.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - Research Analyst*

Okay, great. You also mentioned you're active in -- with the M&A pipeline. What end markets are you looking at now? What kind of leverage are you willing to bet if you do find something suitable? And then any concerns over bandwidth given that you're still digesting Mayday and NRG and Morgan Schaffer?

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

Yes. I would say if things weren't going so well with those integrations, I would have some concern. But I would say that the integration efforts have really gone very well. And a lot of the reason for that is these companies were - well they were all private companies. I think they were all extremely well managed. And fortunately, we've been able to maintain the management teams that we have in place. But that's something that we do talk about and look at as we were making the acquisitions. But the areas that we look in are the ones that we talked about earlier, and that would be the Utility Solutions Group and our Aerospace Group.

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

And John, just to circle back in the second part of your question, on the leverage. As I said in my prepared remarks that we're in about 2.2 leverage in the trailing EBITDA, and we've made commitments that we're not out there looking to swallow a whale. So these would be sized about the size of the companies we just purchased. And so we would not be pushing ourselves much over 2.5 to 2.55 leverage. So these aren't hundred-something million dollar deals that are going to put us up close to 3. And then the other part of it is, it's relative to the cash flow that we anticipate by having Morgan and NRG for the whole year. And the way the cash profile looks there, we'd be able to delever relatively quickly over the next couple of years so that -- let's call it a peak at about 2.5. And then assuming we don't do anything on the back end of that, we should be able to delever in about 2.5 to 3 years. Not our goal to get a 0 obviously, but there's plenty of flexibility on the back end of that.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - Research Analyst*

Okay, got it. And then just one final one, Gary. What's the expected tax rate going forward that you're using?

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

Well, the nice part of picking up Morgan Schaffer, they're Canadian, and they carry a lower rate than the U.S. Obviously, they're not 50% of the business obviously, but they have a very nice tax treaty there. Plus, as we see growth at Plastique and some of the investments we made there, whether it's in the U.K. or Poland, it has a lower tax rate. So we're getting comfortable that it's 33.5% to 34.5%, which is a point lower than our projections have been in the past. So given that foreign contribution benefits also in the tax rate, again, that's all assuming there's no tax reform, that's kind of how we look at next year and beyond.

Operator

Our next question comes from Liam Burke with FBR Capital.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

On the Test front, you mentioned projects being deferred to fourth quarter, possibly first quarter '18. Does that dramatically -- or once those projects come in, do they dramatically affect your project -- profit margins based on product mix? Or have you done enough to reduce costs to hold that current margin?

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

I think the margin would be okay. If you have -- mix has always been a little bit of an issue. But I'd say certainly in the near term, that's not going to be a big issue because we've already kind of dialed in what our expectations are. And the other thing is getting some of the costs out, particularly in Europe, has helped a good bit on cost structure. And I think that's what we've seen in the third quarter and what we're looking for in the fourth quarter as well.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

Okay. And on -- in Filtration side, aerospace is a large percentage business. The market seems to be doing pretty well. Do you see any pricing softness at all?

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

We really, knock on wood, have not seen a lot of that. I mean, the reality is, once you get on these big projects, you're on them. And the contracts are usually pretty long-term, and you have the clauses in there for escalation or, in some cases, de-escalation as the volumes go up. But the competition you really see is getting on those projects upfront and how much is nonrecurring cost you're willing to take and how much [I'm sure] you're willing to share, that type of thing. So the real pricing is getting on the projects.

Operator

(Operator Instructions) Last question comes from Ethan Potasnick from Needham.

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

This is Ethan Potasnick filling in for Sean Hannan. I was wondering if we could go back to just about commercial aerospace. I was wondering if you could elaborate on the business momentum you guys are seeing and whether or not it's accelerating at all in the near or medium term? Or should we kind of assume that the recent business levels are going to persist?

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

Yes. I would not say we see an acceleration. I mean, we're seeing a little challenge just on some of the timing of the delivery ramps. The A350, we had a lot of orders, but they aren't building as fast as what they had projected. I would not anticipate there would be a big ramp-up versus what we're seeing today. The orders are there with the aerospace manufacturers. So feel very confident those things are going to happen because they -- both Boeing and Airbus have huge backlogs. And so the business is out there, so it really just comes down to timing of that. Honestly, I don't see anything that's going to say, boy, it's going to grow a lot faster than what we've seen over the past year or so.

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

Okay, got it. And then with regards to Doble, performance has been a little up and down. So with the current activities and leadership you guys have in place today, when do you feel you have high confidence in this businesses securely on a more stable 10% like growth path? Or do you guys kind of feel like you're in that position today?

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

Yes, I'm very comfortable with the management team we have there with the focus we have. Fortunately, we don't have a lot of big one-off projects at Doble. There's a few that are larger than others obviously, but it's not like our Test business where will have a project that could be 10% of sales for a year. I mean, these are typically much smaller contracts either for products or services. So I think we're in a position to really move the business forward. I think we have good cost controls in place, and then with the addition of the acquisitions, I think we'll get a little leverage on that as well.

Operator

Our next question comes from Shaun Nicholson from SBH.

Shaun P. Nicholson - *Segall Bryant & Hamill, LLC - Associate Portfolio Manager and Lead Portfolio Manager*

Just a couple of questions on M&A, just going back to that. From a valuation perspective and just the pricing that you guys are seeing. I don't know if the pipeline is filling up enough to where you feel like these are reasonable valuations that make sense. And maybe talk to you how they compare to NRG and Morgan Schaffer.

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

So the Morgan Schaffer was a little more competitive than some of the others, I would say. And so I would say we paid full price for that. But it was really something that we needed to have in our portfolio. As you know, there's only -- as you may know, there's really only 3 DGA manufacturers in the world that really have substance, and they were the last one that was available. I would say that other than that, the other acquisitions that we've made have been probably a little more reasonable from a multiple perspective than what we've even seen in the past. And a lot of that has just been finding the right companies at the right time. Those are things that we're looking at today, I would say, are more consistent with that. So while there's always competition out there, I would say that the multiples that we're seeing are not that obnoxious. And I would say they probably would be better than they were even 6 or 8 months ago.

Shaun P. Nicholson - *Segall Bryant & Hamill, LLC - Associate Portfolio Manager and Lead Portfolio Manager*

Okay, great. And then just on the EBITDA growth, obviously, you guys are -- you've been growing EBITDA, looks like double digits over last year. Obviously, the backlog's there going into '18. I mean, from an EBITDA growth perspective on just the organic that's in place today, how should we think about that going into '18 particularly just from a -- just putting M&A aside, is that trend sustainable with this backlog and kind of the book-to-bill you guys have been putting up?

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

I'd say as we -- obviously, we're not totally wrapped up and are planning stuff for '18. But I'd say there's optimism there relative to what we're looking at across the platforms because the beauty of our diversity is that while everything doesn't go great, at the same time, it doesn't go brown at the same time either. So we see nice pockets of growth across the platform. And while the organic growth is reasonable, I think what's really going to benefit us on a full year basis is having acquisitions on the inorganic side. From an EBITDA perspective, while we're getting dinged this year for having these extraordinary costs in a short period of time, the beauty of it is they're behind us next year, and then you get a 12-month contribution on those deals that we just acquired. So when you look at EBITDA just on apples-to-apples basis and, at the moment, don't bifurcate it between organic and inorganic, there's going to be substantial EBITDA growth provided by the new partners, having them for the whole year, supplemented by the organic growth. So I think as we frame up '18, just the favorable calendar and having these things for 12 months versus 3.5 or 4.5, things like that, works to our benefit. And then some of the noise goes away. And then as Vic said, little things that add up, not having to spend money on R&D at Doble on things we were doing that now Morgan Schaffer had. So there's some costs that kind of just go away naturally by attrition, by some of the other things we're doing. So while we don't have a stake in the ground yet, it's a pretty attractive feeling as we're seeing '18 shape up. And we'll have that tied down here in the next month or so as we have a planning in mid-September. So we feel pretty good about it.

Shaun P. Nicholson - *Segall Bryant & Hamill, LLC - Associate Portfolio Manager and Lead Portfolio Manager*

Okay, that's great. And I was kind of looking at just from a -- just kind of maybe an opinion. Just on multiple, you guys trade at a discount seemingly to kind of the peer group and from an EBITDA multiple. And obviously, if you're growing double digits, and clearly, there's -- even if you shift out to '18, there's quite a bit of upside just applying a normalized EBITDA for peer group, and some deals in M&A are getting done at much higher levels, what are you guys -- I mean, do you guys feel like there's still a disconnect between the valuation that you get in the market versus kind of the growth you're putting up in the margin profile?

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

Yes. I mean, I think it's getting better than it has in the past. I think we're getting recognized for the growth. And so yes, we are seeing businesses trade over the last 12 months at 14 and 15x EBITDA, and we're below that. But as a going concern, that it seems okay for the moment. But I think if we can replicate some growth here in '18 based on the things we just talked about, it would be hard-pressed for your side of the formula to not appreciate that value and see that there's something sustainable there. So whether that's 14x EBITDA or 15x relative to peer group trading, that's kind of your, guys, decision, not ours. We're going to demonstrate the one part of the equation, which is getting the EBITDA up at a meaningful level and then make it sustainable and predictable, all that fun stuff. And then we would hope that the market appreciates that and sees what peers trade at. And as we get larger, I think we get on more people's radar screens. And just the simple function of having sales at a -- not at the $1 billion, but we're a lot closer to $1 billion, as we migrate forward and get the EBITDA, it makes sense that the multiple ought to increase commensurate with the other growth we have. But that kind of more realized on your side of the formula. But we are at a discount to our peers. I think if you look across the sell-side universe and the people who -- whether it's our definition of the peer group or their definition of the peer group, we would be in the lower half on valuation of EBITDA into a multiple. So it certainly feels like there's upside to that, but that's your guys decision.

Operator

And I'm showing no further questions at this time. I'd like to turn it back to the speakers for closing remarks.

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

Okay. Thanks to everybody, and look forward to talking to you in the next call.

Operator

Ladies and gentlemen, this does conclude the program for today. You may all disconnect. Everyone, have a great day.

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

Thanks.