

Operator: Greetings. Welcome to Graham Corporation's Second Quarter Fiscal Year 2023 Financial Results Conference Call. [Operator Instructions]

At this time, I'll turn the conference call over to Deborah Pawlowski, Investor Relations. Mrs. Pawlowski, you may now begin.

Deborah Pawlowski: Thank you, Rob, and good morning, everyone. We certainly appreciate your time today and your interest in Graham Corporation. Joining me here are Dan Thoren, our President and CEO, and Chris Thome, our Chief Financial Officer. You should have a copy of the second quarter fiscal year 2023 financial results, which we released this morning before the market. Also, for your information, posted on our website are slides that will accompany today's conversation as well as supplemental information that provides greater detail regarding sales, bookings and backlog by industry and geography. Those can be found at ir.grahamcorp.com. I will first have Dan and Chris do a formal presentation, after which, we will then open the lines for Q&A.

If you'll turn to Slide 2 in that deck that I mentioned, I'll review the safe harbor statement. You should be aware that we may make some forward-looking statements during the formal discussions as well as during the Q&A session. These statements apply to future events that are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from what is stated here today. These risks and uncertainties and other factors are provided in the earnings release as well as with other documents filed with the Securities and Exchange Commission. These documents can be found on our website, ir.grahamcorp.com or at sec.gov. During today's call, we will also make some non-GAAP financial measure disclosures. We believe these measures will be 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 the reconciliation of non-GAAP measures with comparable GAAP measures in the tables that accompany today's release and the slides.

With that, if you would please advance to Slide 3, I'll turn the call over to Dan to begin. Dan?

Dan Thoren: Thank you, Deborah, and good morning, everyone. I am pleased to report that we're tracking to plan. Our results are as we expected and we are on track to achieve our fiscal year guidance. Our second quarter was a big bookings quarter with over \$90 million in new orders. Approximately \$70 million was attributed to our defense market and another \$20 million to space and refinery petrochem.

All of these newly booked orders have better margins than in the past. We were able to increase pricing on both our Navy and energy jobs. We are seeing continued strong demand in our refinery petrochem aftermarket business. We have not seen an increase in commercial capital equipment orders yet, but our customers tell us they expect those orders to come in calendar 2023.

Execution is improving through continual improvement in the short term and with capital investments for the long term. Both business units are working hard to improve manufacturing processes and are seeing improved cost and yield because of the effort. This quarter, our Board approved the acquisition of an automated welding machine, a new mill turn machining tool, a pump test rig and a facility expansion.

The automated welding machine will reduce cost and rework on some of our heat exchangers that we're making in Batavia. The new mill turn machine tool will significantly reduce manufacturing time on production torpedo programs, while the facility expansion will enable a higher production delivery rate for these programs.

The pump test rig will be used to demonstrate life cycle for high compliance production pumps that we are making in Arvada. As we clear the low-margin jobs through the year, we expect profitability to continue improvement. For the quarter, given the product mix, GAAP loss was about \$200,000 and EBITDA was \$1.5 million.

With that, I'd like to hand it over to Chris Thome for a discussion of our financial performance.

Chris Thome: Thank you, Dan, and good morning, everyone. I will begin my presentation on Slide 4. As Dan mentioned, our second quarter performance was in line with our expectations. Sales were \$38.1 million, up 12% over last year's second quarter and 6% over the trailing first quarter. I would like to point out that this growth was all organic as both periods included a full quarter from Barber-Nichols. Year-over-year growth included \$3 million from the space industry, where we are building relationships with many of the key commercial players. In fact, during the quarter, we were recognized by Virgin Orbit as one of the critical suppliers, which we believe is a testament to the value our solutions and engineering services bring to that industry. During the quarter, we continued to see strong growth in the refining and petrochemical commercial aftermarket, which was up 36%. This is significant in that we view aftermarket sales as a leading indicator of future capital investments by our customers.

As Dan mentioned, we expect the next capital investment cycle to begin in calendar year 2023. Offsetting these increases were sales to the defense market, which were down \$5 million compared with the second quarter of last year,

which was a record quarter for this business. The change was all about project timing, reflecting the significant level of defense industry business we have in our backlog.

As noted in our release today, we delivered an additional first article unit for a critical U.S. Navy program and are on schedule to ship the remaining first article units by the end of the first quarter in fiscal 2024. For the quarter, sales in the U.S. increased 16% to \$30.3 million and represented 80% of our sales, while international sales of \$7.8 million accounted for 20% of total sales and were consistent with the prior year.

The mix of U.S. to international sales has shifted over the last couple of years, given the growth in our Navy business as well as the addition of Barber-Nichols, which sells primarily into the U.S. Gross profit and margin improved over the prior-year period on a better mix of higher-margin projects, namely space, commercial aftermarket and new energy, as well as better execution and pricing. The decline sequentially was as expected and was due to pivots on projects made in the first quarter to keep production moving that resulted in that quarter benefiting from a better mix of business.

SG&A expense for the second quarter was \$5.3 million, consistent with the prior year; however, as a percentage of sales, SG&A expense improved to 14% compared with 15% in the prior year as we maintain strong cost discipline while growing our top line. The net result was near breakeven net income for the quarter, adjusted earnings per share of \$0.03 and adjusted EBITDA of \$1.5 million.

Turning to Slide 5, you can see our capitalization. Net debt at quarter end was \$5 million, up slightly from \$4.2 million at the end of the trailing first quarter due to the timing of milestone payments. We have instituted strong cash management discipline throughout the organization, which includes actively managing working capital and operating expenses while increasing oversight of capital expenditures to ensure proper returns. As a result, capital expenditures in the quarter were \$0.9 million and we have reduced our guidance for CapEx spend for fiscal 2023 to be approximately \$3 million to \$4 million. The investments that we are making that Dan highlighted earlier totaled approximately \$4 million and will occur over the next 4 quarters with each project having a greater than 20% IRR.

Turning to Slide 6, as previously announced, we had record orders during the quarter of \$91.5 million, driven by repeat orders for critical U.S. Navy programs. We believe these repeat orders validate the investments we made over the last year and our customers' confidence in our execution. We also expect these repeat orders will be at higher margins through increased pricing and better execution.

In addition to strong defense sales, we had \$13 million in refining and petrochemical orders, which related to continued strong commercial aftermarket demand, and \$4 million of orders each from space and other commercial, which is comprised primarily of new energy. The orders for the quarter resulted in a book-to-bill ratio of 2.4x and reflects the breadth and diversity of our customer base.

If you turn to Slide 7, you can see that these orders drove a 20% increase in backlog from the sequential first quarter and now sits at a record \$313 million. We believe 40% to 45% of this backlog will convert within the next 12 months. Most of the backlog expected to convert beyond 12 months is for the defense industry, primarily to the U.S. Navy. Defense now comprises 79% of our backlog and is significant in that it provides greater visibility and stability to our business.

Slide 8 provides our guidance for fiscal 2023. Our first half results were in line with our expectations and gives us confidence we will be able to achieve our full year guidance. As such, we are reaffirming our expectations of revenue and adjusted EBITDA growth for the year.

Revenue is expected to be between \$135 million and \$150 million, which implies top line growth at the midpoint of 16%. From a margin perspective, we are looking for a gross margin of 16% to 17% and expect SG&A to be 15% to 16% of sales. The net result is that we expect adjusted EBITDA to be in the range of \$6.5 million to \$9.5 million, which equates to an adjusted EBITDA margin of 5% to 6%.

As discussed, year-to-date fiscal 2023 results were impacted by our larger lower margin first article U.S. Navy projects. We believe this negative impact will continue through the first quarter of 2024 when the last of these larger first article projects are expected to be completed. I should also point out that the company's third quarter is typically impacted by lower labor hours due to the holidays.

With that, operator, please open the phone lines and Dan and I will be happy to take your questions.

Operator: Our first question comes from the line of Theodore O'Neill with Litchfield Hills Research.

Theodore O'Neill: Congratulations on meeting the estimates for the quarter. So, in your opening remarks, you talked about some new equipment that you're ordering. What kind of lead times are you looking at for that or is it already on its way?

Dan Thoren: Lead times for those machine tools typically are around a year. And so, as Chris had mentioned, we're kind of expecting that capital expenditure to go over the next 4 quarters. We put money down at the beginning to get the order going and, then, we pay for it when it's delivered. So, there are some things that are relatively quick and, then, most of that capital equipment ends up being kind of a year long.

Theodore O'Neill: Right. Can you talk about what you're seeing in terms of inflation or supply chain issues in your business?

Dan Thoren: Yes, certainly. In inflation, we are seeing increased prices from our suppliers and we're able to build those into our bids fairly well. Suppliers are continuing to hold short validity dates for the material and we're just passing those on to our customers. I'm thinking that pretty much all of our customers know exactly where we are with supply chain and we haven't had any pushback for needing to revisit material pricing, for instance, when we accept orders. It may be a little bit better, but supply chain is still a little bit challenged.

Theodore O'Neill: I noticed that, under the product line sales, the space segment was up strongly this year over last. Is that a market share gain or is the pie just getting bigger?

Dan Thoren: Probably a little bit of both. We're seeing some activity continuing in launch type activities and, then, we're also seeing some more orders in the thermal management systems for communication satellites. Both of those continue to grow as a market and we're able to participate in those.

Operator: Our next question is from the line of Andrew Shapiro with Lawndale Capital Management.

Andrew Shapiro: I have a few questions here regarding the low profitability or breakeven first article units. These are the units for the sub programs, right?

Dan Thoren: Correct. We have one for the sub program and, then, one for the carrier program.

Andrew Shapiro: Are both of those suffering presently from low margins because these are the first article units?

Dan Thoren: Yes. They are.

Andrew Shapiro: When you say that the first article units will be done in their delivery through Q1 fiscal '24, that's the June 2023 quarter. Is that right?

Dan Thoren: Yes, that's correct, Andrew.

Andrew Shapiro: Okay, and this is first article for both the carriers and the subs in terms of that kind of quarterly completion?

Dan Thoren: Yes, exactly.

Andrew Shapiro: Okay. Remind me. I think I asked this one or two quarters ago when I first got interested in the company. Are these fixed fee contracts that you bid on and, of course, you learn from experience and that's why there'll be better margins the next time or were these some type of R&D with cost plus in them?

Dan Thoren: They are firm fixed price contracts that are bid competitively upfront, then you go through all the learning and, then, when you bid them again, you basically get to bid what your actual hours were expended in the first article. Your pricing actually improves for the second one.

Andrew Shapiro: Got it. With the automated welding equipment to be installed and activated in Batavia, which I think is where you're doing much of the first article work and the second article work, when is that equipment expected to be installed and activated?

Dan Thoren: That has like a year lead time to get it in, get it installed and get it operational. We would expect that probably fall of next year is the time frame that we'll be able to bring that online in our production process.

Andrew Shapiro: Okay. When you bid out, we'll call it, the second articles or the second wave of contracts that have now gone into the backlog, was that on any assumption of the productivity enhancement this new equipment would provide or will that be an added benefit and bonus?

Dan Thoren: If we're successful with the implementation of the automated welding equipment, it will reduce both labor hours that we put into the jobs as well as rework hours that we would have with a manual process. It should improve margins from that from where we bid those jobs.

Operator: Our next question is from the line of Brett Kearney with Gabelli Funds.

Brett Kearney: Congrats on the continued execution. I have two quick ones. It was great to see growth in, really, all areas of the business, but particularly on the new energy side. I'm curious. With so much happening in some of these spaces, what opportunities are you seeing that Graham and Barber-Nichols are best suited for? Do those primarily fall within the U.S. geographically? How are you thinking about the global opportunity set across some of those areas?

Dan Thoren: Very much right now, they're all domestic. We're seeing biodiesel applications, both new and existing. There's some good activity on the hydrogen side in the hydrogen production, transportation, distribution, fueling type of area, and there continues to be some good activity on the small modular nuclear side. That ends up being very much R&D, where the other two are more on the production side. There are some interesting opportunities, but they are, again, all domestic at this point.

Brett Kearney: Great. It sounds like you've identified some attractive internal investment opportunities that are moving forward. I was wondering, as part of the process overhauls you put in place with the organization, if you could talk about how these investments bubbled up and how you are looking at identifying and going after some of these attractive internal investment opportunities in the future.

Dan Thoren: Pretty much all of the really good ideas come from the floor, with people that are struggling with the process or challenged with a piece of equipment that they can see that there's a better way. We get some really good ideas from folks that are on the production floor, who are dealing with it every day. Certainly, there are some manufacturing engineering and design engineering type ideas that come through, too. We're excited, and that's really why I wanted to highlight in my opening statement that we're able to see some of those opportunities and start investing in them today. We don't expect immediate return, but a pretty quick return in the next couple of years that really will improve our efficiency and throughput and enable us to accelerate on the revenue side. So, we're excited about all of them. It's just that continual improvement mindset that both businesses have that's starting to come through.

Chris Thome: I think I would add to that, Brett, that one of the projects is capacity expansion as well, one of our defense programs, which is seeing some nice growth. We needed to take on additional space and purchase some new equipment as well to accommodate their request for volume.

Operator: The next question is from the line of John Bair with Ascend Wealth Advisors.

John Bair: It appears that your cost of goods sold rate of change is starting to slow down. Am I reading that right and is that something that you think is going to continue?

Dan Thoren: If you recall, John, the first quarter benefited from a really good mix and we did expect that gross profit percentage to come down in the current quarter. I would say the margin for this quarter was in line with our expectation. We continue to see some impact from these first article jobs in the second half of the year, but, as those jobs make their way through our backlog, we would expect our margin to improve after that.

John Bair: Okay. As you move through these projects and get into the second tier, if you will, looking out over a couple of years, what do you think the mix could be on winning new project orders as a winning first bid to where the order backlog, as it grows, becomes more of a mix of repeat business for existing projects? That as opposed to maybe getting new bid wins that would require this first article learning curve.

Dan Thoren: If we focus on the defense for now, we are building up some nice backlog of repeat work; and so, necessarily, we would expect that repeat work to be a higher percentage of any new first articles. We will be bidding additional new first article jobs in the future, because that's where the growth in our years really comes, but, as a percentage of our overall business, it should be a smaller percentage going forward.

Operator: The next question is from the line of Gary Schwab with Valley Forge Capital Management.

Gary Schwab: Nice defense orders. Was there any first article new business included in this big defense order that you just got this quarter?

Dan Thoren: No, it was all repeat.

Gary Schwab: Okay. As far as cutting back on CapEx for the year, you said 3% to 4% and, I think, last quarter you were saying 4% to 5.5%. What in your plans is being deferred, if anything?

Dan Thoren: I would say, at this point, it was just the discretionary spend. We've been trying to be prudent as we work our way through these projects. We are trying to be prudent with the spend, given the cash flow that we were generating, but where we expect the CapEx to pick up is our cash flow expense. Basically, we're only spending what we're generating from a cash flow perspective, but we're certainly not putting these projects behind in any way. These are a little bit larger projects that had to go through a full financial evaluation. I think we said at the beginning of the year that we thought they would be more towards the second half of the year, so those are right on schedule.

Gary Schwab: Okay. Your planned expansion at Barber-Nichols and the new equipment that you mentioned, is that all in this 3% to 4% or has that even been paid for yet?

Dan Thoren: It's going to go through the next 4 quarters, but a portion of it is built into that 3% to 4%, yes.

Gary Schwab: Can you give us an update on arc and flame? I think you said that, for November, you're going to have a big graduation month. What about your next class? Have you been able to attract any more experienced welders since the last call?

Dan Thoren: You have it right on there, Gary. Our next graduating class is in November. We have been seeing an uptick with some experienced hires, but it is a continual battle for sure and we're not out of the woods yet. We've made some good progress, though. We're able to maintain a level workforce right now and we do expect to bump up once that class graduates in November but it remains a daily battle.

Chris Thome: And then, the next arc and flame class will start in January, if I remember right.

Dan Thoren: Yes.

Gary Schwab: Okay. Are you graduating the full class or are you getting dropouts?

Dan Thoren: We've had a few dropouts, but that's normal. We go through some rigorous testing and, unfortunately, some don't quite make it through, but we've retained a good majority. I think we started with 11 and we're down to 10 now, so that's not too bad.

Gary Schwab: Okay. You're keeping the bulk anyway. In June, you were running a full first shift, but only a small second shift. Has that improved much and do you have any idea when the second shift would fill?

Chris Thome: It has improved quite a bit. Essentially, what happened is, again, we listened to employees about what they wanted and we floated the idea of a 4/10 kind of arrangement where they could work their 40 hours in 4 days and then have a longer weekend. We rolled that out on second shift and, as it turns out, people really like that. We have a lot more people on the second shift now than we had before. It's getting close to being a full second shift and, now, we have availability on first shift to hire and fill there, too. So, we've made good progress on balancing the shifts at this point.

Gary Schwab: That's good to hear. And then, finally, with the recent political conflicts between the U.S. and China, is it having any deleterious effects on your China business outlook?

Dan Thoren: We haven't seen anything to date. That China business can run in the \$5 million to \$12 million range. It has been a little bit lower recently, but we haven't seen any bad effects from that conflict thus far. Certainly, we're keeping our eyes and ears open and trying to understand what's going to happen there. It ends up being a relatively small piece of our overall business, so we're not too concerned about it, but we're certainly watching it for sure.

Gary Schwab: Okay. I just have one last question. You said last quarter that there was going to be some low-margin business that didn't come in in Q1, when you thought it was going to eventually come in. Did that all come in and did that go out in Q2?

Dan Thoren: We had some lower-margin business for the India market and probably 90% of it cleared in the second quarter. We felt like that would be a little bit of a drag and it was for the second quarter, but that appears to have cleared. I think the last item shipped the first or second week of November.

Gary Schwab: Okay. So, that was the biggest reason for your lower margin in the second quarter?

Dan Thoren: I don't know if I'd characterize it as the biggest, but it was one of the reasons.

Operator: Our next question is from the line of John Deysher with Pinnacle.

John Deysher: I was happy to see the backlog up significantly. I just want to make sure I understand the nature of that backlog. I think you said 80% was defense-oriented, which is about \$250 million. Does any of that \$250 million of defense backlog include any new first article projects?

Dan Thoren: No.

John Deysher: Does it include any second article projects?

Dan Thoren: In our backlog, there are the first articles that we've been talking through that aren't complete, that ship through June of 2023, and some second articles that also are in that time frame. So, yes, it does include lower margin stuff, and that's what we had talked about earlier in the call.

John Deysher: Right. That part is clear, but what would be a rough percentage of the backlog that is going to be the higher-margin second article projects?

Deborah Pawlowski: John, we announced the \$90 million in orders that we got, which was a record order level, of which \$70 million was related to defense. That's the second article. That's all-repeat orders; that's the Navy.

Dan Thoren: That's the higher margin, better pricing orders that are in our backlog.

Deborah Pawlowski: And that's what caused the backlog to step up as much as it did.

John Deysher: So, \$70 million is the total of the second article projects embedded in the backlog.

Daniel J. Thoren: There's more than that, because there's a carrier program also that will have better margins. I wouldn't characterize it as just the \$70 million in the backlog. It's more than that. That backlog also includes quite a bit from Barber-Nichols. There's about \$100 million for Barber-Nichols and a big portion of that is repeat production on some of their programs also. We're actually very happy about the backlog that we have and we're encouraged that it's good margin and we can continue to improve and better that going forward.

John Deysher: Okay. Great. When does the second article backlog start to become produced?

Dan Thoren: We're actually producing these second article equipment in Batavia now. On the carrier side, we've ordered material for some of the submarine programs. And then, Barber-Nichols is absolutely in the production of follow-on orders that have good margins associated with them. So, right now, think about it as kind of clearing the lower-margin jobs through June of next year and then what we have in backlog is actually pretty good stuff.

Operator: At this time, we've reached the end of the question-and-answer session. I'll turn the call over to management for closing remarks.

Dan Thoren: Thank you very much. In closing, I'll just say that we're very excited about the future of Graham and I am especially grateful to the entire Graham Corporation team for their commitment, their resiliency and their contributions to delivering on the quarter and to driving our future potential. Thanks for your interest in our company. I hope you have a great day and I look forward to talking to you again.

Note: This transcript has been edited slightly to make it more readable. It is not intended to be a verbatim recreation of the Graham Corporation (GHM) financial results teleconference and webcast that occurred on the date noted. Please refer to the webcast version of the call, which is available on the Company's website (grahamcorp.com), as well as to information available on the SEC's website (www.sec.gov) before making an investment decision. Please also refer to the opening remarks of this call for GHM's announcement concerning forward-looking statements that were made during this call.