

**Operator:** Greetings and welcome to the Graham Corporation Second Quarter Fiscal Year 2014 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your help telephone keypad. As a reminder, this teleconference is being recorded. It is now my pleasure to introduce your host, Karen Howard, Investor Relations for Graham Corporation. Thank you, you may begin.

**Karen Howard:** Thank you, Christine, and good morning everyone. We appreciate your participation in our Second Quarter Fiscal 2014 Financial Results Conference Call. You should have a copy of the news detailing Graham's results that was released earlier this morning. We also have slides associated with the commentary that we're doing here today. If you do not have the release or the slides, you can find them at the Company's website at [www.graham—mfg.com](http://www.graham—mfg.com).

On the call with me today we have James Lines, our President and CEO; and Jeffrey Glajch our CFO. Jim and Jeff will review the results for the quarter as well as our outlook and then we will open up 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 here today. These risks and uncertainties and other factors are provided in the earnings release as well as with other documents filed by the Company with the Securities and Exchange Commission. You can find these documents on our website or at [www.sec.gov](http://www.sec.gov). And with that, I'm going to turn the call over to Jim to begin the discussion, Jim?

**Jim Lines:** Thank you, Karen, and thank you to everyone that joined our webcast review of our Second Quarter Fiscal 2014 results. Please refer to Slide 3. Our strategy across this expansion cycle in our market is to double revenue to exceed \$200 million at the next peak. We believe our focus on the energy markets with engineered-to-order, custom fabricated products and our commitment to the Naval Nuclear Propulsion Program will provide sufficient opportunity to realize this strategy. Our plans to accomplish this include: 1) leveraging our investment that expands Batavia's execution capacity to take greater market share in global refining and chemical/petrochemical markets; 2) capitalizing on our brand strength, installation record and relationships to have a leading market share for what is expected to be substantial investment in new chemical and petrochemical capacity in North America, driven by low cost natural gas; 3) leveraging our engineering know-how, custom fabrication expertise, and complex project management skills to provide equipment to both surface ship and submarine programs of the U.S. Navy; 4) expanding our presence in power generation markets, including nuclear, geothermal, biomass and other renewable energies; and also 5) driving both organic growth and acquisition growth by putting our exceptional balance sheet to work.

Please move on to Slide 4. We had solid execution in the second quarter and are positioned well at the midpoint of fiscal 2014. Our talented employees put forth a terrific effort. Second quarter sales were down 5%, or \$1.4 million, compared with last year. This was due to customer schedules and the level of bookings during the first three quarters of fiscal 2013. At midyear, sales are up 9%, or \$4.3 million, when compared with last year at this time. Net income in the quarter was flat at \$2.6 million, despite 5% lower sales. Improvement in market fundamentals led to a higher level of short cycle sales that were up approximately 20%. Additionally, higher quality backlog converted during this period. \$48 million in new orders in the quarter is tremendous, and indicative of improving market fundamentals. There was a nice balance of orders across our key end markets of refining, chemicals and petrochemicals, power and the Naval Nuclear Propulsion Program.

The pipeline of bidding activity remains elevated and we believe our global refining and petrochemical markets are in the early stages of recovery. \$800 million to \$1 billion is the range for trailing twelve month total bidding activity. We believe this is a positive leading indicator for the direction of future orders, subsequent backlog expansion and ultimately revenue growth.

Please refer to Slide 5. Sales for global refining markets were \$10.5 million in the quarter, up \$4.7 million. Backlog for Canadian new oil sands upgrader projects began to convert and there were several projects for North and South American refining revamps and replacement equipment that drove refinery sales expansion during the quarter. 58% of sales were domestic and 42% international. The Middle East, Asia, Canada, and South American regions continue to be important international markets for us.

It is important to point out that sales by market or geographic location can vary appreciably quarter to quarter. Always consider longer time periods when evaluating changes to sales mix.

I am going to pass it over to Jeff now for a more detailed review of the financial results. Jeff?

**Jeff Glajch:** Thank you, Jim, and good morning everyone. Starting on Slide 7, as Jim mentioned, we had a good earnings quarter and very strong order levels within the quarter, and despite slightly lower sales compared with the second quarter last year, the margin improvement kept our earnings flat. Q2 sales were \$24.5 million, down 5%, compared with \$25.9 million in last year's second quarter. As Jim mentioned, the sales split of 58% domestic and 42% international was comparable to last year's second quarter, which was 59% domestic and 41% international.

Gross margins were up 330 basis points, to 33.8%, as improvements in product mix and short cycle sales occurred. EBITDA margin was 18% for the quarter, up from 15% last year. Q2 net income and EPS were flat at \$2.6 million, and \$0.26, respectively.

Please turn to Slide 8. Looking at the business on a year-to-date basis, sales were \$52.7 million, up 9%, from \$48.4 million in the first half of last year. Gross profit increased 29%, to \$18.3 million. This was driven by a 550 basis point gain in gross margin which was favorably impacted by the higher sales level as well as the improved product mix. SG&A in the first half of the year was \$8.8 million, up 4%, compared with the first half of last year. EBITDA margin increased 620 basis points, to 20%, in the first half of fiscal 2014 driven by both the increase in gross profit margin as well as leveraging the SG&A costs. Net income in the first half of the year increased 60%, to \$6.4 million, up from \$4.0 million in the first half of last year. EPS was \$0.63, up from \$0.40.

On Slide 9, note that our cash position has increased \$3.2 million in the first half of the year to \$54.9 million. This is also an increase of \$8 million when compared with September of calendar year 2012. We continue to have a clean balance sheet with no bank debt. This allows us to focus on utilizing our cash and, if necessary, untapped lines of credit for internal growth opportunities as well as future acquisition opportunities.

Finally on Slide 10, as we initially discussed on our July call and finalized in our press release on September 24<sup>th</sup>, we are expanding our capacity at our Batavia, New York facility. This will increase the expected fiscal 2014 capital expenditures to \$6 million to \$7 million. To date in the first half of the year, our capital expenditures have only been \$900,000, so clearly we will be spending a lot more cash in the second half of the year. We expect the funding of this to come primarily from operating cash earned in the second half of the year, so we do not expect a significant change in our cash balance position,

positive or negative, over the next few quarters. The majority of the cost of this expansion project will be incurred in the second half of fiscal 2014, however, there will be some costs incurred at the start of fiscal 2015. As with the spending in the second half of this year, we expect operating cash flow to cover the costs which occur early in 2015.

When the expansion is completed in the first half of fiscal 2015, we expect the capacity of Batavia to increase by \$15 million to \$20 million. This will increase the capacity at full staffing of the Batavia site, including outsourcing, to \$150 million to \$170 million, up from our previous estimates of \$135 million to \$150 million. In addition, we believe our Lapeer, Michigan facility has an added capacity of \$40 million to \$50 million. The combined capacity will support our \$200 million organic growth target which Jim mentioned earlier.

Jim will complete our presentation and comment on our view for the rest of fiscal 2014, as well as an early top line view of fiscal 2015. Jim?

**Jim Lines:** Thank you, Jeff. I am now on Slide 12. Second quarter new orders were \$48.4 million, an 89% increase from the same period in fiscal 2013. And new orders expanded 48% sequentially. Trailing twelve month orders were \$131 million compared with \$109 million at the end of last quarter.

It is important to note that while total orders in the quarter were within our expected range, there was considerable variation looking at monthly order levels. The pace at which orders have been released is encouraging and supports our belief that market fundamentals continue to improve. Projecting the timing of order placement is becoming better, but still remains challenging. We are pleased to see good balance of orders across our key markets of refining, chemical and petrochemicals, Navy and power. U.S. markets continue to remain strong and represented 61% of total orders.

It was encouraging to have this level of bids in our \$800 million to \$1 billion trailing twelve month pipeline convert to orders. Bidding activity is holding, enthusiasm for North American chemical/petrochemical markets hasn't changed, and the inventory and quality of bids for international markets continues to improve. However, we don't expect order levels in the first six months at \$81 million to hold during the second half. This is a timing issue with the staging of the next large projects rather than a change in market fundamentals.

On to Slide 13. Backlog expanded approximately 26% sequentially, to \$114 million, as of September 30th. Backlog is distributed well across our key markets with 29% for refining markets, 27% for chemical/petrochemical markets, 14% for power generation and the remaining 30% for Naval work and our other markets. 70% to 75% of backlog is projected to convert over the next 12 months, 15% to 20% between 12 months and 24 months, and approximately 10% after 24 months. We expect our markets will continue to improve, although quarterly order levels will likely fluctuate.

Slide 14. We refined fiscal 2014 guidance now that there is clear understanding of conversion cycle for recently secured orders. Revenue range is tightened to \$100 million to \$110 million; gross margin is increased to 31% to 33%; SG&A increased to 16% to 17% of sales. This change, which is an upward change, isn't due to an increase in SG&A expense in absolute terms, but it is a result of a lower revenue level. And a tax rate of 33% to 34%.

It is early to frame fiscal 2015, however we do expect next year's revenue to fall between \$115 million and \$135 million, and the management team is developing plans and strategies to execute at that level.

Christine, please open the line for Q&A. Thank you.

**Operator:** Thank you. We will now be conducting a question-and-answer session. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions.

Thank you. Our first question comes from the line of Jason Ursaner of CJS Securities. Please proceed with your question.

**Jason Ursaner:** Good morning.

**Jim Lines:** Good morning, Jason.

**Jason Ursaner:** You mentioned more clarity on the conversion cycle. Can you talk a little bit about the timing of deliveries and what you expect for the second half versus the orders you're receiving and the reduction in the high end of the revenue guidance?

**Jim Lines:** Sure, if we look at our current guidance and take the midpoint of that, which would be \$105 million, it basically suggests that the second half revenue level is comparable to the first half. And, that's not necessarily due to our execution capacity but more due to our ability to get projects released into the plant tied to customer timing and finalizing engineering design between us and our customer. That gives a more realistic view one quarter later from when we talked about this last call. We now have a better understanding of how these orders will flow through engineering, and ultimately when our customers will release us to begin fabrication. And, again, that reflects a fairly similar, if you take the midpoint of the guidance, revenue level in the second half as we experienced in the first half.

**Jason Ursaner:** Okay. And, can you provide an update on the outsourcing that you plan to do because the orders are bunched up? And, what type of margin impact that might have?

**Jim Lines:** Again, working within our guidance, I think it gives an ability to frame what the second half gross margin would look like on that similar revenue level to the first half. We are doing more outsourcing in the second half than we did in the first half, tied to the way the orders came in and our delivery schedules were bunching up. That does have a margin compression impact on it, however, within our guidance that we've given, you can see that we've upped our overall gross margin guidance from where it was at the last call. It went up from 29% to 31% to 31% to 33%.

**Jason Ursaner:** Is that more due to internal efficiency though? Or, that you are getting better terms on the outsourcing?

**Jim Lines:** I think it's a reflection of a couple things. One is the market fundamentals continue to improve, pointing to perhaps an improvement in pricing and, also I believe our operations continue to improve.

**Jason Ursaner:** Okay, I appreciate that. Thanks.

**Jim Lines:** Thank you, Jason.

**Operator:** Our next question comes from the line of Paul Dirks with William Blair. Please proceed with your question.

**Paul Dirks:** Good morning, Jim and Jeff.

**Jim Lines:** Good morning, Paul.

**Jeff Glajch:** Hi, Paul.

**Paul Dirks:** So, a couple questions if I may. First, to tack on to that last question, with regards to your gross margin outlook for the rest of fiscal '14, how should we think about your expectation for short cycle orders over the balance of this fiscal year and into next year? Is there an expectation that they will continue to be robust and that they can help offset any of these dilutive impacts from outsourcing and timing of backlog execution?

**Jim Lines:** Sure, there is a counter balancing of that as we go into the remainder of this year. If I would have characterized where we view our short cycle sales, comparatively to a year ago, first quarter and second quarter, we're roughly 20% up in terms of the revenue level. We are expecting that to hold as we work through the rest of this year, for the short cycle sales, and that does counter balance, to an extent, some of the margin compression we realized through outsourcing. But, we are seeing a materially different outlook on our short cycle work as we've been able to experience this first half of the year, which is up about 20% year-on-year.

**Paul Dirks:** Okay, that's certainly helpful. Now, regarding the recent announcement confirming for the increase in your capital investment in Batavia, how confident are you at this point in the cycle that you'll be able to fill the new capacity with the kind of high quality, high margin work that could be out there, coming from North America especially? And, are you taking new orders for the additional capacity now?

**Jim Lines:** Two questions there. We had a decision to make. We were going to become potentially capacity limited because our lead time reduction strategies could not release capacity in alignment with how order rates were coming in. We had a decision to make at this juncture, which was do we manage this cycle as we did last cycle, which was simply take the best of the orders and underserve the market, underserve our customers? Or, because of our perspective on the outlook, the clarity that we had into our bidding pipeline, we could make this investment to take greater share, to be the supplier our customers are expecting us to be. And, because of our conviction over the next several years of how market fundamentals are playing out, we chose to make this investment and we are selling into that expanded capacity right now.

**Paul Dirks:** Okay, that's certainly encouraging. One more question related to that expansion. Does this have, in any way, an impact or perhaps push out the timing of some of your evaluation as far as making additional acquisitions? Should we think at all about the Batavia expansion, perhaps, putting some of those plans off to the side for a little while?

**Jim Lines:** I would characterize it this way and then I might turn it over to Jeff for a fuller response. If we look at the aspects of our acquisition program that would have related to addressing our core markets, I would say that the capex that we're putting into Batavia addresses that aspect of it, which wasn't necessarily a diversification investment, it was to capitalize through an acquisition on the strong fundamentals we were perceiving in our market place. I think we've addressed that with the capex that we're putting into Batavia operations to drive our core business expansion. Around diversification and the strategic objective there, I'll turn it over to Jeff to maybe offer a response on the acquisition program.

**Jeff Glajch:** Paul, if you think about our acquisition process, one of the things that we have done is cast a fairly wide net around the areas that we're looking at. So, we've looked at product diversification and we've looked at market diversification. Certainly one of those areas can also be looking at the incremental capacity or serving our existing customer base. So, as Jim mentioned, we think we've hit that by investing internally. But there are many other avenues for our acquisition program to go down, and this capacity expansion, we believe, was the most efficient and least risky avenue to take advantage of within our existing markets given the strength of the North American business today. But, we clearly have many other avenues to look at for acquisitions. So, I think the summary answer to your initial question is no, it really does not affect our acquisition program other than in that one avenue.

**Paul Dirks:** Very well, I appreciate the call. Thanks guys.

**Jim Lines:** You're welcome, and thank you.

**Operator:** As a reminder ladies and gentlemen, if you would like to ask a question press star, one on your telephone key pad. Our next question comes from the line of Joe Mondillo with Sidoti & Co. Please proceed with your question.

**Joe Mondillo:** Good morning, guys.

**Jim Lines:** Good morning, Joe.

**Joe Mondillo:** I was wondering, in terms of gross margin, is there any difference amongst different geographies or different end markets in terms of gross margin, generally?

**Jim Lines:** Yes, that's a very insightful question. If we look at what's driven our bookings growth, it's one of our core product lines, which are surface condensers. And, if we think about margin profile across our different products, we have spoken in the past about the injector product line in general has a higher margin potential than does surface condensers, and vacuum pump packages has a lower margin potential than either of those two. So, from a product point of view, the margin potential of a surface condenser order is a little different from injectors, primarily because it has a higher labor content than injector systems do, so, therefore, the impact on COGS changes a little bit with that particular product. So, from a product point of view, that gives an idea of margin potential with what's been driving the bookings pattern.

On a geographic perspective, North America, and I would argue the Middle East, are fairly comparable in terms of margin potential. Where we move into the other international markets of Asia, China, or South America, the margin potential can be less than the Middle East or North America.

**Joe Mondillo:** Okay. So, having said that, does that have anything to do with the product mix that you're getting in the back half after the year? Just trying to understand a little bit more on the product mix shift from the first half of the year to the second half.

**Jim Lines:** Well, the product mix in the second half of this year relates to orders that were secured in 2013 to a large degree, except for the short cycle work. I'm going to answer it this way. The margin that's being relieved through backlog and reflective in sales, if we think about the surface condenser product line, we're replenishing that backlog with higher margin work. However, the second half versus the first half relates to orders that were secured in 2013, which was a different market environment and a different pace for orders being released and, therefore, pricing was different.

**Joe Mondillo:** Okay. So, it's a higher mix of condensers versus maybe injectors in the back half of the year.

**Jim Lines:** Yes.

**Joe Mondillo:** Okay. And then, in terms of the backlog, the backlog beyond 12 months has, in the last two quarters, started to jump up quite a bit. Are customers starting to make orders much sooner in advance? And, as a result, are you seeing any upside in pricing because of that?

**Jim Lines:** The elongation of our backlog has two aspects to it. You identified one, Joe, which was that in some cases we had received orders in the June timeframe and in our second quarter that were ahead of when we ordinarily would have gotten those orders because our customers are recognizing the supply chain is starting to tighten up. The critical equipment suppliers, and we are one of them, are beginning to have their backlog expand. So, they wanted to lock down those critical suppliers, such as Graham, earlier and the delivery dates, therefore, are extended for when they actually need the equipment, but they want to get the engineering and secure the supplier they want. So, that has an aspect of taking what had been a normal cycle of around twelve months, from order to shipment for these large orders, to maybe 15 months to 18 months depending upon the particular project. And then secondarily, we have secured some additional Navy work and that tends to have a longer cycle.

**Joe Mondillo:** Okay. So, in terms of your first comment regarding maybe capacity tightening up around the industry, is it fair to say that the work that you're receiving today and the work that you received in the second quarter is much better margin than you've seen in the past?

**Jim Lines:** As a high level remark, if I look at a year-on-year comparison or just reflecting on what was relieved from our backlog reflected in our sales gross margin versus what went into backlog with new orders, the margins in general are better.

**Joe Mondillo:** Okay. And then, the backlog in the other commercial and industrial, that jumped up quite a bit. I was just wondering what the driver there was.

**Jim Lines:** Well, what goes into that category is our other markets, which include edible oils, pharmaceutical, industrial, HV/AC and Navy work.

**Joe Mondillo:** So, it's just a combination.

**Jim Lines:** As I mentioned, we did secure some additional work last quarter and the quarter before that is for the U.S. Navy vessels.

**Joe Mondillo:** Okay. And then lastly, the capacity expansion. I think you said in the past that you had capacity at Batavia, correct me if I'm wrong, of around \$125 million. So, I was just wondering where this expansion would bring the up-side of your capacity, following the expansion.

**Jeff Glajch:** Joe, this is Jeff. We have historically said that it is about \$135 million to \$150 million here in Batavia and that would include kind of a normal level of outsourcing. So that is engineering capacity as well as fabrication capacity. We believe, with this expansion, we have taken that \$135 million to \$150 million up to \$150 million to \$170 million.

**Joe Mondillo:** Okay. So, in your decision-making in terms of this project, essentially you've seen where the market is progressing, the increased demand, and you guys obviously have an idea or a feeling that you're going to have to get to this. You're going to see \$150 million to \$170 million at some point in the near future, in the next couple of years. Is that fair to say?

**Jeff Glajch:** Joe, I think that's fair and I think that, if you think about it from an economic analysis standpoint, the way I looked at this was the funding of this capital obviously needed to be justified economically. And, so to get to that additional volume was something we certainly couldn't invest today and expect it to take a long time to get there, otherwise the math doesn't work. So, yes, we do believe that it is in our future.

**Joe Mondillo:** And lastly, does this at all take away from any of the outsourcing that you'll have to do? And, if so, will that increase your profitability in some projects?

**Jim Lines:** Ideally, exactly correct. We plan to continue to have an outsourcing strategy, however, not have it be to the degree that we had to outsource because of the burst of business we saw June through this last quarter. So, we plan, over time, to continue to have that relief valve of outsourcing but do less of it than we have to do because of how orders came in in the second quarter and end of the first quarter.

**Joe Mondillo:** So, you've always talked about how this cycle you think gross margins could be in the high 30s. Could that maybe put a little upside to that?

**Jim Lines:** I believe it still reflects that general view of mid to upper 30s for gross margin as we move to the peak of the cycle.

**Joe Mondillo:** Okay, great. Thanks a lot.

**Jim Lines:** You're welcome, Joe.

**Operator:** Our next question comes from the line of Dick Ryan of Dougherty & Company. Please proceed with your question.

**Dick Ryan:** Thank you. Let's say, Jim, moving off the core business, can you talk a little bit about what's going on at Energy Steel and the nuclear side and the power side as well as overall?

**Jim Lines:** Sure. If we do a look back over the last 12 months to 15 months, we did experience a subdued order environment that had two catalysts. One was Fukushima. Secondly, was the potential change, which seems to be real, in the energy mix of low cost natural gas, and, therefore, driving toward more combined cycle power plants for incremental capacity versus what had been thought to have been fulfilled by new nuclear. We have seen our customers pull back and evaluate which direction the markets are going, and that was what we were seeing the last 12 months to 15 months.

If I look forward, I'm far more encouraged by what we're seeing in our bid pipeline and the opportunities and the changes that were implemented by the management of Energy Steel to go after expanding the addressable opportunity set and go after it more aggressively. As we go forward, I'm more encouraged than if I think about the last 12 months to 15 months with Energy Steel, in particular.



And, as we look at the power market as a whole, beyond nuclear to the renewable side, I think here, too, low cost natural gas has changed the fundamentals of tax credits that were around biomass to energy. We feel there will still be some of that work in North America, but the tax incentives are changing and the investment pace has changed somewhat.

Moving beyond that to geothermal, we see a lot of geothermal power bidding activity, which is in our pipeline, in North America, Central America and Southeast Asia. Those have a pace that can be unpredictable. They're nice projects when they do materialize, but what's good is we have a pretty large array of opportunities that we have in our bid pipeline. So in general, we see our power segment, I would say, picking up from where it had been the last 12 months to 15 months and lifting off of what I would characterize as what had been a bookings bottom.

**Dick Ryan:** With the expansion of the opportunities such as you talked about, is that taking the Energy Steel capabilities internationally? Or, does it have more to do with seeing some of the increasing safety issues as a result of Fukushima coming through?

**Jim Lines:** I think it's the latter and it's principally centered around North America. Not that we've lost sight of international work, but my commentary really reflected a more positive outlook that we have today in our North American nuclear markets than we had around 12 months ago.

**Dick Ryan:** Okay, good. Thank you.

**Jim Lines:** You're welcome.

**Operator:** Thank you. Ladies and gentlemen, due to time constraints, we have reached the end of the question-and-answer session. I would now like to turn the floor back over to Mr. Lines for closing comments.

**Jim Lines:** Thank you, Christine. We appreciate your time this morning and your interest in the direction of Graham. As you can see, we're very enthused about the level of order activity. We recognize the second half of fiscal 2014 reflects the order patterns in 2013, but the real story here is beyond 2014 and as we grow into 2015 and 2016. And, we're very encouraged by the degree of bidding opportunities that we see throughout our pipeline across all of our markets. We'll update you on our progress on the January call. Thank you again for your time.

**Operator:** Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.

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