

**Peter Lisnic:** Good morning, everyone. Welcome to Baird's 2009 Industrial Conference. My name is Peter Lisnic, Senior Research Analyst, covering building products and general industrial secs. Our next presenter today is Graham, manufacturer of vacuum systems and heat transfer equipment for the chemical, refining, and power generation industries. With us from Graham today, we have Mr. Jeffrey Glajch, Vice President - Finance and Administration and CFO, and Mr. Alan Smith, Vice President of Operations. Jeff, I will turn it over to you.

**Jeffrey Glajch:** Thank you. Good morning. I am here to talk about Graham Corporation. We are a company that designs and manufactures engineered-to-order products for the energy markets. We are based in Batavia, New York, which is just outside of Buffalo and Rochester.

Graham sells products primarily to the refining and petrochemical industries and the other energy markets. We sell ejector systems, condensers, heat exchangers, and specialty-made pumps, as well as an aftermarket business. Our business is pretty well split 50-50 between the United States and international markets. As we see the markets moving forward, we believe that will shift to be a larger percentage of international, probably closer to 60%.

This is a picture of an ejector system that was installed at a refinery in China. You can see the tall cylindrical objects on the side of the distillation column within the refinery. Those are the ejectors and on the bottom section you can see a condenser. An ejector lowers the pressure within a distillation column and allows products to be separated at a lower temperature, more efficiently. Condensers are used to support a steam turbine and can be used in an ejector system or they can be used independently in other applications.

We sell into diversified markets. In the first half of fiscal 2010, our fiscal year starts in April, we sold about 45% of our products into the refining market, about 28% into the chemical processing market, and 27% to the power and other markets. The refining market has really been pushed by activities in the U.S. over the last couple of years. And as we move forward, we anticipate the refining market to be stronger outside the U.S., as well as the petrochemical and power markets.

You can see the markets that we serve. In the refining area, we serve not just conventional crude oil, but oil sands in Alberta, Canada. In South America, we help in the processing of heavy crude oil, the sour crude. We have a significant number of applications in the petrochemical area. The power generation side tends to be on the smaller end. So it's smaller cogeneration facilities along with some geothermal and waste energy options. And then we have some other applications that we also serve.

We have a very diverse order and sales set, not only by industry but also by region of the world, and specifically, the countries that we sell in. Over the last couple of years the U.S. market has been very strong for us. As I mentioned before, as we look forward to some of the international markets, we believe we've seen a piece of the recovery occur already. It is our view that the recovery will occur in the Middle East and in Asia, probably followed by South America, and lastly by the U.S. and western Europe.

Looking at the global distillation capacity growth over the next five years, you can see of the six million barrels per day of incremental capacity that we anticipate coming on line, the vast majority of it is coming out of the Asian region and out of the Middle East, about 70% in total. We are particularly seeing strength in China.

If we look at our competition, there is no one that purely competes with us. There are different companies that compete with pieces of our business. This slide shows our North American competition. In the next slide I will show you our international competition. Typically our competitors are either very large public companies with a small component of their business, such as a Gardner Denver that competes with us, or some smaller, privately-held companies that compete with us.

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In North America we are competing primarily with U.S. companies, and in the international markets, we are competing with both U.S. companies as well as European companies. We don't compete much in the European arena. Typically, the European competitors compete very strongly there. We are very strong in the Middle East, and we are also very strong in China. In fact, we put a sales and engineering office in China about three years ago, and since then we've had a very strong capture rate of over 50% of the major refineries that have been built in China.

What's unique about Graham or what is our competitive advantage to sell our products to our end-customers? This is a typical project cycle for a large refinery or petrochemical facility. You can see from conception to final construction is about a five-year process.

The first two years, there is a lot of activity that occurs before contracts would be awarded. And it's in those first two years that we believe Graham gets a significant competitive advantage. Rather than waiting until the RFQ comes out at the end of year two, we are working early on with our potential customers, helping them to engineer their facility, understand the trade-offs between capital and operating expenses, and working with them to make sure that they've got the best solution going forward. The advantage that it provides to Graham is that when we get to the point when the RFQ comes out, we have already been there for quite a long time. We've built the relationships and this gives us a higher capture rate and allows us to generate greater profitability on our projects.

This slide shows a little more detail of the first two years of that cycle. Throughout this process we are often very heavily involved before the EPC is actually selected, which typically occurs about 18 months into the process. We are involved all the way from the front of the project until the RFQ occurs. Once the RFQ occurs, and hopefully, Graham is selected, the construction timeframe from that is another year or so. Our products have already been at the facility about three years into this five-year cycle. We are a key component to their facility as our equipment helps to drive the efficiency of the facility and that also ensures that it's a critical component. Even though it's a relatively small spend of a very large facility, there are a very small number of vendors that are even allowed to bid on our product sets.

Let's look at Graham's financial performance over the past few years. You can see, as the markets have been very strong over the period from 2005 through 2009, Graham grew dramatically. Graham grew from \$40 million to \$100 million over that time period, a growth rate of about 25% per year. We are now in a down-cycle, as everyone is aware. We have given guidance for fiscal 2010 of revenue between \$60 million to \$65 million, which is 35% to 40% below fiscal 2009.

I think an important thing to understand, though, is that through this growth process, we have dramatically improved our margins. Our margins at the beginning of this cycle were in the high teens and low 20% range, and we were able to get them to grow as high as the low 40% range in fiscal 2009. Now we believe the low 40s is probably a little higher than a normalized up-cycle margin. Normally, we would be in the mid- to high-30s, which is significantly better than Graham had been in the past and significantly better than in a down cycle. As we are looking at this current down cycle, the guidance that we've provided for fiscal 2010 is in the 33% to 35% range. At the absolute trough, which we believe we are in now during the second half of this fiscal year and the first half of next fiscal year, we are looking at margins in the mid- to high-20% range. So, even in a down cycle, we estimate we are going to have gross margins at that level, and we will continue to be profitable.

Net income and EPS, along with our revenue and our gross margins growth, saw a significant ramp up over the past couple of years, particularly in 2008 and 2009, with net income of \$15 million and \$17 million, respectively. That led to a strengthening of our balance sheet. At the beginning of the cycle we had a little bit of cash-on-hand and a little bit of debt. We've grown our cash-on-hand dramatically. We have no bank debt whatsoever. Our long-term liabilities are some minor things, such as the tax deferments, but nothing significant from a long-term liability standpoint. At the end of the second fiscal quarter on September 30, we were sitting on almost \$55 million worth of cash.

How have we gotten there? Obviously, the earnings side has helped us dramatically, but the other area that we've focused on over the past few years has been working capital. We've driven our inventories down. We've worked to manage our receivables. As we win contracts, we get progress payments from our customers, which allow us to offset that by the progress payments that we receive as we purchase raw materials.

As you can see our net working capital, which is net of our cash and cash equivalents, has gone from around \$8.5 million to, essentially, zero. It fluctuates between a little negative to \$2 million dollars positive, but we are able to operate this business without needing to utilize that \$55 million worth of cash. That is allowing us to look at that \$55 million worth of cash as something that we can utilize for acquisitions and other external growth.

I mentioned cash management. I think this is an important thing to understand. We don't look at cash management as a finance activity. We look at cash management across our entire business from the sales side to the purchasing side, as well as with the finance organization. Our cash cycle has dropped since 2005 from 112 days down to 17 days last fiscal year. We are going to be somewhere between 20 and 30 days in fiscal 2010. This is an important metric that we measure within the organization. We continue to focus on cash management, not just the top line and earnings.

There has been a pretty dramatic shift in the market over the past 18 months. You can see our orders and our backlog have grown pretty dramatically from 2005 to 2008, where our orders peaked at \$107 million. The vast majority of our orders, about 70%, are projects that we win when we bid on them. They have a 12- to 15-month life to them. So, we have pretty good visibility over the next three or four quarters of what our sales are going to look like and a reasonable idea what our profitability is going to be.

In fiscal 2009, we saw a drop-off in our order level. Fiscal 2009 sales were strong, based on the orders in 2008. Obviously, as we move into fiscal 2010, we start to see the orders drop off a little bit more. One of the encouraging signs that we've had is that our backlog, which had dropped from \$75 million to \$48 million and at the end of the first quarter was down around \$37 million, we've seen that point of inflection occur. Our second quarter orders were very strong at almost \$30 million. The second quarter orders were at their highest level in 18 months, so while we don't believe we are out of this, we do see some encouraging signs.

We are seeing one-off signs of activities picking up in Saudi Arabia, where a couple of very large refineries are being built. We are seeing signs in China, where there is continued activity. China has announced, on average, about one new refinery per quarter over the last three years. That's pretty significant if you think about it. That's 12 over a three-year period. In the U.S. there are 149 refineries. So building 12 new refineries in China in three years is a pretty significant level. We believe that level of activity in China will continue.

Our view is that the activity in the Middle East will continue to improve and that we'll start to see some activity in South America. All of those areas are very encouraging to us. That being said, we are still seeing some slowness from our customers going through the RFQ process, ultimately to order, but we do believe we are seeing some signs of improvement. Certainly the point of inflection that we saw in our backlog, back up to \$50 million, was very encouraging and we are hoping that that continues.

I want to talk briefly about cyclicalities. Graham is in a cyclical market, and we have some control, but not complete control, over the cyclicalities of our revenue, we do believe we have significant control over the cyclicalities of our profitability. To give you a couple of points-in-time examples of where Graham was and where it is today, if you go back to fiscal 1998 to fiscal 2000, that was the start of the last down cycle. In fiscal 1998, our sales were around \$52 million and two years later they had dropped about a third, to \$35 million. Our gross margins were in the low 30s. They dropped into the low 20s, and they actually dropped, as I showed a few slides earlier, down in the high teens. Our operating margins dropped from

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just below 10% to break-even by fiscal 2000, and then a couple of years later we lost money for a couple of years. That was the old Graham. There has been significant focus over the past three or four years by Jim Lines, who has been our CEO for the last three years, and the management team and the employees at Graham to identify how we get out of the cycle where in an up time we make a decent amount of money but in a down cycle, we breakeven, or we lose money. We believe we've broken that cycle.

How did we break that cycle? I will go through some more details in a few minutes, but it took very thoughtful processes on the way up, looking at how we could get additional capacity out of our existing facility. We grew from \$40 million to \$100 million over the 2005 to 2009 time period without putting out one dollar of capital to expand our facility. We certainly put some capital into our existing facility, but we did not expand the roof line.

We did do some very intelligent things. That led us to the level of profitability we saw in fiscal 2009 of over 40% margins, operating margins of 26%, EBITDA margins in the high 20s, and as we are looking at 2010, we are still seeing operating margins in the mid-teens, and EBITDA margins in the mid-teens. So, we believe in this down cycle that we've shown that we are a different company. We are not a break-even company anymore. We are making the level of profitability in a down-cycle that many manufacturers would be quite proud of in an up cycle.

How did we get there? There is a lot of information on this slide, but I want to focus on a few areas. On the selling process, we've rebranded Graham. We add a lot of value to our customers. I talked about how we work with our customers early on in their process. The reason we are working with them is that we provide vacuum distillation technology, which is an expertise that they don't have in-house. They used to have it 20 or 30 years ago, but they don't have that in-house anymore. So we provide that value.

We've defined our decision rights on who can make pricing decisions within the Company so that we are making uniform pricing decision across the Company. It doesn't mean we have uniform pricing. It means we have certain thresholds that we will not go below. We are not going to take business just to take market share. We want to make sure that business is profitable. We've come to the conclusion, to reiterate that point, that not every order is a good order. We don't want to win business just to take market share. We want to win business to make money and to generate cash.

We have spent a lot of time on our people processes. We've got a very long history at Graham of a very long and secure employee base. Our average employee in the shop, in sales, and in the office has been with us around 20 years. We've brought in a couple of change agents to help the organization evolve, but still recognize that the long history that Graham has had as a reliable supplier to the refinery and petrochemical and power industries is very important.

On the operational side, there is a capital plan. I mentioned that we didn't expand our roof line. Our capital spending in a typical year is about \$1.5 to \$2 million. We don't have the need for an enormous amount of capital. But we've taken that \$1.5 to \$2 million and identified how we can spend it most efficiently to get additional capacity through our system, whether it's on the fabrication side by streamlining and leaning-out our manufacturing or processes or on the engineering side. Because we are an engineering company, along with a fabrication company, some of the areas that needed to improve process flow were on the engineering side. So we made investments in IT, which is something Graham had not done in the past. These investments in IT allow us to be more efficient. A large investment for us is typically \$200,000.

This fiscal year we are only spending about \$1 million, because that's what we need to keep our business moving forward. We're focused on lead time reduction. We're focusing on trying to get faster. When we talk about getting faster, it is how we get through the order process moving the product out the door as quickly as we possibly can. We focus on that, and by doing that, we're able to add capacity without adding to our roof line.

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On the sustainability standpoint, we have a long-term vision. We look at our monthly and our quarterly results, but we don't make our decisions based on those results. We make our decisions looking out two, three, five, and ten years. When our customers are building a facility, they aren't looking three to six months out, they are looking at three to five years out. We are looking out a much longer term to make sure that we are making the right decision, not just the right decisions for today, but more importantly the right decisions for Graham in the long term.

For our near-term strategy, we are in a bit of a downturn right now, but are starting to see some upside. What near-term things are we focusing on? Clearly, we are focusing on our people, our processes, and our capital plan. We've been very public about the fact that we want Graham to be twice as big in four years as we are today. This is twice as big as the \$100 million number, not our fiscal year number for 2010.

We want to stay close to our customers. We believe that by continuing to focus on the consultative selling process that we'll continue to gain market share. We'll continue to add to our pipeline. Our quote activity hasn't changed over the past few years. Even though the market is down, the quote levels are very high. It is taking longer to move from the quote to the order right now, but we believe there is some pent-up demand. When it will open up, we are not sure. But we have seen some signs of opening. We believe there is an opportunity for that demand to come forward.

We want to maintain profitability and positive cash flow. I can't over-emphasize this. In an up-turn, we want to take advantage of the market growth, but in a downturn, we want to continue to be profitable. We want to continue to generate cash so that we don't need that \$55 million of cash that I mentioned before to run our business.

We are evaluating potential acquisition opportunities in this market as a way to use that cash. We believe in the down-turn we are going to continue to capture market share, and as we come out of the down-turn and the market starts to pick up, we want to expand our market share. We are ready for the up-turn. We want to go up the growth curve faster this time than we did last time, and we want to continue to take market share and invest in and improve our business.

The last couple of slides briefly talk about our acquisition strategy. This is not something Graham has done in the recent past, but it is something we are looking forward to doing. I've been with Graham for about eight months, and I have an acquisition background. Part of the reason I was brought in was to help with some of these activities. What is Graham looking for? We are looking really in a couple of different arenas. One is to expand geographically. We have one manufacturing facility in western New York. It serves us well. It serves the world well, but we believe by having manufacturing facilities in specific locations we might be able to better capture some of the local share.

The other option we are looking at is diversifying our products and our markets. We have a good product line. We'd like to have a broader product line. Through that consultative selling process, one of the things we identified is that we could potentially sell more to our customers if we had a broader product line. So, we are working in that avenue too.

What are our criteria around this? I talked right at the start that we are an engineered-to-order products company, and we want to continue to be an engineered-to-order products company. We believe that's what we do well. We don't want to be in a business where we are not selling highly-engineered, custom products. So if someone wants to order something, they can call and simply get it out of our inventory. We don't have something sitting in our inventory. That's not our business. Our business is engineered-to-order products, where everything that we sell is engineered for our customers' use.

We are looking at acquisitions up to \$60 million in revenue. We've talked to a \$20 million to \$60 million revenue range as our guideline for acquisitions. That doesn't mean we wouldn't go smaller, nor does it mean we wouldn't go larger. But it needs to be the right fit for Graham. We need to have a strong

management team and a quality culture within the acquisition that we look at. We want to make sure that they fit in well with the Graham organization.

And finally, once we get all those laid out, we want to ensure that our return on our investment exceeds our cost of capital. Certainly we are sitting with cash on our books right now and all that cash is invested in U.S. Treasury Bills making single or low double-digit basis point earnings. We can very easily improve our earnings per share by making an investment in an acquisition that makes mediocre returns. We don't want to do that. We are not doing this to generate slightly better earnings per share. We are doing this to generate cash. The earnings per share will follow, but we want to make sure, just like we do everywhere else, that we make the right long-term decision for Graham. It needs to generate a very strong return in the short term as well as in the long term.

Again, expanding slightly on the acquisition strategy, a geographic expansion, looking at Asia, especially China, we believe the Chinese market is very fruitful. We have activities there now. We are able to do well there now, but we believe we can better penetrate the local market by manufacturing locally. There are opportunities in the Middle East and South America to manufacture. Particularly, we are starting to see projects that are requiring some local content and the need for us to have local manufacturing is there.

Production diversification. I spoke about that before. What are we looking at? We are looking at specialty heat exchangers, process vacuum equipment, packaged systems, process vessels, environmental, again, all things that we believe would fall in the engineered-to-order category. And market diversification. We are focused on the power markets, whether it's nuclear, solar, or alternative energies. We play in all these markets today, but we believe we could play much stronger if we had a slightly broader product set and a little more focus in those areas.

So, with that, I can answer any questions.

### Question-and-Answer Session

**Unidentified Participant:** You have a strong cash flow and you pay a small dividend. Will you look at increasing that?

**Jeffrey Glajch:** When we look at our cash, the highest criteria we'd like to use the cash are for acquisitions. We also announced the share buyback program in January. We've announced the ability to purchase up to a million shares from January to July. From January to July, we've repurchased about 300,000 shares. That has been extended through July of calendar year 2010. We did not purchase any shares on our second fiscal quarter. But that's certainly a secondary use of cash.

On the dividend side, we do pay a very small dividend. Our expectation is not to dramatically change that payment. We believe that we'll be better off to utilize our cash to grow the business.

**Unidentified Participant:** Now regarding acquisitions, what is your assessment of the supply chain and demand of potential candidates? Who are the willing sellers and what are they looking for?

**Jeffrey Glajch:** As I mentioned, I've been on board for about eight months and since I have come on board I have noticed when looking at private companies, their internal valuation was a lot higher back in March, although public companies had been dramatically impacted by the market. A lot of private companies were still looking back at calendar years 2007-2008 and thinking that was the level of profitability they could sustain and that they should sell themselves on. I felt valuations were too high. We have started to see the valuations of the private companies come down. Obviously the public companies are following what's occurring in the market.

There are certainly opportunities out there. We've done a lot of work. What I can say very confidently is we have certainly found strategic fits for us that made sense, and we've found companies that we felt,

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from a valuation standpoint, made sense. What we haven't found is a strategic company with the right valuations. So we are being extremely prudent here. We don't want to overpay. We want to make sure that somebody who fits our business and fits our culture will help us expand our presence in the market, but we don't want to over pay. We want to make sure we pay a fair price and that we've got a company that we're happy not only on the day we make the acquisition but also, more importantly, we are happy 12, 18, and 24 months later. That looking back we can say we made the right acquisition. There are opportunities out there but it's a matter of matching up a good strategic fit at the right price.

There are certainly competitors out there who are looking at acquisitions, and we'll run into them in a number of situations. Some will decide to make acquisitions that are strategic to them or the right price for them that we have not. But there are others out there that are doing it, and to that point, there are also some folks out there that are looking to sell, whether it's their financial situation or they may be a very good business that over-leveraged, for example. So there are people buying and there are people selling. So, it's a competitive market. I wouldn't say it's a hot market. I would say there is just some activity going on right now.

**Unidentified Participant:** What are your thoughts on assimilating your acquisitions? Are you looking to just buy brick-and-mortar, or are you looking to buy a management team?

**Jeffrey Glajch:** We are fairly open. If we look at the geographic expansion, the bricks-and-mortar will be important to us because we want to have local fabrication. If we look at a scenario where we are looking at a product line expansion and it may be domestic or it may be international, having bricks and mortar might be important or it might not be. In all cases we want to ensure that when we buy someone we are getting a good management team that can work with our existing management team. That's important for us from an integration standpoint. The bricks and mortar depends on what type of acquisition we make.

**Peter Lisnic:** We have to stop. So, thank you to Graham for presenting.