
Operator: Greetings, ladies and gentlemen, and welcome to the Graham Corporation Second Quarter Fiscal 2019 Conference call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions]

And it's now my pleasure to introduce your host, Ms. Karen Howard from Investor Relations. Thank you, you may begin.

Karen L. Howard: Thank you, Jenn, and good morning everyone. We appreciate you joining us today to discuss Graham's fiscal '19 second quarter and first half year results. You should have a copy of the news release that was distributed across the wires this morning. We also have slides associated with the commentary that we're providing here today. If you don't have the release or the slides, you can find them on the company's website at www.graham-mfg.com.

On the call with me today are Jim Lines, our President and Chief Executive Officer; and Jeff Glajch, our Chief Financial Officer. Jim and Jeff will review the results for the periods, as well as our outlook. We will then open the lines for Q&A.

As you are aware, we may make some forward-looking statements during this discussion, as well as during the Q&A. These statements apply to future events, and are subject to risks and uncertainties, as well as other factors, which could cause actual results to differ materially from what is stated on the call. These risks and uncertainties and other factors are provided in the earnings release, and in the slide deck, as well as with other documents filed by the company with the Securities and Exchange Commission. These documents can be found on our website or at www.sec.gov.

I also want to point out that during today's call, we will discuss some non-GAAP financial measures, which we believe are useful in evaluating our performance. You should not consider the presentation of this additional information in isolation or as a substitute for results prepared in accordance with GAAP. We have provided reconciliations of comparable GAAP to non-GAAP measures in the tables accompanying today's earnings release.

And with that, it is my pleasure to turn the call over to Jeff to begin. Jeff?

Jeffrey F. Glajch: Thank you, Karen, and good morning everyone. If you could turn to Slide 4 in our deck, Q2 sales were \$21.4 million, up 24% from the same period last year. As we discussed in Q1, we believe we are in a recovery of our key markets. Also, please note the Q2 of last year was a very easy comparable as we were at the bottom of the downturn. Q2 net income showed a strong improvement, again, versus an easy comparable. Finally and importantly, orders in Q2 were very strong at \$34.4 million, with key wins in both the refining and petrochemical markets.

Our backlog has improved to a record \$127.8 million. It is important to note that, while our Navy backlog

continues to be strong at just above \$65 million, our commercial backlog is now \$62.5 million, or nearly triple the \$22.8 million level of the commercial backlog just 12 months ago.

On to Slide 5. Q2 sales were \$21.4 million compared to \$17.2 million in the second quarter last year. Sales in the second quarter were 70% domestic and 30% international, compared with last year's second quarter, which were 65% domestic, 35% international. \$3.9 million of our \$4.2 million increase in sales in the quarter, came from the domestic market with the remaining \$300,000 coming from the international markets.

Gross profit increased to \$6.2 million from \$3.7 million in last year's second quarter, primarily due to higher volume, improved pricing, as well as a few high margin projects. Gross margin was up to 29%, from 21.7% in last year's second quarter. EBITDA margin was 10.3%, up from 4% in last year's second quarter, driven primarily by the higher gross profit margin. Net income increased to \$1.8 million or \$0.19 per share, up from a reported level of breakeven or an adjusted level of \$200,000, or \$0.02 per share, last year. Last year's net income number was adjusted for a small restructuring charge, which occurred in the second quarter of the previous year.

On to Slide 6. Sales in the first half of fiscal 2019 were \$51 million compared with \$38.1 million in the first half of last year. Year-to-date sales were 56% domestic and 44% international, compared with 68% and 32%, respectively, last year. Domestic sales increased 10% to \$28.5 million, compared with \$25.9 million last year. International sales were \$22.5 million, up 86% from \$12.2 million last year. You may recall, as we discussed in the first quarter, we had a very large Canadian project, which recognized most of its revenue in the first quarter, and finished up early in the second quarter and has skewed the split between domestic and international a bit for the first half of this year.

Year-to-date gross profit was \$13.4 million, up from \$8.5 million last year, and gross margins are up 380 basis points to 26.2%. Year-to-date EBITDA margins were 10.8%, up from an adjusted level of 6.4% in the first half of last year. Finally, net income was \$4.2 million or \$0.42 per share, up from a reported level of \$900,000, and an adjusted level of \$1.2 million, or \$0.12 per share, last year.

On to Slide 7. We continue to have positive operating cash flow in the first half of this year of \$5.1 million. We paid just over 1/3 of this as dividends or \$1.9 million. You may recall, that we increased our quarterly dividend by 11% this past August. Our cash balance is now at \$79 million or just over \$8 per share. This is up from \$76.5 million at the end of fiscal 2018.

We continue to be pleased with our expanding acquisition pipeline, despite the higher prices that we're seeing in that arena. We will continue to be disciplined, however, we do hope to be able to utilize some of our cash to grow inorganically.

Capital spending has been very light in the first half of the year at \$400,000, the same as the first half of last year. We still expect to spend between \$2 million and \$2.5 million in capital for the full fiscal year. We

had a similar back-end loaded capital spending plan in fiscal 2018, where we spent approximately 80% of our capital in the second half of the year.

Jim will complete our presentation by providing more depth on Q2, our market outlook, and updating our full year guidance.

James R. Lines: Thank you, Jeff. Good morning. We appreciate everyone joining our second quarter earnings conference call today.

I will begin my remarks on Slide 9. Overall, as Jeff noted, sales in the quarter were up 24% compared to a year earlier. Definitely, orders improved about one year back, and that now was reflected as a recovery in quarterly sales. We've discussed a number of times during previous calls that when refining markets came out of the downturn, spending on existing facilities would occur before new capacity investment. Three factors are relevant when considering the importance of that view.

First, is that Graham has a rather large installed base throughout North America, and in the Middle East, Asia and in Latin America. Second, is that the original equipment supplier often is preferred for retrofit or replacement, as that supplier knows precisely how the existing equipment was designed. And third, is these investments move quickly, and not as slowly as new capacity investment. Replacement equipment bid opportunities may be in our bid pipeline for just a few months, whereas new capacity bidding could be in the pipeline for more than a few years.

Approximately 75% of the \$9.7 million of sales to the refining industry during the quarter, were derived from our installed base, which highlights the significance of investment in our refining installed base, and how Graham is positioned to benefit from these investments. Another beneficial consideration is that retrofit and replacement work has higher margin potential than will most new capacity investment.

Turning to chemical industry sales. While sales were down \$1.9 million compared to last year, we consider that to be timing. The chemical industry is active. Here too, there can be retrofit or replacement sales along with new capacity sales. We do, however, view the chemical industry, as a whole, differently and that it is more about new capacity. However, for North America, with low cost natural gas as a primary feedstock, we are seeing from our installed base retrofit and replacement orders as chemical plants restart, revamp and expand existing facilities, implying sales to this sector will improve in the coming quarters.

Sales into the power industry were flat, while sales to our other markets that include defense were up 18%. There is still a heavier weighting toward domestic sales, due to the U.S. refineries' commitment to improve their existing operating assets, low cost natural gas in the U.S., burning capacity expansions in the chemical industry and, of course, our Navy work is domestic. We should expect this trend to continue where greater than 50% of our sales are for domestic markets.

Please move on to Slide 10. The trailing 12-month new order trend of \$140 million is encouraging, although it is impacted by two back-to-back \$40 million bookings quarters. If we were to annualize the last two quarters, that would imply a 12 month bookings level of \$112 million. Due to the size of certain orders, it is difficult to model a bookings run rate. On a qualitative basis, I can state, however, that the bookings environment today is superior to 18 to 24 months back. Again, refining industry new orders were strong with a combination of orders for new capacity and for those derived from our installed base. Chemical industry orders were up nicely, driven by orders that are for new capacity in the US Gulf Coast.

Let's now discuss backlog and details provided on Page 11. As Jeff said, we have a record backlog at just under \$128 million. It sets up nicely fiscal 2020 for year-on-year growth. Importantly, refining industry backlog is up \$20 million from this time last year, and similarly, chemical industry backlog is up approximately \$15 million. It is encouraging to have a strong high-quality backlog from our traditional refining and chemical markets that is complemented by our large Navy backlog.

Additionally, backlog conversion spans several years with 55% to 60% of backlog converting to sales within the next 12 months and 25% to 35% converting beyond two years from now.

Turning to guidance for the remainder of the year, I ask that you refer to Page 12. Full year revenue guidance has narrowed to \$98 million to \$105 million. Gross margin is expected to range between 25% and 27%. Our SG&A spend will fall between \$18.5 million and \$18.75 million and our effective tax rate for the year is projected to be approximately 20%.

The focus our team has had during the downturn on improving execution capability, along with effectively managing our bid pipeline will enable us to deliver 25% to 35% top line growth in fiscal 2019 compared to fiscal 2018, and also to have a strong backlog setting up fiscal 2020 as another growth year. I commend the Graham team for their impact on improving the Company.

Activity on the M&A front is providing a number of high-quality strategic fit targets that would expand our addressable market, leverage Graham sales channels or diversify revenue opportunities into less cyclical end markets. We are, however, finding these targets to be expensive and to have challenging risk-adjusted returns. Management and its Board of Directors are committed to putting our balance sheet to work to expand and diversify the Company and we will stay disciplined about deploying capital for growth. Jenn, I would ask you to please open the line for questions. Thank you.

Operator: Thank you. Ladies and gentlemen we will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of John Sturges with Oppenheimer & Company.

John Sturges: Very nice improvement in gross margins, done with great execution. I'm just curious about the revenue recognition change in the quarter. The new accounting rule, I thought you might have

recognized work-in-progress is being higher than the percentage completion, which is historically what you've done?

Jeffrey F. Glajch: John, thank you. This is Jeff. The revenue recognition in the quarter being a negative number is simply due to one specific project which is in process right now, which under the old rules, would have been a percent complete project. It was started this year, and it will finish up in the next quarter. Therefore, under the old rules, it would have been percent completion. Under the new rules, this particular project, because of the specifics of the project, will actually be completed contract. The old way, we would have had revenue in this quarter and then some revenue next quarter. In the new way, we had no revenue this quarter and we'll have a larger revenue next quarter for that project. No transition of anything from fiscal 2018, it's really the uniqueness of this particular project. For the full year, we expect the impact of the revenue recognition standard to increase this year's revenue by a little over \$4 million. First quarter, we had a positive of a little over \$3 million, this quarter we had negative, next quarter we will have positive. Probably by the end of the third quarter, we should be pretty well through all this. So it's a confusing issue because you've got last year things going on and in this particular case, you have an in-year adjustment going on, but hopefully by the end of third quarter, we should be pretty well done with the impacts of the revenue recognition change. I apologize for the confusion but unfortunately didn't write the rule.

John Sturges: It is what is, a transition effect. Thank you.

Jeffrey F. Glajch: Exactly.

Operator: Our next question comes from the line of Bill Baldwin with Baldwin Anthony Securities.

William Lewis Baldwin: Can you offer any color, Jim, on your visibility as far as the outlook for the refinery business, looking out over the next 12 to 24 months? At least directionally, do you believe that it will be stable or hold its own, how do you see that in relation to what you've seen over the last 12 months?

James R. Lines: In comparison to the last 12 months, from what we have identified in our bidding activity, we are seeing a pickup in EPC work, or FEED work, that would pertain to new capacity. We did win in our last quarter, the quarter that recently closed, some new capacity or expansion work, but we are seeing more of that type of work come into our bid pipeline, predominantly in Asia, in China and in India, but elsewhere, outside of those two countries, we are also seeing some new capacity work come into the bid pipeline.

William Lewis Baldwin: Is generally, new capacity work, Jim, is it, in terms, of project sizes equal to or larger than replacement type orders?

James R. Lines: Surprisingly, as this has evolved over time, we've seen the revamp retrofit upgrade work closely approximate the opportunities that we see from new capacity, which is also very encouraging. I would say, though, it does depend on the size of refinery being built and some cases, there are some 300,000 barrel per day and 400,000 barrel per day refineries that are being evaluated. Those would be much larger than a retrofit or a replacement opportunity.

William Lewis Baldwin: In relation to this replacement market, can you talk a little bit about the additions you've made to your sales organization to go out and focus on that retrofit and replacement market? At least, that's the way I interpret your initiative in terms of the sales effort, to get more focused on the end customer, which I assume is basically on the installed base? And how that initiative is going?

James R. Lines: Sure. That initiative is going very well. We have a very effective, strong EPC-centric sales organization that does have some coverage of the end user. What we felt strongly about was, we want to get closer and provide greater coverage for the end user, because that's where we see spending growing in the coming decade versus new capacity. And we've made some investments as you commented upon, and as you've seen our SG&A, our "S" expense begin to expand. We are taking steps now to better prepare our organization for where we think spending will come in the 2020 to 2030 timeframe, which would be on the installed base. And we're seeing those investments that we've made in both North America coverage, as well as in the international markets, we're not through that full spend yet, but we've taken a pretty good bite at it over the last 12 months.

William Lewis Baldwin: Does that involve adding new salespeople?

James R. Lines: That's probably an easier way to answer the question, yes. We've added sales personnel. We've added a good number already. And as I said, we're not completely through that organizational build out. We need to just be measured in that, and not get too far ahead of the corresponding revenue, but we've nearly come close to doubling our traditional chemical and refining focused direct sales force.

William Lewis Baldwin: That direct sales force is focused primarily on the retrofit and replacement market?

James R. Lines: And also EPC.

William Lewis Baldwin: And also EPC. So a salesman will do both, he or she can focus on replacement as well as EPC.

James R. Lines: Right. The sales people have to do that, but also underneath the sales organization, we're building up a technical services or performance improvement organization that also complements the sales team in how we serve and ultimately create value for the end user. We think the concentration

is going to be on getting more out of the existing assets the chemical industry has, and the refining industry has. So we've set up and we are setting up an organization of performance improvement specialists that will go in, and help our customers figure out how to get more out of what they currently have. We're in, probably to be candid, we've made some strategic moves here, but I'd say we're in inning number two or number three of a nine-inning game on building out that org structure, but we are going after it, we're investing in it. We see that as the right move, as we look at the spend trends and the focus of the industry on the installed base, and we're getting in front of it early. But we're not quite through the org build out on that.

William Lewis Baldwin: Jim, are you, from a philosophical standpoint, do you go out and hire experienced sales people? Or do you bring in people and train them yourself in the way you want them to be trained and focused?

James R. Lines: Well, we do a combination of both. We do like to bring in diversity of experience and skill sets. So that brings in middle career folks. And then we also like to bring in some entry-level folks, or people that have been in the industry, one to five years, where they're more in the initial training phases. We sell a complicated product and have a complicated sales process. So unless you've grown up inside the Graham organization, we don't see our competitors selling how we sell. We don't think they bring the technical acumen to the table that we bring to the table. We need to build competencies and capabilities, regardless of whether there are 15 or 20 year veterans or one to five year veterans on how Graham sells, how Graham creates value, how Graham treats its customer. We have a very particular way in which we do that. We've not seen other organizations bring the acumen to the table that we bring. It does take time.

William Lewis Baldwin: I understand, it is very hard. I mean it's hard, but it's so important. So, good luck. That is going to pay dividends long-term, I'm sure.

James R. Lines: We know it will. Thank you very much, Bill, for your questions.

Operator: Our next question comes from the line of Chris McCampbell with Hilltop Securities.

Christopher McCampbell: With record levels of cash and the cycle having bottomed, and no acquisitions on the horizon, why isn't a buyback of our Company's shares not in the best interest of shareholders here?

James R. Lines: That's a consideration that we do talk about pretty much at regular intervals at the Board meeting about capital deployed for external growth, internal growth or as distributions back to the shareholder in the form of dividends or buybacks. Right now, we have a building pipeline of M&A. Well, you heard me comment that we've seen some expensive deals. We want to put that money to work toward growing our business, diversifying our revenue opportunities. We have this rich pipeline that's in front of us. Can we consummate a deal in the next six months to 12 months? I can't comment on that, but we see a lot of opportunities, and we want the dry powder, ready to pull the trigger.

Christopher McCampbell: I understand that, although at a certain point, I would think some of the folks you're looking at, or talking with would probably want some stock in consideration, just because they'd want to benefit from the deal as well. Just seems to me like, considering where you are in the cycle, and where the stock is relative to that, I'm just trying to understand why it wouldn't make some sense to at least consider buying some along the way, if nothing else, I think, it could help the volume even, from the standpoint of liquidity.

James R. Lines: Sure. What I can share with in conclusion is, this is a topic that's highly debated every quarter, between management and the Board around deployment options, and then the timing of when an acquisition might materialize. It is something that's discussed quite comprehensively, every 90 days or so at the Board level. And the shareholders are clearly on the Board and management's mind as well as the size of our cash on the balance sheet, and the need to put that to work or do something different with it.

Christopher McCampbell: Okay. Could you give a little bit more color on the Naval pipeline, where we are in the process of new business there?

James R. Lines: That's a very exciting sector for us, in terms of the pressure, I'd call it pressure, which we're feeling for the cadence of demand out three to five years from now. The messaging was quite clear from the shipyards, and from the Navy, that the build cadence is going to step up. There is an urgency with the shipyards, and the Navy, to make sure the supply chain is ready. We're having very healthy conversations with our direct customer as well as the Navy to understand from their perspective, that we will be ready, are we making the right moves early enough to be in a position to capitalize on the expanded demand. So we're very excited about this. It doesn't move at a quarterly pace, it moves at a longer pace, a more measured pace. But we are feeling pressure to ensure we have readied the organization for a stepped-up cadence of demand, and that's quite real. And we have a lot of discussion across the management team, and with our Board around deploying capital, in support of that internal growth initiative. It is a pretty exciting time in the Naval sector, or at least as we've talked to the shipyards, and the Navy.

Operator: Thank you. Ladies and gentlemen, at this time there are no further questions. I would like to turn the floor back to management for closing comments.

James R. Lines: Thank you, Jenn, and thank you everyone for listening in on our conference call today, and for the questions that we did receive. We always appreciate your interest in Graham. And we look forward to updating you on our progress for the remainder of fiscal 2019, and how we see fiscal 2020 shaping up on the next conference call, end of January. Have a great day.

Operator: Thank you. Ladies and gentlemen, this concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.