Graham Corporation
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GRAHAM
ENGINEERING ANSWERS

NYSE MKT: GHM

Jefferies Analyst: Good morning. Welcome to the 10th Jefferies Global Industrial Conference. We are pleased to welcome Graham Corporation's CEO James Lines and CFO Jeffery Glajch.

James, please go ahead.

Jim Lines: Thank you, good morning and welcome. We will make forward-looking statements and I would just ask you to familiarize yourself with the risks associated with those statements. Graham is traded on the NYSE under the ticker GHM. Our current market cap is about $300 million; we have 10 million shares outstanding, roughly 75% of which are held by institutions; and we do have a $0.16 per share, per year dividend. When we speak throughout this presentation, note that our fiscal year ends on March 31, so we are now in fiscal year 2015.

Our near-term goal is to grow our business from its current level of $100 million of revenue to $200 million of revenue, while focusing on what we do best, which is engineered-to-order products that are custom fabricated and serve principally the energy markets. We've had a successful track record with the current management team that has been in place since fiscal 2006. Across this period of time, we've had a top line CAGR of 11% and net income has expanded more appreciably than that across the cycle.

As our markets do become active and there is a lot of buying activity, we have seen our growth rate year-on-year be in the 20% range and our EBITDA margins in the mid-20% range. We generate strong cash flow. From 2006 to present, 90% of our net income went to our balance sheet, and we do have a debt free balance sheet. Our priorities for capital allocation are around growth, whether that would be organic growth or growth to diversify or expand our business via acquisitions. Secondarily would be increases in dividends and share repurchases.

This graphic shows the transition of Graham from historically serving two key markets; oil refining and petrochemicals or chemicals, which for much of our history represented about three quarters of our sales mix. As we've begun to diversify/expand our opportunities in power and Navy and other markets, we've seen our sales mix to be more balanced and, as we go forward and grow our business further to the $200 million, we have a pretty well balanced portfolio across four key markets: refining, petrochemical, defense or Navy and power generation. Acquisitions, of course, provide another level of diversification or shifting of the percentages in the pie charts.

This graphic gives a very clear indication of the transformation of Graham over the last 7 to 10 years. Historically, Graham was characterized as an industrial company that had net margins in the mid-to-upper single-digits at the top of the cycle and we would break-even or lose a little bit of money at the bottom of the cycle.

With the management team that's in place now and their focus on productivity and process improvement, we've shifted the profit profile of the business to, at the bottom of the cycle, have net margins in the upper single-digits, low double-digits and, at top of the cycle, approaching 15% to 20% net margin. The team has done a fantastic job in a short period of time to transform our business to a far more profitable company, while we've grown the business.

We spoke about our key markets. There's ample opportunity to fuel our growth. Much of our growth is around taking share. We are a business that is in demand, our products are in

demand, and we've been working on expanding our execution capacity so we can take the share that's available to us. The refining market presents annually about $150 million to $200 million of opportunity, and petrochemical $80 million to $100 million of opportunity per year.

In the power market, we are focused on the existing U.S. nuclear utilities and the MRO strategies there, and that's a diversification strategy, as is our Naval Nuclear Propulsion programs strategy, which is to become a consistent supplier to surface ships, primarily the carriers, along with the two submarine programs. As you can see, there is a pretty appreciable content per vessel for Graham, with carriers at $35 million to $40 million per carrier, one sub class at $15 million to $20 million and the second sub class at $20 million to $25 million of opportunity per vessel.

As I said at the onset, we are focused on engineered-to-order products that are custom fabricated. That's what we do extraordinarily well. That's where we differentiate ourselves from most of our competitors and many other industrials. Where we serve our customers is when the application is critical, performance is paramount, and failure of our product to perform as specified has dramatic consequences to the user. That invariably creates a very long sales cycle, where we have a very effective platform to serve our customers and create a lot of value before the order is placed. We bring our process know-how, our familiarity with how to integrate our products into their processes and, ultimately, allow the customer to meet their operating objectives. This is where we differentiate.

An important distinction on the pie chart also, which should be brought to mind, is we have a very high percentage of the work that we do that's aftermarket now. In our past, about a decade ago, about 15% to 18% of our sales were for aftermarket, with our focus on growing this more predictable segment of our business. It's now about 30% of our sales and it gives us an improved level of stability up cycle, down cycle and throughout the cycle.

I mentioned the long sales cycle, and this is very important, because we believe this is where the money is made; this is where the margin is garnered; this is where the value is created for our customer and created for ourselves. We may be involved in these projects one-year, two years, sometimes three-years before an order is placed with us. We want that. We want early involvement. That's where we shine. That's where we have a very effective platform to provide our services to our customer. Even though they are not paying us, we are creating that differentiation. We are creating that close relationship with the decision-makers. Ultimately, we are positioning ourselves to win with one of three outcomes: we win; or we improve our margin and win; or we're in a position to say no thank you, that's not the right order for us right now.

As we think about our growth and how we are going to grow from $100 million today to $200 million, we've built the very robust pipeline of bids that's double the size that it was at the start of the last cycle in the mid-2000s. A bid pipeline back then was about $400 million of opportunities. Today, it's about $800 million to $1 billion of opportunities and that gives us confidence about the market demand and our opportunity to grow our business across the cycle. And that $800 million number excludes any bids we are providing to the Navy, which can be quite appreciable.

So, we think the pipeline is set up to support our expectations of growing our business. We do have, at this point in time, our record backlog of just under $115 million. You can see that it's been fairly steady, but with a step up in the last few quarters of about 20%, from roughly $90 million to $115 million. It's important to bear in mind a couple of things here. One is that one-third of our

current backlog includes work for the Navy and includes work from the nuclear power markets. These two markets were not markets that our company served back in 2009, 2008, 2007 and earlier, so our diversification strategies have taken hold and have had a meaningful impact.

And you can see that the market mix for our backlog is pretty well distributed, roughly one-fourth, one-fourth, one-fourth across our key markets. And importantly and as a management tool, we have fantastic visibility with our backlog. About 75% of our backlog converts over the next 12-months, another 15% to 20% converts in year number two and 5% to 10% after two years out. If you think about our selling process giving us about one year visibility into the pipeline, one year longer visibility for our backlog, it's a fantastic management tool to have highly credible views of where our business is going.

This graphic again shows the transition of our business across an expansion cycle which was 2006 through 2009, where we had a top line CAGR of about 25% and very strong profitability with EBITDA margins eclipsing 25% to 27% and gross margins eclipsing 40%. During the last three or four years, arguably, we've been bouncing across the bottom of the cycle. Structural downturns as we've just experienced are difficult sometimes to come out of with high velocity, but I do think we're at a point now where we've hit the inflection point with our backlog, with the pipeline we have, the expectation of bookings, for strong growth as we bounce off what we see here as a bottom. And even at the bottom, though, we've had respectable gross margin and strong EBITDA margins of upper teens.

For our first quarter, we had fairly flat sales. We did have a very tough comp. Our gross margin and our EPS and EBITDA margins were down on a relative basis compared with a year ago because of mix. We had a very strong percentage of our sales one year ago that was aftermarket and, as you can imagine, aftermarket typically has a higher margin potential. We did have a very tough comp; however, we came in line with what our expectations were for the quarter with respect to revenue, margins and net income. As we go through the year and as you look at our guidance slide, we are expecting these margins to begin to improve progressively.

Our balance sheet is extremely strong. We have $60+ million in cash. Operating working capital is just under 10% of sales for the trailing 12-months. Capital expenditures have stepped up. Historically, we've typically spent around 1 to 1.5 times depreciation, with depreciation now being about $2 million. To fund our growth expectations, we have had a higher CapEx this past year, as well as the current year, but, other than that, we tend to think of our capital plan for expansion, or CapEx, to be in the 1% to 1.5% of sales range ordinarily.

Our guidance for fiscal 2015, the year we're currently in, is for revenue to expand between 17% to 27% to fall between $120 million to $130 million, up from $102 million; gross margins in the 30% to 32% range; SG&A at 15% to 16% of sales; and an effective tax rate of 33% to 34%, showing both very appreciable top line and bottom line growth year-on-year.

Our strategy for how we are going to go from the $100 million that we're at today to doubling our business is multifaceted. We have been investing the last four years, while we were in the downturn, to ready our business for the projected growth. We've invested in our facilities through our capital expenditure plans. We've invested in our infrastructure, our people and our IT to support growth.

We have the execution capacity in place now that's about 1.5 to 1.75 times greater than it was

three years or four years ago. We are not a market-limited business. We have been an execution-limited company and the management team has worked very intelligently to resolve the execution constraints. It’s a great place to be.

In terms of being a value-based provider of our services, we are focused on improving the service to our customers, moving and advancing our on-time delivery, which each year has improved for all of our products, large and small, while we have been reducing lead times.

Focusing on quality and driving errors out of the business, investing and leveraging information technology, so the managers and their employees have the information they need, when they need it, and our performance management process to drive our employees in support of our corporate goals and that’s been a very effective unlocking of the potential of our employees. And as a management team, we are focused on sustained long-term growth and improving the profitability of our business, while reducing earnings volatility, generating, of course, strong cash flow from operations and, ultimately in the end, staying very focused on serving our customers.

Organically, the organic component of our growth strategy is all around taking market share, entering the submarine programs that we’ve spoken about a moment ago, securing our position with the Naval programs in general, taking market share internationally in our refining and petrochem markets, capitalizing on the strong investment that’s occurring in North America, driven by low cost natural gas and new petrochemical facilities. That’s enabled us to have a very strong share in the last 12-months of the work that has been awarded.

Around acquisitions, putting our money to work, we are focused on ways in which we can leverage our sales channel, we have a very effective sales channel, consolidate our supplier base or competitor base, expand execution scale, expand into advantaged regions where the growth rate might be higher than a global growth rate.

And our balance sheet, as I have mentioned a couple times, is in great shape. The dry powder there are $61 million of cash, a credit facility that is currently $25 million, with an accordion future of another $25 million, and currently a debt-free balance sheet.

Around acquisitions, we are going to stick with our knitting, sticking with engineered-to-order products that are custom fabricated, primarily serving the energy industry or closely adjacent industries that require the same type of operating or selling model. We are looking for businesses that have a strong management team, strong brand, a commitment to the customer, long-term focus on growing the business and serving customers up cycle, down cycle, throughout the cycle, and a management that desires to stay with us to help us grow their business together. The revenue size that we have been looking at is typically between $20 million and $60 million for an acquisition target. We have and will look above that and we have and will look below that, but that’s the range in which we are looking right now. And most importantly, as we look through the acquisition candidates, we are not in a hurry to do something that is simply accretive to earnings. The acquisition has to surpass our internal hurdle rates for returns on capital, which are in the mid-to-upper teens as we think about that.

We are also just not focused on quickly growing earnings accretively, but on ensuring we are good stewards of our capital. We spoke about this in the ways in which we would think about an acquisition, around leveraging our sales channel, entering new markets, operational scale that goes across all of our key markets, so these are part of the metrics of how we are looking at

acquisition targets. And just in summary, as I think about where Graham is today, I think we are uniquely positioned to take advantage of a strong global investment period over the longer period of time here in the energy markets and adjacent markets and we've done the right things the last three or four years to ready our business to capitalize on this.

I am very committed, as is the management team, to realizing our doubling of the business. We have an exceptionally strong brand. We are who the market wants. As I mentioned earlier, it hasn't been about market limitations; it's been about execution limitations and our management team has been addressing that. We are a strong industrial company. We believe we perform in the upper quartile with respect to our growth rates, as well as our profitability, and we view Graham as a very sound investment, as you think about our company and you think about where we are and the opportunities as Graham goes forward.

With that, Jeff and I would be happy to answer whatever questions you might have. Any questions for us?

Q&A

Q: As you look around the world, what specific countries would you say are most attractive at the moment and going forward for a company like Graham in terms of international expansion?

Jim Lines: In terms of international expansion, we would think of Asia, in particular, which has a very strong growth trajectory in refining and petrochem. China has a very well documented investment plan to expand through capacity. Also, in South America, there are some very strong investment programs for the state-owned refiners. The challenge there is predicting the timing of when they are actually going to spend the money. But, we're thinking of Asia, Middle East and South America as strong areas for refining and petrochem growth and where an operational footprint might make sense.

Q: I have a question about your 2015 revenue build. I think you said in backlog about 70% or so converts over the year. I was just thinking through, if you have a very long sales cycle, it looks like you have about $80 million coming from backlog into 2015 revenue. Can you talk about where the remaining $45 million will come from to achieve your guidance?

Jim Lines: Sure. That comment that I made around the 70% and 75% is for the next 12-months. There are only roughly nine-months left in fiscal 2015. We've segmented our business a couple of ways: one is large project work, which has a long conversion cycle and that's generally about two-thirds of our sales mix, and then, we have short-cycle work, which typically comes in and out in one quarter and that's about one-third of our sales. So partly, we need to make up some of the remainder from that short-cycle business. At this point, the backlog for the large work that we called the major work is sufficiently in-house now to support the $120 million to $130 million. There is little time now for new orders to be won and we are on percentage of completion to contribute appreciably to revenue in 2015, but it's that backlog we have and our ability to pull that forward and our short-cycle work that give us the confidence of landing between the $120 million and $130 million.

Q: And where does the aftermarket fit in?

Jim Lines: It fits generally into that short-cycle, although, at times, we do get very large

aftermarket orders that could be $1 million or $2 million. We have one now in our backlog that's $5 million and that tends to have a larger conversion cycle than in and out in one quarter.

Any other questions? We have about a minute and a half left.

Q - Jefferies Analyst: If there is no question on the floor, I have one. Nearly three quarters of your sales actually come from oil refineries and petrochem, right? And most of your growth has been from taking market shares, right? Can you just give us a sense of where the underlying core growth in these markets are, how they are running right now, because we have heard some companies talking about a slowdown in oil refining maintenance. Can you confirm that or would it be otherwise?

Jim Lines: As we think about oil refining, there are four drivers of demand for Graham. One simply is new capacity. That's more of an international requirement. We are seeing investments. We are doing bid work right now for the Middle East, for South America and for Asia that we would classify as new capacity. We're not really seeing that abating at all; we're actually seeing that begin to pickup.

The second driver is around feedstock diversification, trying to take advantage of lower cost crude oils, which could come from South America or heavy, poor quality crudes. That's really not an expansion, that's taking advantage of the lower cost feedstock, but that has a similar importance to us as new capacity. That's been something that we've been benefited by for the last 20 years, as different refiners have taken advantage of lower cost feedstock, which creates great demand for us.

The third driver is government regulations for lower polluting transportation fuels. We did have a press release this morning for a North American refining order that we received, which is around cleaner transportation fuels, ultra low sulfur diesel. That's a third driver.

And, the fourth driver is that refining is a nasty environment; it's corrosive, erosive. Our equipment lasts a long time, but we have a very rich installed base, having been in business for eighty years almost. And about a third of our aftermarket is in some way associated with refining. We've never seen that really back off, so the MRO work in the refining sector, as it would relate to Graham, we have actually seen that step up in the last decade and not really drop off in the near-term.

Thank you for your time. Thank you for your interest and thanks for the questions.