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PRESENTATION

Operator

Good day, and welcome to the Q4 2018 ESCO Technologies Inc. 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 now 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 2019 and beyond EPS, adjusted EPS, EBITDA, adjusted EBITDA, growth, profitability, sales, costs productivity, tax rate, 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 these 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. Before I hand it over to Gary to discuss the specifics of the fourth quarter and our full year results, I want to make a couple comments.

I'm sure some of you were concerned about the big ramp up we projected in the second half of the year and particularly, the expectations we set for the fourth quarter. I'm very happy we were able to manage this ramp and not only hit our numbers but exceed them, which resulted in our fourth quarter being the strongest quarter in ESCO's history. Not only were the results good on a stand-alone basis, but I think it demonstrates the earning power of the business at higher volumes.

With these higher volumes, 2 of our segments had EBIT margins in excess of 25%, and our Test segment reported 17%, another all-time high. Our challenge is to continue to grow these businesses to better leverage the fixed overhead throughout the year.

For the year, on an operating basis, we finished $0.02 above the top end of our guidance range and $0.07 above consensus. In some areas, we overachieved versus our expectations. In others, we fall a bit short primarily due to sales timing and mix. The results are a testament supporting our multi-segment, multi-industry strategy.

In addition to our solid earnings, another bright spot was cash generation. Cash from operating activities was almost $103 million. This excluded the pension contributions which allowed us to pay down debt to a point where our leverage ratio is well below 2x.

In addition to the financial results, we took a number of actions to further cut cost and enhance our competitiveness. In fiscal year '17, we made some fairly significant moves in our Test segment, which bore fruit in '18. In '18, for USG, we worked to leverage our excellent distribution network at Doble, which allowed us to shut down 4 small international offices and right size our workforce in Watertown. Additionally, we will begin to move VACCO's aircraft product business to consolidate it into operations at PTI. This allows us to better utilize available space that we own in Oxnard and reduce our rent space in South El Monte. The aircraft products are also better aligned with the core PTI business and should enhance our ability to accelerate growth in that product line.

Continuing in this vein, we have announced our intention to reduce the European footprint of our packaging business. We'll be shutting down our headquarters facility in Tunbridge Wells and relocating the activities to our existing plants in Nottingham and Poland. The majority of the costs associated with this action will hit our first half of '19. In addition to a reduction in cost, we think that operating from 2 facilities, some level of enhanced productivity will be achieved.

So before I turn it over to Gary, I will wrap up by saying we had a very solid year financial performance and have taken a number of proactive steps to enhance our cost competitiveness, which I believe should accelerate our future growth.

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

Thanks, Vic. As we've done all the year, I will focus my commentary on the as adjusted numbers as these are more relevant measures of our operating performance when compared to expectations and the prior year. As noted in the release, we closed out the fiscal year reporting adjusted EPS of $2.77 a share, which is $0.02 above the top of our expected range of $2.65 to $2.75. The $2.77 is also $0.07 above consensus estimates for the year and 25% above 2017's adjusted EPS of $2.22.

As noted in our previous quarterly reports, we delivered solid operating results throughout the first 9 months of 2018. And stating the obvious and as Vic noted, we delivered an extraordinary fourth quarter when measured in nearly all financial metrics. Simply put, this was our best record -- best quarter on record.

Comparing Q4 '18 to Q4 of last year, we increased sales 12%, increased adjusted EBIT 28%, increased adjusted EBITDA 23%, increased adjusted EPS by 54% and increased cash flow from operating activities by 16%. These increased profit percentages are well above our sales increase, which clearly demonstrates the earning power we can deliver when we have quarterly sales at this level. Exceeding the top end of our expectations for Q4 and the year demonstrates that what we saw earlier in the year with our back half weighting and the Q4 significant volumes which impacted that second half weighting that it played out as expected, which this should provide some support for our 2019 sales and EPS profile as noted in the business outlook section of the release.

Now touching on a few specific segment highlights from Q4. Filtration sales increased 13%, while we delivered a 26% EBIT margin, which increased significantly over Q4 '17's EBIT margin of 22%, and this is led by the strength of our commercial aerospace and Navy businesses. Test increased sales 16%, which resulted in a 17% EBIT margin on this volume and with a favorable sales mix. The 17% margin also reflects the lower cost structure and operational improvements that we implemented over at Test over the past 2 years, as Vic mentioned.

Within USG, sales increased 7% as Doble and Morgan Schaffer sales increased significantly, while NRG's sales into the renewable market declined compared to Q4 of '17. The group's adjusted EBIT margin was 29% compared to 23% in Q4 of '17 with the margin contribution following the related sales deltas as I mentioned. As noted in the release, we also took some additional cost actions within USG to improve operational efficiency, and we've excluded these when calculating our adjusted amounts.

Additionally, and as noted in the release, subsequent to fiscal year end, we sold Doble's headquarters campus to a developer for $17.5 million cash. And later in fiscal '19, we will be relocating to a more cost-efficient building in Marlborough, Massachusetts where we will consolidate our 2 operations into 1 facility. The building sale resulted in a pretax gain of approximately $7 million, which we'll recognize in Q1.

So for our final comment on the year, I'm also really pleased with our cash flow from operating activities for the year as this created a reasonably low level of debt. And coupled with our remaining credit capacity and available liquidity, this has us well positioned to effectively execute on our M&A strategy.

So in closing, before I pass over to Vic, I'll be happy to address any questions when we get to the Q&A.

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

Thanks, Gary. I want to provide a backdrop for our 2019 forecast.

You saw in the release our operational forecast has us growing top line, approximately 5%, EPS growing 7% to 10% and EBITDA increasing approximately 10%. I think it's really important to remember that all of this growth is organic. Also, I'll point out that we benefited from a 22% adjusted tax rate in fiscal '18 versus our projected rate of 24% in fiscal '19. This rate differential results in approximately $0.07 a share of EPS headwind in '19.

We certainly plan to remain aggressive on the M&A front, and any success we have in this area would be additive to our results. In this area we have several significant opportunities we're pursuing, which could provide an upside, or as a minimum, could cover any downward pressure should it arise. Obviously, certainty and timing of these opportunities makes it unwise to include in our base forecast.

In addition to the restructuring of our packaging business in Europe, which I mentioned earlier, as Gary mentioned, we made the decision to sell our Doble facility in Watertown and relocate it outside of the Boston proper area. This decision was made for several reasons. It is additive to our GAAP earnings and provides us with approximately $12 million of cash after taxes, commissions and moving costs. Also, it should help us in our recruiting and retention efforts by being located in an area with a lower cost of living. The new facility will be purpose built for Doble, which should lower our operating costs, significantly enhance our productivity and be the showcase for our customers.

Over the past several years, we've made a lot of changes to the structure of our business. And while cost containment will always be a prime piece of our strategy, I think the heavy lifting is behind us. We plan now to put much more emphasis on our organic growth, and this focus should help us meet our '19 numbers and assist us as we move into '20 and beyond.

So in closing, our focus remains constant to continue to improve our operational performance and to execute our growth opportunities both organically and through acquisitions, therefore enhancing shareholder value.

We'll be glad to answer your questions you have now.

QUESTIONS AND ANSWERS

Operator

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

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

First question I want to see if I can get through here is as you folks look at the range that you're providing for your segments for expected growth, could you talk a little bit about what some of the highlights might be in key contributors or what might be weighing against us? For example, I think NRG is a little bit of a headwind there within the USG segment. A little bit more detail if we could hear from you, Vic and Gary, around that would be very helpful.

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

Sure. Well, I think we're seeing some decent growth really across the business. We are projecting growth that, I'd say, obviously about GDP and above what we're seeing from our industrial competitors. But there are challenges obviously. The Fluid Flow group is solid. That's a very predictable business. The Doble business is solid as well. We are having a few headwinds at NRG. I mean, really the -- I would say just the pickup rate that we anticipate is not quite as strong as we thought it would be. I think it's probably a temporary thing, and we're still very happy with the business. And we got some new products we're looking to introduce, which should help us in that area. But it's just a little more volatile in the short term than maybe we thought. The longer term, it's a great place to be, and we continue to look for opportunities in the renewable space to add to that. Packaging business, we're going through that restructuring. I think it's going to really pay dividends. We're making some investments to make sure that we're more competitive. And then the Test business, they're coming off a really strong year. They're going to have another strong year next year, but we are finishing up a couple of big projects that we had entered in the past couple of years. Fortunately, we're not dependent on another big project to make our numbers for '19. They're really looking to add a lot of smaller $1 million to $3 million projects, which quite honestly usually work out better for us in any case because we have a lot less pass-through content in those smaller projects. But again, as I mentioned in my comments, all the growth that we're seeing next year is organic. So if we are able to accelerate some of that or make an acquisition, then that would be some solid upside for the business.

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

And Sean, I'll add one thing on the efficiency side. If you recall a year or so ago when you came along with me and we toured the aerospace facilities and the impressive nature of the automation and what it's done for efficiency in manufacturing at Crissair, in particular, and PTI and VACCO secondarily, we continue to make those investments. We spent a little bit of money last year in fiscal '18 at May Day to expand our capacity as well as improve their efficiency around the labor pool. So to Vic's comments, these all supported the sales side. And I just want to remind you on the EBIT contributions that we're getting, we are not shy about investing in equipment that improves operational efficiency. And you are able to see a couple of those things last year, and we have some additional ones in place now that will benefit '19.

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

Sure. Understood. Okay. And I suppose drawing off that, it sounds like as we think about each of the segments here that there should be some degree of margin expansion across all of them for next year, maybe Test not as much, but -- or actually, I think from your comments earlier, Vic, maybe we will see that. Can you just help to validate or comment on that part as we kind of drill down into the margin profile of each?

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

Yes, and in each of our operational units, not just within the segment, but within the operating units as subsets of the segment, we'll see margin percentages increasing, in some cases, nominally like in NRG because they're not getting -- they are getting some level of growth but just not where we thought it would be. And then a little bit more substantial across the Filtration aspect, again, with volumes increasing in automation and that sort of thing. And then we will have a little bit of disruption for a couple months while we move the aircraft business from VACCO to PTI. But once it gets settled in there and hopefully in the second quarter, you'll see back half efficiencies coming out of that. So each of the operating segments has some level of percentage EBIT margin improvement in '19 compared to '18.

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

Yes, and I'd say one other area where it's a little unclear today and, of course, as you know, we're always a little bit conservative about these things because we want to see them play out, but for some of the acquisitions we made that were additive to Doble as we get those more and more into their distribution network, we've seen some increases in sales already and I think we'll get some increases in efficiency as their level of sales go up. But if you look at a couple of acquisitions, we significantly improved their profitability and they were already pretty profitable businesses that I think getting inside a larger corporation with a little more knowledge on automation, some things like that, is really starting to pay some dividends.

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

Okay. Very helpful. And then last question here, I'll hop back in the queue. It sounds like we're -- if I'm reading the way that the wording is laid out here in the press release, it seems that you feel you might be very close to really bringing through some M&A acquisitions to close. And just wanted to get your viewpoints around that. Obviously, you mentioned, that the pipeline looks fairly healthy. Just trying to get a sense of what we could potentially expect out of some additions there as tuck-ins to the portfolio.

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

Sure. So M&As are always very difficult to predict, as you know. And obviously, the fourth quarter -- our first quarter of the 4 fiscal quarters is typically pretty light because there's a lot of holidays and people typically aren't taking a lot of activity, although we are seeing some things that are at least going to start to come into market during this time frame. So there are a number of things out there. We've looked at a number of things over the past year. At this point, we weren't able to close on anything and it's primarily because some of the multiples have just been really kind of much higher than what we were comfortable with. As you know, where we do a really good job is if we're able to find a privately owned business that's really looking to make sure that they go to the right type of partner or acquirer and then we're able to get in there before they go to auction. Having said that, we have won some at the auction as well. But there's a lot of activity there. I would say we'll probably pick up more so after the first of the year, but we'll remain aggressive there. And as you know, our operating folks are not shy about pursuing these types of opportunities when they find them.

Operator

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

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

You're moving a lot of facilities at once. Can you quantify the headwinds from an operational standpoint as they're implemented? How much risk have you given yourself -- risk cushion have you given yourself? And on the flip side, how much savings are you counting towards in '19 in your guidance?

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

So I'll answer that last half of it and kind of draw a blank there. But we always put a contingency in place when we're making these types of moves, I mean, because there are things that pop up. Having said that, we've done a lot of this for the good or bad, and we've done a lot of it. I think the folks have really done a very good job of understanding what needs to be done. We have people that we've started deploying that really help us with this activity, their internal people that have been through it before. So they were not kind of relearning how to do this every time. So my confidence level on getting these things done properly is very high. We -- obviously, over the past couple of years, we probably had 4 or 5 of these types of actions that we've taken. And obviously every one of them has come in either on budget or under budget and on time. So I don't anticipate any significant problems here. And to the extent that we have any issue, I think we've got contingency to cover that.

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

Yes, and John, on the dollar side of it, the way we look at it is we have a very rigorous or diligent process on how we time phase these things. I'll just address each one. For instance, on the Doble sale, we sold that the first week of October. The process is underway. So you were just out there and you saw that facility. It's a 3-story building. I can't remember the square footage, but that's not something you move out of in 30 days. So we will gracefully move out of there across the '19 fiscal year continuum. And so we baked in -- obviously, there's inefficiency when you're packing people and moving. But I think we've done a good job of baking in where the inefficiency would come out. So to answer your cost savings, you're not going to see a whole lot of cost savings in '19 because that process will probably take the majority of the year. But in '20, you will see a meaningful improvement by being out of an outdated, very expensive facility to maintain and that sort of thing into, as Vic said, a very specifically well-built building that we'll be renting. So I'd say '20 is the best way to think about that. On the packaging side in Europe, as everyone knows, we had to, unfortunately, do some of these things where you're moving people. The time frame of the European severance programs and garden leaves and all that are not immediate. So there will be a transitory period as that cost goes away. And I'd say maybe by the fourth quarter, we'll start to see some realistic savings there. And as we said in the release, we'll be spending about $1.5 million to $2 million. The payback is greater than that when you get in to the facility. So the payback is a little -- about a year to 1.25 years. And then when we get to the things that we're doing with the VACCO aircraft move, obviously, when you're dealing with a sensitive customer like that, you have to have all the approvals in place and all that, which we're in the process of getting. But because -- that size of the revenue is about $9 million or $10 million that we'll be moving. And so to make sure we don't break the supply chain, we will build ahead, and so we will build some advanced inventories. So physically, the move will only take a couple of days, but the preparations for the move will take 60, 90 kind of days. So I think in the second half of '19, you'll see the benefit coming out of the Filtration group by that geography move in there. So I think we've done a really good job of capturing the delay and disruption costs across those 3 platforms. But I would really think of it more beneficial as the impact it's going to have in fiscal '20 when it's kind of "clean" as we go across because that's really how we look at it. We do an ROIC on every one of these things, and we make sure that the payback's reasonable and we're doing it for the right reasons. I mean, we're not going to talk about 2020 at this point. But I think as we get to that point, you'll see meaningful margin improvements there.

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

Okay. Do you have a dollar amount or a run rate you plan to save at all? Or is that to be determined some later?

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

Well, I'll just say it this way because we don't want to really get commenting on 2020. But I would say that the payback across each of these continuums is roughly a year. So I think if you think of talking about $2 million here and there, the payback of $2 million annually is not an unrealistic expectation.

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

Okay. Great. And then just one more for me. The cadence for the quarter as you head into'19, any large projects that are hitting in certain quarters? How should we expect that all to play out as we go through the year?

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

Yes, I'd say -- because that's obviously one of the things that we pay a lot of attention too as well as we go through that. So this past year '18 that we just wrapped up was, I would say, extraordinary to have the profile that we had. We knew that at the beginning of the year. But going in, we certainly -- we understand some of the, as Vic mentioned in his prepared remarks, some of the concern that shareholders had relative to the way that stair step looks. So the good part of fiscal '19 is while it's still back half weighted, It's not of the nature that it was on '18. So to just put numbers around it, we were about 30% of our $2.77 happened in the first half and 70% hitting the back half. We're about -- I'd say we'd be a lot closer to 40% to 60% versus the 30% to 70%. So it's still back half weighted, but the stair stepping is not as steep, if that makes sense. So if you were to think of 38% to 40% of our -- pick whatever your midpoint is going to be on our guidance, and if you were to say 38% to 40% in the first half versus 30% in first half of '18, you'd be pretty squared up.

Operator

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

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

A lot of the emphasis on -- for the company has been on improving or growing the ROIC. Your debt levels are down fairly low. How has it changed your capital allocation strategy? Or how are you evaluating acquisitions as the ROIC begins to improve and how it becomes an increased discipline for the company?

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

Yes, I'll take the first part of that and then I'll let Vic address more of the strategic side on his thinking of valuation and that sort of thing. As I mentioned on whether it's restructuring or putting in a piece of automation or doing anything to a facility, we always have the backdrop of ROIC as kind of the guiding principle there. So taken that into the capital allocation policy, first and foremost, I want to remain consistent with Vic's emphasis on organic growth. We look at that first. So if we can do things that expand our opportunity to create sales and that might come through automation because it makes our cost structure lower, so therefore we can do a little bit more (inaudible) ROIC perspective and capital allocation, first and foremost, the money that we generate is intended to grow the business. Second -- and that's both top line and through efficiency. Second is as we look at M&A, we do have a pretty rigorous structure that we look at. And so we create this chart that we call the bull's eye chart, and in the center of it is dead center of the fairway. So we have a range of parameters that we can make work on valuation. So I'm just giving you a range. That might be something like 10 or 11x EBITDA. As you get into the second ring of that, it's a little less because what drives the circle (inaudible) required ROI. So we will stretch if we get to the center of the bull's eye, but that's kind of how we look at capital allocation. We're really not going to raise our dividend. At least it's nowhere in our near-term thinking. So beyond internal investment for automation and growth, R&D for new products, I'd say, is second. And then acquisitions is the wildcard that, again, has the ROIC focus. And I'll turn to Vic how he thinks about that bull's eye chart and what we're willing to spend.

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

Yes, no, I mean, I think that the valuation really comes down to the company. And while we have metrics that we really focus on, there are times where it's a business we really have to have and we'll pay up for that. And if their businesses could be additive, if they aren't as center of the fairway, as Gary says, that's not something that we will stretch for. I think it's important just to remember that we're going to try to have a combined approach here and have the type of organic growth that we have or projected for this year at least, we understand that's not where we want to be as a company. So we need to do 1 or 2 things. We could either grow faster organically, and we spend a lot of time thinking about that, how we're going to do that and what type of investments we need to make, but also within acquisitions. So we will then have a balanced portfolio. And often when it comes to acquisition, it's really driven by what's available. And so we -- that's one of the reasons we don't set firm targets on organic versus acquisition because we want to do what makes sense with what's presented to us at the time.

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

Got it. And fourth quarter, you converted backlog fairly nicely. As we go into 2019, you have longer-term contracts in place that gives you a fair amount of visibility. But if I can even use Test as an example where it's going to move from more project base to smaller, I guess, you mentioned $1 million to $3 million projects, how much visibility do you have across the board in terms of nonproject related or noncontract related business?

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

So for -- the good thing as we go into this year, we do have a really solid backlog and cash, and I think it's pretty equivalent to where it was last year. And so we're not requiring to get those big projects to make it happen. As we kind of look at how we project that business, we can stratify as we've got the medical business, which runs at kind of a certain level historically and we can project that pretty closely, components are another piece of it (inaudible) business is another piece of it, and then what I would call now the smaller chambers, which we have pretty good insight into that. So then you are really left with a relatively small percentage of the business is, I would say, kind of unidentified, if you will, going into the year. But I would say it's not any different or not significantly different than it has been in the years past. So while we have burned off a couple of big projects, fortunately, we've been able to grow the backlog in some of these smaller projects. And so that's not a concern for us as of today.

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

And I'll add one thing to that, Liam, just on the math. As we look at the backlog, we look at, obviously, when we expect the delivery dates are on that. So it's one of the metrics we pay a lot of attention to is what do we have in backlog today that supports the first half of the year. Because our goal is to try to maintain a backlog level that's relatively close to 45% or 50% of our expectations for next year. So obviously, there are some things that we have to book and ship. We'll get some aircraft orders in February that will ship in February, that kind of thing, which is quick turn. But starting the year at roughly $385 million of backlog is not a challenging percentage of our expected sales next year, consistent with how we started '18 and how we started '17. So going into the year with about 50% roughly of your expected sales already in backlog and the conversion cycle we see gives us comfort in the ability to put our sales increase numbers out there.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back to Vic Richey for closing remarks.

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

Okay. Well, thanks to everyone for your questions and your interest. And I look forward to talking to you on the next call.

Operator

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