Graham Manufacturing Corporation
First Quarter Fiscal 2009 Earnings Conference Call
August 1, 2008

Operator: Greetings and welcome to the Graham Corporation's First Quarter Fiscal 2009 Earnings Conference Call. It is now my pleasure to introduce your host, Ms Tammy Poblete, Investor Relations for Graham Corporation. Thank you Ms. Poblete. You may begin.

Tammy Poblete: Thank you and good morning everyone. We appreciate your time with us today. You should have a copy of the news release that details Graham`s financial results for the first quarter of fiscal 2009 that was released this morning. If not, you can obtain a copy from the website at www.graham-mfg.com. With me here today are Graham's President and CEO, Jim Lines, and Chief Financial Officer, Ron Hansen. Jim and Ron will provide their planned comments first and then we will open it up for questions.

As you are aware, we may make forward-looking statements both during the call and in the following question and answer period. These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from what we discuss here today. These risks and uncertainties are available for you in the press release itself, as well as with filings the company has made with the Securities and Exchange Commission.

With that, let me turn it over to Jim to begin the review and discussion. Jim.

Jim Lines: Thanks Tammy, and good morning everyone. As you have seen from our news release, we had a great first quarter to start off 2009. Sales were at a new quarterly record of $27.6 million and were 38% higher than last year's first quarter. The quarter was up 21%, sequentially from the fourth quarter of fiscal 2008. In addition, we surpassed all records of net income. Net income was $5.7 million in the quarter, which is more than double the first quarter of fiscal 2008, and earnings for the quarter were $1.11 per diluted share.

I would be remiss if I did not point out that this took a great deal of effort and teamwork by all of Graham's employees to successfully achieve these new levels. I congratulate our employees for a tremendous start to 2009.

Bookings in the first quarter were $27.8 million, a 12% increase. As you know, because of the magnitude of our orders, one quarter's results by product, industry and geography does not represent a trend. What is driving demand for our products is the continued expansion of the refinery, petrochemical and power generation industries.

We have a solid backlog that stood at $76 million at the end of the quarter. This provides sufficient visibility to give us confidence in our expectation of 15% to 20% top-line growth for this fiscal year. We continue to make progress on efforts to expand capacity in our engineering and manufacturing processes, primarily through new equipment, automation and technology. The investments made in operations, especially for new welding equipment, such as two new submerged arc machines and various, multi-process welding equipment have improved quality, weld deposition rates and increased capacity.

Investment in engineering is holding to our timelines. We subcontracted approximately 14% of our production hours in the first quarter and continue to expect that we will subcontract between 12% and 15% of our production in fiscal 2009. For the quarter, approximately 10% was subcontracted in North America and 4% in China. We are continuing to expand subcontracted fabrication in Asia, and there are orders and backlogs requiring fabrication in China and South Korea. North American subcontracting will continue to create added capacity as well. Our productivity enhancements and selective outsourcing, combined with the quality of the orders we shipped in the first quarter, led to the very strong gross margin of 44%.

We have raised our gross margin expectations for the year to 39% to 42%, with it being likely that we will be at the upper end of that range. That implies a more normalized margin of around 40% to 41% for the rest of the year. I am comfortable that, given our backlog, we can achieve this level on average. I believe we have proved that we can perform to our expectations. Nonetheless, the question in most peoples' minds is always, "where are we in the cycle," and, "for how long can Graham sustain this level of growth and these strong margins?"

I continue to believe our markets are strong and support continued organic growth. Industry reports, indications by customers, and our quotation activity all suggest tremendous opportunity remains for Graham products and services.

The refinery market outlook is strong. OPEC's 2008 World Oil Outlook recently released provides a great perspective for the coming several years. Hydrocarbon Processing's Box Score Report continues to add new refining and petrochemical projects each month. We are involved in a number of projects at various bidding stages that give us the belief that we can achieve our growth targets.

Examples include several major projects in India, Essar Oil, Mangalore Refining, Hindustan Petroleum, Oil and Natural Gas Corporation and IOCL. China has several planned refinery projects on the horizon: Sinopec Qilu, Sinochem Quanzhou, and Tianjin-Russia joint venture project, to name but a few. China has plans for 17 major investments in refining infrastructure over the next several years. Vietnam is planning significant refining investments. The Middle East continues to expand its refining infrastructure. Aramco and ConocoPhillips have a joint venture at Yambu, Aramco and Total have a joint venture at Ras Tanura in Saudi Arabia. KNPC in Kuwait has a massive project. Qatar Petroleum and Al Shaheen Refinery have a major investment underway. Each major project is for the refining sector and that will require several million dollars of Graham equipment.

We expect additional work in the U.S. for revamping existing refineries to diversify feedstocks, increase capacity, and improve bottom-of-the-barrel conversion. That will represent very nice opportunities for us. Significant investment in oil sands processing and upgrading is expected to take place in western Canada according to the Canadian Association of Petroleum Producers and Energy Resources Conservation Board of Alberta. Again, there will be several million dollars of opportunity for Graham-type products. We are continuing our watch of the power generating markets, particularly nuclear power generation. Petrochemical markets remain active as well.

We continue to win because we have earned a strong, well-respected brand, from the quality of our engineering and manufacturing, the level of service, and high degree of responsiveness we provide our customers and the reliability of the equipment we deliver.

Given the current outlook of our customers and the strength of the fundamentals of the industries we serve, we expect a solid continuation of growth through 2010. We believe our strategy to be a world class leader in the design and manufacture of engineered-to-order products for the process industries will derive further opportunities beyond that.

Let me turn it over to Ron.

Ron Hansen: Thank you Jim. Today we reported net sales of $27.6 million for the first quarter of fiscal 2009, a 38% increase over sales of $20 million in the first quarter of fiscal 2008.

After-market sales were particularly strong due to a couple of large capital spare orders for domestic refineries. Spare orders of this magnitude are infrequent. As a result of these large orders, after-market sales were $8.9 million, or 32.2% of total sales in the quarter. After-market profit margins are generally very good. We do expect that as our base of installed equipment continues to expand throughout the world, after-market sales will continue to grow as a percentage of our overall revenue.

Sales of condensers were also strong in the quarter at $5.8 million, or 21% of total sales, up from $3.8 million in the first quarter of fiscal 2008, while our ejector system sales dropped slightly, to $8.1 million, or 29% of total sales, compared with $10.5 million in the first quarter of fiscal 2008.

Domestic sales made up 67% of total sales in the quarter, while international sales were 33% of our sales. As we repeatedly mention, quarter-to-quarter fluctuations in sales by product classification or destination are expected, considering the size and timing of our orders, as well as the fact that we sell globally and can service all process markets. Orders were $27.8 million in the first quarter, a 12% increase, compared to the first quarter of fiscal 2008.

Orders for surface condensers for the refinery, petrochemical, and electrical power industries were strong in this quarter, representing 31% of total orders, compared with 14% in the same period the prior fiscal year. We had a strong quarter of international orders, which increased to 65% of total orders, compared with 18% in the same quarter last fiscal year. Again, quarter-to-quarter comparisons will vary. We do not believe these reported numbers represent trends.

At the end of the first quarter, backlog was $76 million, a 28% increase compared with backlog of $59.2 million at the end of the first quarter of fiscal 2008. We expect that 5% to 7% of this backlog will not be converted to sales over the next 12 months.

Gross margins were strong in the first quarter, at 44.2%, compared with 33.4% in the same quarter last fiscal year. The large after-market sales pushed gross margin higher in the quarter as a higher percent of the mix was weighted to higher margin sales. Additionally, our order selectivity and efficiency gains in engineering and manufacturing continue to contribute to profitability improvements.

SG&A expenses were $3.8 million, or 13.8% of sales, in the first quarter of fiscal 2009, up slightly on an absolute basis compared with $3.1 million in the first quarter of fiscal 2008 but down from 15.4% as a percentage of sales. Higher sales commissions and variable expense compensation costs were the primary reasons for increases in SG&A costs. Of importance, we continue to gain leverage on our SG&A expense as sales continue to grow.

Interest income was $131 thousand in the quarter compared with $230 thousand in the first quarter of fiscal 2008, primarily due to the fall in general interest rates. Concerned about the bond market, we adjusted our investment portfolio to 100% U.S. treasuries six months back. Last year, we were invested in U.S. sponsored agency notes, which yielded greater returns than U.S. treasuries. Our effective tax rate in the first quarter of fiscal 2009 was 33% and represents our estimated annual effective tax rate for fiscal 2009.

Net income in the current quarter was $5.7 million, more than double the net income of $2.7 million in the first quarter of fiscal 2008. Diluted EPS was $1.11 compared with $0.53 per diluted share in the first quarter of fiscal 2008. We ended the first quarter with approximately $45 million in cash and investments, up from $36.8 million at March 2008 and $19.3 million at June 30th 2007, one year ago.

We have a $30 million revolving bank line of credit, of which there were outstanding letters of credit of $8.9 million and no borrowings at the end of the quarter. Net cash provided by operating activities was $6.9 million in the first quarter of fiscal 2009 compared with $5 million in the same period the prior fiscal year. The increase was due to higher net income and our continued efforts to reduce our working capital requirements.

Capital expenditures were $219 thousand in the quarter, up from $163 thousand in the first quarter of last year. We believe cap ex spending will be in the $2.1 million range in fiscal 2009.

Finally, as many of you are aware, my retirement as Graham's CFO is effective today, so in addition to reviewing the operating and financial results for the quarter, I have some closing remarks I would like to share.

My 15 years at Graham have been a pleasure. I want to assure you that I believe I leave Graham in good hands. Our future looks extremely bright; business conditions are exceptional. As we have said before, our customers are telling us we have not seen busy yet. One accomplishment I am very proud of is that my departments are in excellent shape to carry on. They, as with all of Graham's departments, are rich in talent, with dedicated and experienced people. For Graham, I believe the best is yet to come. We have a strong three-year growth plan and the talent, financial resources, and business opportunities to reach our goals.

Jim Lines: Thank you, Ron. Operator, please open the line now for questions.

Operator: Thank you, ladies and gentlemen. Our first question comes from the line of Brandon Osten, with Venator.

Brandon Osten: Hi. Just a fantastic quarter. Congratulations. I guess the one thing I wanted to sort out is I'm trying to model the annual financial statements here. Based on your guidance, your normal seasonal patterns would be a really strong fourth quarter. So, is it fair to say that the second and third quarters are both going to average about $25 million a quarter, maybe weighted a little more towards the second quarter?

Jim Lines: Well, our guidance for the year for top-line is 15% to 20% growth, and we've had a $27.6 million first quarter. If there is seasonality in our business, it is our third quarter, which typically has a slight downturn in revenue.

Brandon Osten: Ok. From an earnings perspective, obviously you had that big jump in the first quarter. If I were to look at the earnings, is $1.10 the best quarterly earnings per share number you're going to throw out this year? Do you think you can get ahead of $1.10 given that you expect margins to be a little lower over the rest of the year?

Jim Lines: Again, from a guidance perspective, we have updated our gross margin guidance from the upper thirties, which was 37% to 40% gross margin to, now we're saying for the full year on average, 39% to 42% gross margin. We expect to drive the business hard. We're going to push this business to improve its performance, but we're sticking to our guidance that we've given thus far and will update you quarterly as we go forward, if there are improvements that we can make.

Operator: Our next question comes from the line of James Bank with Sidoti & Company.

James Bank: Hi. Good afternoon. Congratulations to you both. $1.10 in your first quarter, when you only did $0.89 two years ago for the full year of 2007, is quite an accomplishment. Really, not too many questions, the first being SG&A. To me with the sales you've put up, it seemed a bit light. Clearly, on an absolute dollar basis, it increased. But in terms of the profit-sharing plan, you have baked into your G&A and the selling expense. Did that just not impact you much in the first quarter or, Ron, is it the comment you made that the leverage you have on the SG&A is just coming into play here?

Ron Hansen: It's the latter.

James Bank: Ok. Fair enough. And with the new updated gross margin guidance, and with the comments you have made in terms of "you haven't seen busy yet", one would safely be able to assume that there's no reason why gross margins would fall from where you're anticipating in 2009? In fact, you might even be able to assume that they could improve.

Ron Hansen: Certainly, we're gaining. We're continuing to work on improving our leverage over our costs, both step variable and fixed variable, as well as a variable, and we're continuing to make good gains in improving the efficiencies in the company. I think we've said many times that we think we're probably only half way to the identified improvements we can make. We'll continue to work on order selection and gross profit. Our models call for continuing to grow the top line aggressively and continuing to improve earnings per share. So, as we see good orders out there, that's going to have good drop-down and give us good leverage. That's going to be more important to us than just continuing to try to drive up gross profit margins per se. For us, it's all about improving our earnings per share and continuing to get a better sales expansion globally and position ourselves better with our larger customer base.

James Bank: Right. Thank you, I appreciate that color. And lastly, on the after-market business, historically, and correct me if I'm wrong, that was a bit more lumpy than maybe your core business? But again, from your remarks, it seems as though it's stabilizing and/or you were able to get higher visibility on it and it's going to trend as long as your other core products are trending?

Ron Hansen: This particular quarter we had two large after-market orders, which were unusual for us. And after-market orders have a good profit built into the after-market business, so the overall rate helped the gross profit margins for this quarter to 44%, whereas Jim, for the year, is making reference to up to 42%.

As we continue, a large portion of our after-market business comes from our ejector sales, which have been strong for the last couple of years. We continue to think they're going to be strong to stronger going forward. But that's not our only product that has after-market business. The more we grow our sales and the more we grow particular products within our sales, the more installations we're going to get out there, which will lead to a continued growth in after-market business. Other areas that are taking place right now are refineries and businesses, because they're so busy. Where they can, they'll have a tendency to go in and repair and fix their processes to keep them going, versus brand new installations. So, we are also seeing a growth in our after-market business just because, in some cases, it's a quicker fix than a longer term fix.

James Bank: Ok. So still then, it will be slightly lumpy going forward. I just want to add, Ron, an individual congratulations to you and best of luck in your retirement.

Operator: Our next question comes from the line of Greg Garner, with Singular Research.

Greg Garner: Hello. First of all, congratulations on a fabulous quarter. My questions have primarily been addressed, but for some little clarity on some of the after-market orders, if you could characterize a more normal quarter for after-market orders in the first quarter, wouldn't it have been approximately $4 million less, about half of what was there? I'm just trying to get a feel for how much of a big boost this was for the first quarter versus what would have been, perhaps, a normalized view of it.

Jim Lines: If we look at our after-market business on an annualized basis, it has been between 16% and 18% of overall sales. I would project, going forward on a more normalized basis that will still hold true.

Greg Garner: Ok. And with all this cash built up, is there any sense on what might be a good use of this cash?

Jim Lines: Yes, right now we're accumulating cash. Of course, we can't help it with the amount of free cash flow our P&L is generating. But, to continue our growth, which is absolutely our plan, we'll need acquisitions and other business combinations going forward. We believe our balance sheet is under-leveraged. We believe it can take on more debt. With the cash that we're building up, we believe that we will be able to use our balance sheet strength and our cash to help continue to grow the business through acquisitions and other business combinations, which could include joint ventures or whatever makes sense as we go down the road.

You saw that we did have a stock split and a dividend increase announced, so we are certainly mindful of our shareholders. Additionally, while we're on this subject, let me just say that we did have additional shares authorized at the last annual meeting and our only plan for those shares at this time was the stock split that is now announced. We have no additional plans at this time for those shares. We wanted those shares approved so that we could get the need for authorized shares or the potential need for authorized shares announced at one time and not have to continue to go on. But we really have no specific plans for a share offering or anything that would dilute earnings for our shareholders. We're very sensitive to our shareholders and dilution. I think that's kind of a long-winded answer. In case I'm reading more into your question than the cash per se, we plan on acquisitions through cash.

Greg Garner: It's good to hear, because you're in a great cash generating mode right now. It's a nice problem to have, but it's something that needs to be addressed.

Jim Lines: Absolutely, we're absolutely 100% in line with what you're saying and to get to where we want to go organically, as well as other growth plans, it will require utilizing that cash. It's not just going to sit there.

Greg Garner: A quick follow-up on the previous question and your answer about the gross margin improvement, you've identified other improvements that you feel you're only half way to the total, the end game there. Would that correlate on a gross margin basis of a few percentage points in the coming years, given the same kind of mix in the sales, if that were the case?

Jim Lines: What we're looking at, Greg, to expand our capacity and improve our productivity are a number of strategies that are taking place in our operations in the plant, engineering, and the office to make better use of our infrastructure. There's greater demand than we have capacity across the business. We can't fulfill all the demand. Our strategy is to continue to grow the business, and as Ron appropriately said, continue to increase our earnings per share. That will come by increasing our productivity, becoming a more efficient company, a faster company. These are the strategies that we have in place, and we're executing well on to take greater advantage of the strong economy for our products right now.

The gross margin really will come down to the sales mix and, hopefully, we can improve the leverage across the infrastructure. We do expect, and we said this on the last call, to have very good quarters going forward. There may be quarters that are below the 44% or below the 42% gross margin that we spoke about earlier. Our objective is to drive the business, but not make decisions solely that center around optimizing gross margin. They will center around expanding our earnings and building sustainability into the business.

Greg Garner: Ok. Again, I appreciate that color and congratulations again, on a great quarter. Ron, I wish you the best in your retirement and thanks very much. The ship's in good shape.

Ron Hansen: Thanks very much Greg

Operator: Our next question comes from the line of Brandon Osten with Venator.

Brandon Osten: One quick follow-up. I know you have your total growth target on the basis of organic and acquisition, and you foresee a very good cycle for at least for the next three years, which is great. Could you give me a sense on the organic side? When you say the cycle's going to remain strong for three years, what kind of growth do you foresee over those three years from an organic standpoint? Is it a continuation of 20%? Is it more mid-teens? I'm trying to get a sense of what you characterize as strong organic growth.

Jim Lines: We expect a target-rich environment across our markets, as well as other markets we're looking to penetrate. The compound annual growth rate as you noted has been above 20% for the last 4 years. It's around 23%. I would expect going forward, aside from the fiscal 2009 guidance, which is 15% to 20%, top-line growth that is nearer to the mid teens.

Brandon Austin: Right. That's awesome. Thanks a lot.

Operator: There are no further questions. I would like to turn the call back to management for closing remarks.

Jim Lines: Thank you. Thank you for your questions and for listening to our earnings call. I am proud of the work our employees are doing to make Graham a better company. Our financial performance and the improvements to our operating statistics are from their commitment to put our customers first and to our continued success as a company. Our employees continue to concentrate on delivering solid financial results while staying focused on building toward a better future for the company.

Ron, I thank you for your years as a senior executive at Graham. Our company and I, personally, have been fortunate to have a financial executive of your calibre on the team. You have prepared the company well for your retirement. I wish you well for a long and healthy retirement.

Ron : Thank you very much, Jim.

Jim Lines: In closing, I continue to be optimistic about our future. We are executing well on our improvement and capacity expansion strategies. Our brand continues to become stronger, and we are using our engineering and manufacturing know-how to expand the market share and win in our markets. I look forward to updating you on the next quarter results. Thank you.