Richard W. Hoss, Analyst, ROTH Capital Partners: Today we have Jeff Glajch, CFO from Graham Corp. joined by Debbie Pawlowski, Investor Relations. For those of you who don't know, Graham makes ejector systems, focused on oil refineries, but they also play with petrochem, fertilizers and there are some other applications, condensers, Navy ships and the like. So, welcome, Jeff.

Jeff Glajch: Thanks, Rick. The first slide is our Safe Harbor statement, in case I say something forward-looking. Graham is a publicly-listed company with a market cap of about $190 million based in Batavia, New York. We've been a public company for about 40 years.

What does Graham do? Our vision is to be the world leader in the design and manufacture of engineered-to-order products for the energy markets. The key thing is the "engineered-to-order" and the "energy markets". Everything that we make has to be engineered-to-order for our customers' equipment, and we believe that allows us to garner profit margins and to ensure that we're able to keep a long-term relationship with our customers. We primarily serve the refining, petrochemical, and power and other markets.

If you look at what we sell, as Rick mentioned, we sell ejector systems, surface condensers, small specialty heat exchangers and pumps, and we have an after-market business. If you look at the top of the slide, you'll see a picture of a distillation column, and those small cylindrical tubes that run up beside it are the ejector system. An ejector system lowers the pressure within a distillation column. That is important because it allows one to separate the fluid within the distillation column into its components much more efficiently and at a much lower temperature. You can see a picture of a surface condenser on the bottom right corner. Surface condensers are used in parallel with a steam turbine to generate power.

Our fiscal year ends in March, so you will see nine months results here. In the first nine months (of FY 2010), our business was roughly one-half international, one-half domestic. If you look backward, we were about 60% domestic during the last couple of fiscal years. If you're looking forward, we believe we are going to be 60% international.

We sell primarily into the refining, the petrochemical and the power and other markets. Normally, you'll see this graph be about one-third for each market. Based on the recent strength in the refining market prior to this last downturn, we've been a little more heavily weighted toward refining.

We sell to OEMs, the engineering procurement contractors, and the end-users directly. Often, even if we are selling to the EPCs, for example, the end-users will have a significant influence on the purchase of our equipment. On the refining side, you'll see we not only service conventional crude oil, but also heavy crude oils, and sour crude in the oil sands up in Alberta. Chemical processing includes some fairly basic products such as ethylene and nitrogen and then some more specialized ones, such as coal-to-liquids and gas-to-liquids.

Power generation markets utilize our surface condensers. We're typically in markets that are 75 or 80 megawatts and smaller. You are not going to see us in a large hydro facility but in a co-generation, waste-to-energy, or geothermal facility. On the other application, we sell in a number of arenas. Ethanol was very hot a couple of years ago. We were in there as well as bio-diesel, edible oils, oleochemicals, and industrial gases. There is a broad range of industries that we sell into in the power markets.

If you look at our business and our orders over the first nine months in this fiscal year, you'll see the graph split according to those markets. What I think is important here is looking on the right side of the slide in which you see the geographies that we are selling into. As the U.S. refining market and the U.S. petrochemical market have become weaker, we've seen a lot of our business shift toward the international markets. We're starting to see significant activity in the Middle East, Saudi Arabia and Oman. We're seeing significant continued activity in Asia, particularly in China. Looking at these splits, you can see power generation is a pretty big number for us, bigger than you would have seen a couple of quarters back. We have a very large order, in excess of $25 million, that we won with Northrop Grumman to support a U.S. Navy carrier set.

Global distillation capacity. You hear a lot about the demand for oil going down, and that is true in North America and in Europe. Where it is not true is in the Middle East, Asia, and even in South America. If you look at global distillation capacity over the next five years from this information from OPEC, you will see that of the six million barrels per day of incremental capacity, about 70% of it falls in the Asia-Pacific region and in the Middle East.

The only comment I would make on this chart, other than the numbers, is in regard to the Latin American, South American markets particularly. We think there is going to be some additional activity beyond what's represented here, and we're certainly starting to see that.

As I mentioned, we expect our sales mix to move more toward international. Our orders have moved that way in the past three or four quarters. We're seeing continued activity in the refining market as well as a pick up in the petrochemical and fertilizer markets in Asia. particularly in China. In the Middle East a couple of very large refining projects that had been put on hold were activated within the last few quarters, and we've been successful in winning business at a couple of those. We are also seeing world-scale petrochemical facilities being built in the Middle East. South America is a little behind those first two regions, but we're starting to see activity there also and expect to see a significant increase over the next twelve months. We expect the North American market to be weaker in the near term.

Why Graham? Why do our customers buy from Graham? What's the secret sauce there? Well there are a couple of things. One is our customers buy on value; they don't typically buy on price. Why do they buy on value? If you are looking at a large refinery, you may be talking about a $5, $6 or $7 billion dollar investment. Our equipment might be anywhere from $4 to $10 million of that or less than two-tenths of one percent of the total spent at the facility. That being said, it is mission-critical equipment that has a high cost of failure. So they are going buy on value; they are going to buy on service. Graham's reputation in the market is unparalleled, we believe, and allows us to win a significant portion of the business that is out there.

What else do we do well? If you look at our selling cycle – this is a typical project cycle for a major refinery petrochemical facility – it is a five-year cycle from conception to ultimate start-up of the facility. In that five-year period, from the point that they decide to build the facility until they award the contract to someone in our industry, such as Graham, is about two years. So, in that first 24-month time period there is not an RFQ, per se, coming out for our equipment.

However, in that 24-month time period, we are working with the end-user. We're providing our engineering resources to help them identify trade-offs between operating costs and capital costs, and optimize their facility. Doing something that our competitors do not do gives us a significant competitive advantage. Two years later when the RFQ is ultimately put out, we have additional information and have built up relationships, which help us win a greater share of business. We also think it helps us maximize our margin, which is a huge competitive advantage for us.

In this current downturn where a lot of companies would have gone away from performing that type of support, we've done just the opposite. We have kept our sales organization and our engineering organization completely intact; we've actually added resources there. We've been spending a lot of time with our customers even though they didn't have a project ready to go, and we believe that will help us as we are coming out of this downturn to garner further market share.

With regard to our financial performance over the past few years, this slide shows that we grew from 2005 to 2009 at the rate of 25% a year. 2005 was the start of the most recent upcycle, and as you can see, we grew pretty dramatically. We could have grown faster, but we didn't have the capacity to do that at the time. We have it now, but in the fiscal year 2006 - 2007 range, we didn't have the capacity that we needed to have in place to grow faster.

If you look at the guidance that we provided at the end of January, on revenue we expect to be down about 35% to 40% in the $60 to $63 million range. This is a typical downcycle. It is usually down about 35% from the peak. We understood that walking in. The important thing is that we are remaining profitable through this downcycle.

An important shift occurred within Graham over the past few years. If you look at the previous cycle from 1993 to 2000, which was really the beginning of an upcycle which peaked in 1997-1998 and then started to drop off subsequently, you'll see our EBITDA margins in the peak of that cycle were in the low double-digits, in the 10% to 11% range. In the bottom of the cycle you saw it was actually around 3%. In fact if you looked out a couple of years beyond 2000 you would see that our EBITDA margins were negative.

As the organization has changed over the past three or four years, particularly under the leadership of Jim Lines our CEO, we've seen a significant change in the structure of our business. Our EBITDA margins at the peak were not 10% or 11%; our EBITDA margins were in excess of 25%. Our EBITDA margin in the trailing twelve months of fiscal 2010, and in fact in the nine months of 2010, are just over 20%. So we believe we have shifted the company. We believe downcycle EBITDA margins are not necessarily 20%; we believe they're a little lower than that, and if you look at the second half of fiscal 2010 and the first half of fiscal 2011, that is what we believe will be our trough. Why do we believe it's our trough? Because we've got a backlog which is significantly expanded over the past couple of quarters. I think it's important to see the shift. We've proven that we can blow past that 10% or 11% EBITDA margin in an upcycle, and just as importantly, we've proven that we will continue to have strong EBITDA margins in the downcycle.

You can see from this slide that our net income over the past few years has grown pretty dramatically from break-even up to $17.5 million in fiscal 2009. That has really driven the strong balance sheet. At the beginning of this cycle, we had a balance sheet with minimal cash and minimal debt. If you look at our balance sheet right now we have no debt on our balance sheet. We have no long-term liabilities other than a few minor things such as deferred taxes. We have almost $58 million of cash on our balance sheet ready to be used for other things.

How we've gotten there? Certainly the profitability has helped us but another thing we focused on as we changed this organization is our working capital management. To go back to 2005, our net working capital, which is our working capital excluding cash, was over 20% of revenue. As the business grew from $40 million to $100 million, the working capital number actually went down from $8 million to $3 million at the end of fiscal 2009. In fact, at the end of the third quarter of fiscal 2010, the net working capital is a negative number.

How do we do that? We do that by funding our projects with our customers' cash. A major project might be a 12-month-long event from when we win the order to when we deliver it. In that 12-month period, we're getting progress payments consistent with how we're putting cash out the door. So we are able to utilize our customers' cash to fund our projects, and that's an important change in the organization from where it was a few years ago.

I talked about structural changes to get our margins up. I talked about structural changes that dealt with our working capital. How did we do all that? Well we did that through a number of process improvements on the selling side, the people side, and the operation side, and really looking at how to sustain that. We branded Graham. Graham's got a good reputation in the market; we need to take advantage of it. We've got disciplined decision rights around pricing and cash flow within our organization. Our sales organization has a very detailed list of what they can and cannot do. Beyond that, they have come to either me or to Jim Lines for approval.

We've looked at how to gain market share. But at the same time, we've also realized that we don't necessarily want to win every order. We don't want to win a bad order. So the change in mentality is that not every order is a good order. On the people side, we've aligned our whole organization to focus on growing the business and remaining profitable throughout the downturn as well as maximizing the profitability in an upturn.

On the operational side, one of the challenges that we had in the last upturn was that we didn't have enough capacity going into it and were stagnated because of that. We've looked to our front-end, which is our engineering process, and our backend, which is our fabrication process, and identified what we need to do to expand that capacity. We've put that plan in place. We didn't go and expand our roofline; we targeted those parts of the process that were bottlenecked. For example, you might have a piece of equipment that was slowing the manufacturing process down. By identifying that piece of equipment and spending $200,000 or $300,000, not millions of dollars, we were able to significantly expand our capacity in the fabrication side.

On the front-end, on the engineering side, it was the same thing. The one area that we had under-invested in historically, and we've correctly invested in over the past few years, is IT technology. We've gone through and identified what things we can provide our engineering team to ensure that they have the ability to replicate what they do, to do things with much more automation as supposed to doing things manually. All of that has dramatically increased our capacity without spending a significant amount of capital. We've also looked at how we could expand capacity by potentially out-sourcing some fabrication, and we will do that on a selective basis. But we will not give our IT away; that's very important for a business like this.

We have a long-term vision. We're not focused on this quarter or next quarter. Certainly, we pay attention there, but we're not going to make a decision today that will give us an extra $0.01 or $0.02 per share in this quarter and potentially loses $0.10 a share 12 or 18 months out. Through this process of working our way through the downturn, we have made some cuts. But we have not made cuts in the sales side; we have not made cuts in the engineering side, and we've ensured that we are well-positioned to grow going forward. We're looking out multiple years, not multiple months.

You can see in the graphs the dramatic cycle in our order patterns. The grey graph shows the orders over the last number of years, and you can see they grew up to a $107 million and then started to dip back down. We've had significant improvement in our orders in the last couple of quarters. Do we believe we are out of the downcycle yet? Not completely.

We certainly have some very big orders; we had a very big order with the U.S. Navy in the last quarter, which was in excess of $25 million, which certainly made our numbers look very good but that's not a repeatable order. That's not an order we're going to see every quarter. In fact that's the type of project that comes out every four to six years; it's a comparatively big project.

The orders have started to go back up, and importantly, our backlog peaked around $76 million at the end of fiscal 2008. It dropped by one-half by the quarter that ended this past June to $37 million. We saw that point of inflection, and now our backlog is almost $90 million, which for Graham is a record.

We're seeing the backlog growth. We're seeing the order flow. While it's still inconsistent and certainly not out of the woods, we've seen significant improvements in the last few quarters. We believe our backlog bodes us well in the future.

The last thing I would like to talk about is the possibility of acquisitions. I showed you the balance sheet and the fact that we had almost $58 million of cash on the balance sheet. What do we need cash for? I showed you that we really don't need it for working capital. For capital spending, we typically spend about $1 million to maybe $2 million a year in capital. Next fiscal year we'll spend a little bit more to support that Navy project, probably closer to $3 million, and we have a small dividend that is less than $1 million a year.

So, we don't have an enormous amount of cash need for the cash that we're generating. We are looking at that $58 million and saying, "What can we use it for?" We believe the best value for our shareholders would be for us to grow via acquisition.

What are we looking to do? We're looking to grow engineered-to-order, looking at engineered-to-order companies in the energy industry. That's what we do; that's what we do well, and that's what we want to continue to do. We're looking for a strong management team with a quality culture consistent with Graham. Size-wise we've talked about $20 to $60 million revenue range; we would go north of that, we would also go lower than that if it was the right opportunity.

Finally, once we've identified the right opportunity we want to make sure that we're going to generate cash with the cash that we are spending. We're not looking just to improve our earnings-per-share. Given that the $58 million is currently invested in treasury bills making 10, 15, 20 basis points it would be very easy to improve our earnings-per-share and make a sub-optimal acquisition. That's not our intent. Our intent is to make an acquisition that will generate on a cash basis a return that exceeds our cost of capital.

What are we looking to acquire, where and in what kind of markets? We have three options. We have a geographic expansion option, which is looking to have local fabrication somewhere outside of the United States, possibly in Asia or China, Middle East and South America. Another option or another avenue we're looking at is product diversification. We have what would define as a fairly narrow product range, a very good product range, but a narrow product range for what our customers buy. We believe that there is an opportunity to expand that product range via product diversification.

Finally, market diversification. I mentioned that we're strong in refining, in petrochemical and we play very well in many of the ultimate energy markets. Some markets we're strong in and some not as strong. We believe that market diversification would be an important focus for us and could come directly from a product diversification strategy. So, there may be an interrelationship there.

Finally, quick investment highlights, we believe there's long-term energy demand growth that will result in expanding capacity around the world that will result in demand for Graham's products. We have a great brand recognition worldwide. We're not afraid to play outside the U.S.; we've been playing outside the U.S. for decades. We have a sales model that is based on involvement with our customer early on. We've got demonstrated success around the world, a very strong balance sheet, very significant opportunities for acquisitions, and a management team that's very focused on results.

Q&A

Jeff Glajch: The question was regarding the fact that our capital is about two-tenths of an investment. When I said value-oriented, I meant the value that we bring to the customer, not price focused. I'm sorry if I mis-spoke I apologize. We are not the price leader. We bring value to the customer, we bring performance to the customer, and we bring reliability. When I used the word value, I didn't mean price, I meant that we offer the reliability to our customer.

Question: What is the barrier preventing your competitors from entering the projects at an early stage?

Jeff Glajch: They certainly could do that. There is cost to that. There is a cost of engineering time and engineering dollars. We bear that cost in projects that we don't necessarily win. So there is a cost there. There is less of a barrier there. I think it's a philosophy of our business that we want to do that. Our competitors have decided not to do that, but they certainly could do that. But even if they did, they would have to do it with probably long-established customers, which we're pretty much already in the door there.

Question: If you could not find projects that exceeded your cost of capital, would you return the funds to shareholders?

Jeff Glajch: We believe there are a lot of projects out there they can exceed our cost of capital. While we have had a share buy-back plan in place, and we've executed on about 300,000 shares in the timeframe of a year or so ago and it's still in place, we believe that is secondary and any other cash return to shareholders is secondary, tertiary to the acquisition opportunities. We think there are opportunities out there, so at this point we're heading down that path. At some time in the future if we get to the point we don't think it's there, we'll deal with that at the time.