Graham Corporation
Third Quarter Fiscal 2010 Quarterly Results
Teleconference and Webcast
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Operator: Greetings, and welcome to the Graham Corporation Third Quarter 2010 Quarterly Results Conference Call. It is now my pleasure to introduce your host, Ms. Deborah Pawlowski, Investor Relations, for Graham Corporation. Thank you, Ms. Pawlowski. You may begin.

Deborah Pawlowski: Thank you, and good morning, everyone. We appreciate your joining us today on Graham's Fiscal 2010 Third Quarter Financial Results call. On the call with me today are Jim Lines, President and CEO of Graham, and Jeff Glajch, Chief Financial Officer. Jim will briefly review the third quarter's performance and will discuss the Company's strategy and outlook as well as his perspective on the state of the industries we serve while Jeff will be reviewing the Company's performance in the recent quarter and first nine months of the fiscal year. You should have a copy of the earnings release that was put out this morning, and if not, you can access it at the Company's website, which is *www.graham-mfg.com*. In addition, we have posted supplemental slides on the website to provide a visual overview of our results.

As you are aware, we may make some forward-looking statements during the formal discussion as well as during the Q&A. 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 from what was stated here today. These risks and uncertainties and other factors are provided in the earnings release as well as other documents filed by the Company with the Securities and Exchange Commission. These documents can be found both at the Company's website and at *www.sec.gov*.

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

Jim Lines: Thank you, Debbie, and good morning, everyone. I will review highlights for the quarter, touch on full fiscal year 2010 expectations, discuss the current market environment, and our outlook. Although it is early yet to frame up fiscal 2011, I will also provide a few remarks about what we expect. Jeff will provide details on the quarter and for the full year.

The third quarter surpassed my expectations for profitability. I cannot say enough about the fine work our team did to control costs, operate at a high level of productivity, and execute. We continue to experience a dismal environment in our markets and, from a sales standpoint, our third quarter, and we believe the next three quarters, represent the bottom of this downturn for the Company. Despite a 50% reduction in sales compared with one year ago, we continued to meet our commitment of remaining profitable and generating operating cash flow each quarter. We achieved $0.08 per share on $12.2 million in revenue and, all things considered, it represented good control over costs and excellent execution.

Our full-year guidance for fiscal 2010 is revenue between $60 million and $63 million, gross margin in the range of 34% to 36%, and SG&A around $12 million. To achieve the upper range for revenue and gross margin, a few things will have to work in our favor, including some assistance from our customers to release engineering during the quarter so we can begin production and no slippage on delivery dates for orders in production. It has been a struggle since the downturn took hold to finalize engineering with our customers for major orders and then release the work into production.

Secondly, we need to book $2 million to $2.5 million of small orders that convert to shipments in the quarter. We have seen a drop-off in this segment of our business during the past year. However, January is off to a good start, and our sales group is working hard to win this type of work. Also, we need to continue to control expenses as we have since the abrupt change occurred in our markets.

Lastly, we must sustain strong execution in all aspects of our business. Given the commitment that we have from our employees and the keen focus on execution by our managers, I have little doubt this will occur.

We did have excellent bookings in these past two quarters, with the third quarter in excess of $50 million and the second just under $30 million. Sales and application engineering continually assess the opportunities in the pipeline, and with aggressive focus, they are active and on top of opportunities that are closing. Importantly, our capture rate during the past two quarters was exceptionally high. As a result, our backlog is a record $89.8 million and is a multi-year backlog. The backlog is planned to convert to sales in this way: 50% over the next 12 months, another 10% to 15% converts by the end of fiscal 2011, with the remaining 35% to 40% divided fairly evenly across fiscal years 2012 and 2013.

There has been a renewed vitality in our markets of late, specifically, in the emerging economies in Asia, the Middle East, and in South America. We aren't expecting the North American markets to recover for several more quarters. As a result, our sales mix for refining and petrochemical markets will continue to be weighted more heavily toward international markets. There is intense competition for the work that is available, and the combination of the competitive environment and the geographic base of the projects is beginning to put pressure on pricing. Of course, the impact on margins of the geographic mix was not unexpected, and increased competition is expected during a cyclical contraction, as we're seeing. We believe we have established strong defenses to hold our leading market position, support our value-based selling proposition, and respond to margin pressure.

Over the last three years, the Company has improved productivity through capital investment for IT and production flow in operations, committed Company-wide to continuous improvement, error reduction, and in becoming faster and leaner.

We've increased and improved our capability to outsource fabrication when necessary and, even during the cycle contraction, we expanded the sales management team in order to stay close to the customer. With these and many other improvements implemented, I believe we can continue to achieve acceptable margin levels while sales mix becomes more international.

Although we have been encouraged with the recent activity in our markets, and we are seeing early indications of a recovery, we believe the recovery is fragile and order levels will remain erratic while the North American markets remain down for some time. We will continue to aggressively defend our leading market position, be disciplined in our pricing, and react quickly to opportunities along with changes in our markets. We are constantly evaluating growth opportunities from acquisitions or other forms of business combinations and, although there have been a few interesting prospects, they are still too pricey for our liking. The criteria remains expanding sales of engineered-to-order products to the energy markets via additional products, accessing new markets and/or expanding our manufacturing footprint geographically.

Regarding fiscal 2011, the next few quarters will be tough and they, like this past quarter, represent what we believe to be the bottom of this downturn. The first half of fiscal 2011 will be comparable to the second half of fiscal 2010 in terms of revenue and profitability. It is the result of light bookings three to five quarters back. As we work through those quarters, we anticipate revenue growth and profit improvement commencing the second half of fiscal 2011. We need a little more time to gain traction on the large projects won recently to understand better how it will convert to revenue. Customer engineering releases have been slow, and that directly affects when we can begin production and start to recognize revenue. I will be in a better position to comment more thoroughly on fiscal 2011 during the May conference call.

Our challenge over the next three quarters is surgically expanding as needed to address the growth we expect beginning in the second half of fiscal 2011 while operating in a weak revenue environment and maintaining profitability. The front end of our business is extremely busy. Engineering, design, CAD, and purchasing are all very busy. And while we are working with customers to try and get early releases, a majority of projects are around elongated time schedules, and customers are watching their own cash flow. As a result, they are not interested in moving projects forward until it's necessary.

Another example of our near-term challenges is the Navy project. Although we do not expect to recognize revenue on this project until fiscal 2012, it is an engineering-intensive project and will be consuming engineering man-hours over the next year. However, our method of revenue recognition is as a percentage of completion, and that is on production hours only, not engineering time. We expect that we can find the proper balance and, despite having to drive through this currently dismal market environment, we are very encouraged as we look beyond fiscal 2011.

Let me turn the call over to Jeff for his remarks.

Jeff Glajch: Thank you, Jim, and good morning, everyone. I will start with a review of sales and operations activity before moving on to orders and backlog.

As you saw in the release, net sales in the third quarter of fiscal 2010 were $12.2 million, a $12.5 million decline compared with last year's third quarter and down $3.9 million from the trailing second quarter of this fiscal year. As expected, Graham sales have continued to shift toward international and away from the U.S. market. Third quarter fiscal 2010 sales were 42% domestic and 58% international, completely inverted from last year's third quarter, while the first half of this year's sales have been equally split between the U.S. and international markets. U.S. sales declined $9.3 million, or approximately 65%, to $5.1 million in the quarter, while international sales declined $3.2 million, or just 32% to $7.1 million. Sales to all major international regions were lower compared with last year's third quarter, with the exception of Africa.

For the first three quarters of fiscal 2010, net sales were down 37% below last year's comparable period. In this period, U.S. sales made up 48% of total sales, and international sales accounted for the remaining 52%. The percentages for the same period last year were weighted more heavily toward the U.S., which had 63% versus 37% international.

Sales from the first nine months of this fiscal year to Asia have nearly doubled to $14.9 million from $7.8 million in the first nine months of fiscal 2009. This, combined with slower U.S. market sales, accounted for the majority of the shift toward international weighting. While the current quarter's order level was heavily weighted toward the U.S., if you were to exclude the large Northrop Grumman Navy project, orders would have been more weighted toward international, as we have seen in the first half of the fiscal year.

Looking forward to the next few quarters, we continue to expect to see our sales and order mix shifting toward Asia and the Middle East and away from the United States. By industry, sales dollars have declined across all segments. The most pronounced decline was in refining, especially in the U.S., as would be expected. Sales to refiners were down to 36% of total sales in the third quarter of this fiscal year compared with 46% in the same period last year. Forty-four percent went to the petrochemical industry, up from 27%, and 20% went to the power industry and other industrial applications, down from 27% last year. For the nine months of fiscal 2010, refining industry sales accounted for 43% of total sales, down from 48% of total sales in last year's first nine months.

Petrochemical sales for this period increased to 32%, up from 24% last year, while sales for power and other industrial applications decreased to 25% from 28% of total revenue last year.

Orders received in the third quarter of fiscal 2010 were a record $51.6 million. The previous record was $35.1 million, which was realized in the fourth quarter of fiscal 2008. Domestic orders totaled $37 million and accounted for 72% of orders. The domestic orders were largely driven by the Northrop Grumman order to support the U.S. Navy's aircraft carrier, which was in excess of $25 million. Please note, as we have mentioned in the past, we expect quarterly orders during this disruptive period in the cycle to be quite erratic, and we suggest using trailing 12-month information to understand our order trends.

At the end of December 2009, backlog was a record $89.8 million, a $39.3 million improvement from the backlog of 50.5 million at the end of September 2009 and $13.8 million above our previous record of $76 million, which was achieved in June 2008. As Jim mentioned, it is important to note that we expect only 50% of this backlog to ship in the next 12 months, and 60% to 65% is expected to convert to sales in the next 15 months, which will take us to the end of fiscal 2011. Our historical 12-month shipment expectation is usually 85% to 90% of backlog. However, the U.S. Navy project is not expected to begin to convert to sales until the start of fiscal 2012. In addition, a significant portion of a pair or large Middle East refinery orders, which we discussed on last quarter's conference call, will only partly convert before the end of fiscal 2011.

Our backlog is split as follows: 40% in refining, 20% in chemical and petrochemical, and 40% for power and other markets. As a side note, the U.S. Navy project falls into and makes up the majority of the latter category. Our equipment is part of the nuclear power propulsion system for the ship. We still have $7 million of orders in our backlog that are for projects currently on hold. This number has not changed in the past quarter. Given our backlog and in general business conditions, we are narrowing our guidance for the full fiscal year 2010 revenue to be in the range of $60 million to $63 million.

Our gross margin continued relatively strong in the third quarter given our level of sales, and was better than previously anticipated. Our restructuring efforts over the last year stuck extremely well without any significant cost increases during the quarter. Gross profit was $3.8 million, or 31.4% of sales, compared with $9.4 million, or 37.9% of sales. in last year's third quarter. For the three quarters of fiscal 2010, our gross profit was $18.0 million, or 37% of sales, compared with $32.1 million, or 42.1% of sales, in last year's first nine months. Based on the strength of our gross margin in the third quarter, we have increased our full-year gross margin guidance as a percentage of sales to be in the range of 34% to

36%. When you do the math, you will find our fourth quarter gross margins will be lower than the third quarter, in the mid to high 20% range. While the planned level of revenue is expected to be similar to the third quarter, the mix contains lower margin projects.

For the third quarter of fiscal 2010, SG&A expenses were $2.7 million, or 22.3% of sales, compared with $3.6 million, or 14.4% of sales, in the third quarter last year. SG&A was also down about 11% from the trailing second quarter. For the nine-month period, SG&A expenses were $9.0 million, or 18.6% of sales compared with 11.3 million, or 14.8% of sales in last year's comparable period. The restructuring initiatives we undertook, both at the end of fiscal 2009 and more recently in the second quarter of fiscal 2010, combined with lower commission costs related to the decline in sales, accounts for the reduction in SG&A dollars in the current fiscal year. We were also able to delay certain spending in the third quarter. We have lowered our expected SG&A spending for the full fiscal 2010 to approximately $12 million. The expected sequential increase in SG&A is related to the weighting of projects based in China and selling expenses associated with them as well as the need to execute some activities that were delayed during the third quarter.

Interest income in the third quarter of fiscal 2010 declined to $11,000 compared with $83,000 in the same period last year as a result of the significant decline in U.S. Treasury yields. Our investments are in U.S. Treasury securities with maturities up to 180 days. Our effective tax rate for the third quarter was just above 31%. Our year-to-date effective tax rate for fiscal 2010 is approximately 35%, although excluding the tax charge we discussed during the last quarter's call, the effective rate is just above 30%. We expect the full-year rate will be between 30% and 31% when you exclude that charge.

Net income in the third quarter of fiscal 2010 was $800,000, nearly 80% below last year's third quarter. On a per-diluted-share-basis, earnings were $0.08 per share, compared with 37% last year. For the nine-month period, net income was $5.8 million for the first three quarters compared with $13.9 million last year. We believe that we have had good results given the significant effect deleveraging has on our business with lower volume. We have structured the business to weather the trough, though we'll be quite happy when we get to the other side and achieve our growth goals.

Graham's balance sheet remains strong, with cash, cash equivalents, and investments totaling $57.7 million at the end of December, up from $54.7 million at the end of September and $46.2 million at the end of fiscal 2009. For the nine months of fiscal 2010, we generated $12.7 million from operating activities and increased our cash and investments positions by $11.5 million. The cash generation in the first nine months of fiscal 2010 resulted from a combination of strong operating income despite the market downturn and continued improvements in working capital. Excluding cash, cash equivalents, and investments, the net of our current assets less current liabilities is negative $2.5 million. We have no borrowings on our $30 million bank line and are utilizing it solely for outstanding letters of credit, which totaled $8.8 million at the end of the third quarter. Capital expenditures were $220,000 in the third quarter of fiscal 2010 and $502,000 in the first nine months of this fiscal year.

We continue to pursue our capital plan, which is an important part of our internal development activities, and estimate the total capital expenditures for fiscal 2010 will be between $800,000 and $1 million, with half of that investment being used for productivity improvements. We do expect our capital spending in fiscal 2011 to be around $3 million in total, as we will need to make a major investment in specific manufacturing equipment for the Navy project. That investment alone will be approximately $1.5 million.

In closing, we expect the fourth quarter of fiscal 2010 and the first two quarters of fiscal 2011 to have similar depressed sales levels as we achieved in the third quarter of fiscal 2010. Despite the lower sales levels, we expect to continue to remain profitable in each quarter and to generate positive cash flow. We expect sales to begin to increase in the second half of fiscal 2011.

That concludes my remarks. Jim, I turn it back to you.

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

Operator: Thank you. Our first question is from the line of Rick Hoss with Roth Capital Partners.

Rick Hoss: Hi, good morning, Jim, Jeff, Debbie. For this quarter, and you've given your expectations for comparable types of revenue levels, but thinking sequentially, would you view this quarter as probably the weakest from a revenue standpoint?

Jeff Glajch: We view that the next three quarters, we'll have revenue in the range that is similar to the third quarter that just ended. However, there can be some upside to that based on releases from our customers and being able to get engineering into production and then revenue recognition. The risk, on the downside, is delays from our customer in doing that and the level of small orders that are won that typically can convert within a quarter. So, we see the right range to think about over the next few quarters is comparable to the third quarter, understanding there could be some upside, and there's some risk for a little downside.

Rick Hoss: Earlier, Jim, you talked about the types of products that you could sell in the $2 million to $2.5 million range. What products are those?

Jim Lines: That comment was for our smaller products. To meet the upper end of the full-year guidance, required an additional level of bookings in this quarter that would convert to sales in the quarter of $2 million to $2.5 million. We have aftermarket small heat transfer products, small ejector systems, and vacuum pumps that fit that category that have an order-to-ship cycle between one week and six weeks.

Rick Hoss: Your comment that January looks pretty good so far, that would be related to those types of smaller quick-ship type products?

Jim Lines: Correct.

Rick Hoss: On the productivity improvements that you mentioned in your release, can you give us an appreciation of what types of benefit we could see? To take a revenue level, looking at 2008 here, you were around $85 million, your SG&A was $13. Can you tell us an approximate level that, given the new structure you're operating under, what sort of SG&A you would expect?

Jim Lines: For the productivity improvements, they relate more to the costs in the gross margin. Although we have business improvement that goes into the SG&A side, much of our capital plan is really related to leveraging the operations side of the business.

Rick Hoss: So, it'd be pretty difficult to nail down as the profitability of future products would probably be lower than you've seen in 2008. However, that would be partially offset by these improvements that you've made in the organization?

Jim Lines: That's a great way to look at it. That's how we thought about it when we embarked on the capital plan, recognizing over a period of time we would be facing margin pressure in the marketplace because of the business becoming more weighted toward international sales and the type of orders that we felt we would win in the coming years. To combat that, we had an aggressive capital plan to improve the performance of the business.

We do think, generally, we'll have margin pressure, and we've done a number of things to have a defense against that, but we've also commented, if you're comparing us to 2008 or 2009 fiscal year performance where gross margin was 40% plus or minus a little bit, we would expect in a comparable period of peak market conditions that we would be a little bit below that, in the mid to upper 30% gross margin range for modeling Graham.

Rick Hoss: Thanks for your insight.

Operator: Thank you. Our next question is from the line of Chris McCampbell with Stifel, Nicolaus.

Chris McCampbell: Good morning. Can you remind me if we still have an active stock buyback program, or did that end last year?

Jeff Glajch: We do still have an active buyback program that is in place until July of this year. We have not repurchased any shares under that buyback program since the first quarter of this fiscal year, however.

Operator: Thank you. Our next question is from the line of Dick Ryan with Dougherty.

Dick Ryan: Good morning. Jim, you talked about an environment where you are seeing increased competition and pricing pressures, but then you comment of an exceptionally high capture rate. Can you walk through what you're seeing there and what's causing that high batting average, if you will?

Jim Lines: What we're seeing right now compared with one or two years back is that the number of opportunities at any given point in time are far fewer for orders that are closing. Therefore, the same number of suppliers are chasing fewer orders, and that increases the competitive pressure. And then you add to that the fact that far less of the available opportunities are for the North American market, which had in the past a much higher margin potential. But, to our credit, our sales team, our application team has had a very close focus on those orders that we felt would be closing and our interaction with the customer, our managing of the sales pipeline, really, has led to an increase in our capture ratio. We've been aggressive for those projects that are closing. In some cases, admittedly, we took a defensive posture to maintain our dominant position in a particular market. In other cases, the margins have been customary. But, in general, I would say the competitive pressure is greater than it had been one to two years ago.

Dick Ryan: On the international side, I think you mentioned you've seen some strength in Africa, and I think South America was mentioned earlier. Can you give us a little color on what you're seeing in some of those regions?

Jim Lines: The recovery appears to be in the early stages in the Asian market, in particular in China. Also, the Middle East has had some activity, and we've had prior announcements regarding orders that we have won for the Middle East. We felt and we had indicated that Asia and the Middle East would lead the recovery in our markets followed by South America. In the sales opportunity pipeline that we're looking at, there are a number of projects on the horizon in South America for the state-owned refiners expanding the refining capacity or adding new petrochemical plants, and we see those materializing over the next one to five years. The Middle East has had a couple of projects move ahead, and China has been pretty steady. Africa was an isolated case of a fertilizer product in Northern Africa that we had won.

Operator: Our next question is from the line of James Bank of Sidoti & Company. Please go ahead with your question, sir.

James Bank: Well, hi. Good morning. I'm joining very late to the call here. I just wanted to quickly ask if there were any new awards mentioned on your prepared remarks, Jim, for the month of January?

Jim Lines: We did not mention any awards.

James Bank: And again, if you've already covered this, I'm sorry, there is a big noticeable increase in your power orders in this recent quarter. I was wondering if there was something specific in there, or this is the type of trend we should see going forward given the fact that refining, especially in the U.S., could slow?

Jeff Glajch: The power orders in the quarter were really related to the U.S. Navy project that we were awarded from Northrop Grumman that we announced in December. That falls into that category.

There are some other things in there, but that's the big driver there.

James Bank: And, lastly for the U.S., any good news to report from some renewable fuel works, any of these alternative areas that you otherwise didn't participate in historically, given this environmental shift?

Jim Lines: In looking at the U.S. market, there is a lot of activity in small power plants, cogeneration, waste to energy, municipal solid waste to energy, combined cycle power plants. Those, historically, in going back to the 1980s, a little bit in the 1990s when it was active, was an area that Graham did very well in, and we have our eye on that.

Operator: There are no further questions at this time. I would like to turn the floor back over to management for closing comments.

Jim Lines: Well, thank you, everyone, and we look forward to updating everyone again on our May call. Thank you.