Graham Manufacturing Corporation
Second Quarter Fiscal 2009 Earnings Conference Call
November 4, 2008

Operator: Greetings and welcome to the Graham Corporation Second Quarter 2009 Earnings Conference Call. It is now my pleasure to introduce your host, Ms Deborah Pawlowski, Investor Relations for Graham Corporation.

Deborah Pawlowski: Thank you and good morning everyone. We appreciate your joining us today on Graham Corporation's Second Quarter Fiscal 2009 Financial Results call. On the call I have with me today Jim Lines, President and CEO of Graham Corporation, and Jennifer Condame, Chief Accounting Officer. They will be reviewing the results of the second quarter and progress on the company's strategies. You should have a copy of the earnings release that was released yesterday, and if not you can access it at the company website, www.graham-mfg.com.

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 and are subject to risks and uncertainties as well as other factors that could cause actual results to differ from what we 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 at the company's website, or also at www.sec.gov.

With that, let me turn it over to Jim.

Jim Lines: Thank you, Debbie, and good morning everyone. I will talk briefly about our progress year-to-date, the current economic environment, and its immediate effects and the longer term outlook for our markets, then turn it over to Jennifer Condame, our Chief Accounting Officer, to provide greater detail on the quarter and year-to-date financial information.

I am pleased that at mid-year revenue is up 20% to $51.6 million. Net income is up 42.6% and earnings per diluted share are $0.99. Gross margin is 44.1% for the first half and our backlog is a healthy $69.7 million.

There has been movement in sales by product or by geographic location; however, that is routine. We did expect our second quarter to have a lower growth rate, which was indicated during our January conference call. Revenue was a solid $23.9 million, gross margin held at an elevated level of 43.9% and net income came in at $4.4 million, or 18.5% return on sales.

The productivity gains from our capital investments in new equipment for production along with ongoing investment in information technology, workflow improvements and the commitment of our employees to become a faster company are expanding both our capacity and our margins. There's more work to be done in these areas and our employees continue to adhere to our timelines.

Turning to the markets and the current economic environment, I can indicate that quotation activity remains high, our sales and applications engineering areas are busy, and they see a lot of opportunity in the pipeline. Our engineering contractors and triple machinery OEM's are indicating their quotation activity is robust as well. However, we are affected by what is occurring in the financial markets and the price of oil along with metal commodity prices. We have seen a slowing or hesitation by our customers to commit to new orders. Bookings in this past quarter were down considerably and totalled $17.5 million. We believe the third quarter bookings may be light as well. We acted proactively when the markets began to change and sales management had close contact with our customers, the end users, engineering contractors, and key OEM's to gain an understanding of how they are affected and responding to the current market conditions.

The general feedback is that it is too early to fully understand the impact of the change in the credit markets. We believe the long-term outlook remains unchanged. Energy demand is increasing globally and investments have to be made for new capacity, the upgrading of existing facilities or changing environmental regulations. We believe the energy markets will be robust long term but will show a pull back in the short term. Major integrated refiners and nationalized oil companies are affected differently by the credit markets. This customer segment has self-financed projects due to their financial strength and strong operating cash flows.

Independent refiners and non-integrated petrochemical companies are directly affected by the credit pullback. We began to see project slowdowns from this customer segment and the suspension or cancellation of projects that were in the bookings pipeline a while back. Independent refiners are important to us; however, they have represented in the past 5-10% of revenue annually.

Project management and credit groups acted quickly to evaluate each major contract in our backlog to gain a clear understanding of our current cash position, how much money has been spent by the company versus what has been received as customer advance payments, to determine the amount of outstanding receivables and payables, and carefully review contract language for cancellation provisions in each contract and talk to our customers to understand the project pace, the risks and if there will be delays. We believe our backlog is secure and of high quality based on the analysis that was done. A couple of projects have slowed and delivery schedules pushed out. In all cases the customers have indicated the projects will be completed. We will, however, continue to monitor this closely.

We are seeing, as I previously noted, a slowing in our markets. Long term fundamentals remain unchanged, and we are confirming prior full year guidance that the revenue will expand 15-20% from last year. I do caution that we now expect to be nearer to the lower end of the range. Gross margin guidance remains in the 39-42% range for the full year. It is too early to comment on fiscal 2010 other than to indicate we are seeing a slowdown for new order rates. However, quotation activity is robust and at a high level and many projects are in the pipeline that we are now quoting and tracking.

I will now turn it over to Jennifer.

Jennifer Condame: Thank you, Jim. For the second quarter of fiscal 2009 which ended September 30, 2008, we reported net sales of $23.9 million, compared with $23.1 million in the second quarter of fiscal 2008. Strong sales of our condenser, heat exchanger, pump package and after-market product lines were mostly offset by a decline in sales of our ejector systems. Condenser sales increased 24.1% in the second quarter of fiscal 2009 to $5.1 million and were 21.4% of total sales, while heat exchanger sales increased to $3.1 million, a 35.5% year-over-year increase to contribute 13% of total net sales. Both pump packages and after-market sales increased due to three large refinery projects. Pump package sales increased to $2.6 million in the second quarter of fiscal 2009, or 11% of total sales, compared with $0.5 million in the second quarter of fiscal 2008.

After-market sales were 17.6% of total sales, or $4.2 million in the second quarter of fiscal 2009 compared with $3.9 million in the same period the prior fiscal year. Ejector systems sales declined to $8.9 million in the second quarter of fiscal 2009, down from $12.3 million in the second quarter last fiscal year. As a reminder, due to the large magnitude of the orders we received and the timing of shipment, quarter-to-quarter fluctuations are common.

By industry, sales to the refining sector were $11.1 million, or 47% of total sales in the second quarter of fiscal 2009, compared with $12 million, or 52% of sales in the same period the prior fiscal year. Sales were 27% to the chemical and petrochemical market, 8% to the power sector and 18% to other industrial applications in the second quarter of fiscal 2009. The portion of sales coming from international markets increased in the second quarter of fiscal 2009 to 37%, compared with 33% in the same period the prior year. We believe international sales will continue to grow and comprise a greater percentage of our total sales through the remainder of fiscal 2009 and into 2010.

As a brief six-month review, sales for the first half of fiscal 2009 increased 20%, year-over-year, to $51.6 million. Product trends in the first half were similar to the second quarter. Ejector system sales were down while condenser, heat exchanger, pump package and after-market sales all increased in the first six months of fiscal 2009, compared with the first half of fiscal 2008. We received $17.5 million of orders in the second quarter of fiscal 2009, down from $20.5 million in the same period the prior fiscal year. In the quarter, orders for ejector systems increased $2.1 million, year-over-year. However, this increase does not offset the decline in condenser and pump package orders.

International orders grew larger, comprising 48% of total orders in the quarter, up from 42% in the second quarter last fiscal year, with the increase primarily coming from Asia. For the first six months of fiscal 2009, orders were $45.3 million, compared with $45.4 million in the first six months of fiscal 2008. Significantly higher condenser and heat exchanger orders were offset by relatively flat ejector orders and decreases in pump package and after-market orders.

International orders were strong in the first half of fiscal 2009, increasing to 59% of total orders to $26.5 million, compared with 29% or $13.2 million in the first half of fiscal 2008. At the end of the second quarter, backlog was $69.7 million, up 23% compared with $56.8 million at the end of the second quarter of fiscal 2008. We believe that virtually all of the backlog will be converted to sales within the next 12 months.

I will now review the operating performance for the quarter and six month period. Gross margin was again strong in the second quarter at 43.9%, compared with 42.9% in the second quarter last fiscal year and higher than the guidance we had previously disclosed, due to the mix of higher margin projects and continued gains in operating leverage. For the first six months, gross margin was 44.1% in fiscal 2009 and 38.5% in fiscal 2008, with higher after-market sales in the first quarter contributing to the favorable product mix. We expect gross margin to moderate in the second half of the fiscal year and the full fiscal year margin to be in the range of 39% to 42%, reflecting the orders in the backlog and declining material prices.

SG&A expenses were $3.9 million, or 16.4% of sales, in the second quarter of fiscal 2009, up from $3.4 million, or 14.9% of sales in the same period last fiscal year, although flat compared with expenses of $3.8 million in the first quarter of fiscal 2009. Consulting costs were incurred in the second quarter, which are expected to contribute to greater efficiencies in IT, engineering, and manufacturing. For the six-month period, SG&A was $7.8 million, or 15% of sales, in fiscal 2009 and $6.5 million, or 15% of sales, in fiscal 2008. Higher sales commissions and variable compensation contributed to the six-month increase in expenses. We expect SG&A expenses to be 15-16% of sales for the full fiscal year.

Interest income was $172 thousand in the second quarter, down from $264 thousand in the second quarter last year, due to the fall in interest rates and the change in our internal investment policy to invest exclusively in US treasury securities rather than both treasury securities and US sponsored agency notes. For the six-month period, interest income was $303 thousand in fiscal 2009 and $494 thousand in fiscal 2008. The effective tax rate was 34.5% in the second quarter of fiscal 2009 and 34% for the first six months. The rate is projected to be 33.5% for the full fiscal year.

Net income in the second quarter of fiscal 2009 was $4.4 million, or $0.43 per diluted share, compared with $4.4 million, or $0.44 per diluted share, in the same period the prior year. For the six-month period, net income was $10.1 million, or $0.99 per diluted share, for fiscal 2009 and $7.1 million, or $0.71 per diluted share for fiscal 2008. The per share data reflects the 2 for 1 stock split that was effected on October 6 for stockholders of record on September 5.

At their meeting yesterday, the Board of Directors declared a quarterly cash dividend of $0.02 per common share. The dividend will be payable on January 5 to stockholders of record on December 1.

Cash, cash equivalents and investments were $42.9 million at the end of the second quarter of fiscal 2009, up from $36.8 million at March 31, 2008. There were no borrowings on our $30 million revolving line of credit at the end of the second quarter and $8.8 million outstanding in letters of credit.

Net cash provided by operating activities was $4.4 million in the first half of fiscal 2009, down from $9 million in the same period last fiscal year, due to higher working capital requirements from an increase in accounts receivable due to timing of customer billings, higher inventory and a $3.5 million contribution to the pension plan.

Capital expenditures were $576 thousand in the second quarter and $795 thousand for the six-month period of fiscal 2009, up from $284 thousand and $447 thousand in fiscal 2008, respectively. We expect capital spending to be in the range of $1.8 million to $2.2 million for the full fiscal year.

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

Jim Lines: Thank you Jennifer. Operator, you may open the line now for questions.

Operator: Thank you sir. Our first question is coming from the line of James Bank with Sidoti and Company. Please go ahead with your question.

James Bank: Good morning. My first question is on SG&A. I think that was the biggest alarm to me, and I guess, the biggest disappointment in the quarter. Why was the expense so much materially higher than it was in the first quarter? On a percentage of sales basis?

Jim Lines: The SG&A has a component that's tied to the profitability of our orders, which is commission and variable compensation. That has been the biggest cause of the increase in the profitability of our work, maintaining the margins at 44.4%, and we had some consulting expenses as well

James Bank: Ok, so given the fact that the gross margins were relatively similar, I suspect the fact that because sales were down, profit sharing still will remain static more or less?

Jim Lines: More or less.

James Bank: Fair enough. Thank you. Jim, could you quantify the hesitation of the large order placement?

Jim Lines: Sure. We began to see some slowing a few months back from our customers. We have commented on several conference calls, going back over the last several quarters, about the difficulty we had in predicting when orders would be placed by our customers. We commented in the past that some orders that we thought would be booked in a particular quarter were still open to be won several quarters later or were booked two or three quarters after we thought they should be booked. We've noticed that there's been a slowdown as a certain segment of the customers are taking a wait and see attitude. Other customers, I would say the independent refiners, have had to change their capital spending plan in light of what's occurring in the credit markets. I commented that the independent refiners are important to us, but they have in the past represented between 5 and 10% of sales. Our integrated customers, or the nationalized oil refiners, haven't seen the credit market affecting their long-term spending plans. Although I would say we have seen a pause or, I believe, a temporary delay in order placement.

James Bank: Okay, so if I had to quantify it, it would probably be in the ballpark of $1 to $3 million for these independent refiners?

Jim Lines: You're trying to quantify the delay within the quarter for the bookings?

James Bank: Yes.

Jim Lines: Well, we are a lumpy business and we have talked about that in the past. We were expecting a couple larger orders to be placed in this quarter that just ended. However, they've carried into the quarter that we're in now. We expect to book them in our third quarter. So some of it is timing, James.

James Bank: The after-market orders certainly were very good in the second quarter again, like the first. What's the driver behind this, if there is one?

Jim Lines: A driver that we've been made aware of is just the strong compelling argument to keep a refinery running. We've seen our refining customers make purchase decisions for capital spares that we hadn't seen them make in the past. The rationalization they were giving to us is that what is most important to them is assuring on-stream performance from a turnaround for the next five years. They can't afford an unscheduled turnaround because of the financial implications of that. So they've had a different purchasing pattern than we've seen in the past, favorably affecting us. That's just due to the strength and the importance of keeping the refinery on-stream.

James Bank: I have just one more question about the orders. When I went back and looked at it historically and what you have done since your fiscal 2000 year, the year-end order number and the subsequent year in sales were pretty much identical. I think there was just one year where your year-end sales were a little bit lower than what that year started with, in terms of orders. If we go to the lower end of your top-line guidance range, that number will now be, I believe, lower than your year-end orders were when you finished fiscal 2008. Is this just a cautious tone we need to take in this type of environment, given what we've seen? Or is there something really underpinning that, that you're not targeting that lower end of your top-line guidance range?

Jim Lines: You are right. Looking back, there was almost a correlation of one between bookings the prior year and sales the subsequent year. This year, however, we are seeing projects extended by our customers. The delivery cycle in the past had been 8-12 months, from order to shipment, for a major contract. Today, and as we've talked about in prior conference calls, the schedules are nearer to 12-15, in some cases 18 months. I don't view this as a capacity constraint for our business. It's a pacing of project execution by our customers.

James Bank: Very helpful. And lastly, the inventory is not a considerable amount, but certainly higher than where it's been in the past. And I took a double-take also because the commodity prices have come down considerably. So what's in that inventory right now?

Jim Lines: With what was happening with our customers, and again going back to delays, we are an engineered-to-order business and there are starts, stops, and engineering change orders that come into play. We felt we were coming into an environment where we would have more of that, so we proactively increased our inventory to give us production continuity and flexibility. That showed up in our WIP and that showed up in our inventory number. That will work itself out, but that was a proactive decision by management to maintain production continuity.

James Bank: All right, fair enough. Thank you, Jim. I'll jump back in line.

Operator: Our next question will be coming from the line of George Walsh with Gilford Securities. Please proceed with your question.

George Walsh: Thank you. Jim, with the pullback in the price of oil, how does that affect certain projects, like in the oil sands in Canada. Anything on the outlook there in terms of near-term impact with pricing and then long-term demand outlook?

Jim Lines: That's a great question. I would say we're in our second year of project delay that we're seeing in the Alberta oil sands area. This is not so much tied, initially, to the price of oil, but more to the ability to execute the contracts, (coordinating) the contractors, the EPCs in that region, the construction, and the availability of human capital to execute the contracts was in short supply. So they've had to slow down those projects. At the same time, the cost of the projects was escalating very quickly. But I just want to put this in context. We look at the oil sands as a scenario where we'll continue to invest; we look at the first one million barrels per day of oil that was brought on stream between 1996 and 2006. If you think in terms of what oil was then, between $15 a barrel in the mid 1990's, up to $50 - $60 a barrel in 2005 and 2006. We know the refiners, today, because of the cost of the projects, are using somewhere between $70 and $85 per barrel for the economic analysis of the project viability, because the cost of the projects have doubled. But we still see the oil sands as an area where investments will be made. If you look at the investments that are going on in the petroleum and administrative district, too, in the US, they're making significant revamps to US refineries in preparation to be able to process the better crude oil that's going to be produced in Alberta, coming from future investments. We see this as a timing issue. We think the break-even for those projects is below where the price of oil is today. We believe, however, there is a timing issue, and we're looking at a second year of delays.

George Walsh: Where do you think that break even point is?

Jim Lines: Well, as I mentioned we know they're looking at somewhere between $70 and $85 a barrel. This is what we're being told in economic analysis, primarily because the cost of the projects has doubled. When we think in terms of what occurred from 1995 through 2004, those projects were in the ballpark of $5 - $8 billion. Today we're hearing numbers that are between $12 and $18 billion for the cost of the project, including the mining and the upgrading. So they're using a higher price for the price of oil in their economic analysis to take some of the risk away.

George Walsh: Jim, another question on another topic. You've used this cycle to beef up the balance sheet. You've got more cash than you've ever had in your history. You have more shares outstanding and you have more liquidity than you've had. You mentioned M&A possibilities for the company. You have had a certain pullback here in the economy and in the price of oil. Has that created any opportunities, or what is your strategic thinking, and what is the landscape in terms of potential acquisitions or any type of M&A activity for you?

Jim Lines: To be succinct, my strategy for the business hasn't changed. Our plan is to double the size of our company over the next three to four years. Three to five years was our initial timeline; doing that through both organic growth as well as acquisition growth. I see what's happening in the marketplace, as painful as it is, as an opportunity. We're going to continue to do what we do well, which is improve our current company and use the strength of our balance sheet, the strength of our brand, to look at external growth options as well.

George Walsh:. I'm just pushing a little bit. Can you be a little more specific in terms of the type of opportunities you're seeing there that you could take advantage of?

Jim Lines: Well I think it's still a little early. The valuation, we believe, for the businesses that are selling into the energy sector still is high. Give it a couple of quarters, depending on the severity of the pullback, and I think there will be some opportunities in front of us in subsequent quarters. But, to give you an idea of what our thoughts are regarding acquisition criteria, the acquisition size would be below $100 million. It would be engineered-to-order products that fit our brand, that are in the energy sector. In the energy sector we're not just talking about oil refining and petrochemical. We are talking about power generation, alternative energy, waste energy, and geothermal. The areas where the Graham brand is exceptionally strong and differentiated solution can be sold at a premium, and that's what we do well. And, we'll look to expand our geographic market presence, perhaps our geographic footprint, and diversify our products.

George Walsh: Ok, very good. Thank you, Jim.

Operator: Thank you. Our next question is a follow-up from the line of James Bank of Sidoti and Company. Please go ahead with your question sir.

James Bank: What was the percentage of subcontractor work in the quarter?

Jim Lines: It was around 6%.

James Bank: Are you going to revise it; is it going to be 12% - 13% for the full year or is it maybe down from there?

Jim Lines: In our earnings release, we guided to a number in the range of 8% - 10%. Entering the quarter, we had forecast at a higher level of subcontracting. But, as is the nature of our business, within a quarter things happen that cause projects to be delayed. We had a large project that will be built in China; it was to commence in the quarter that just closed. However, due to delays, it has been pushed out to commence in the quarter we are in now. We are expecting a higher level of subcontracting, but due to the timeline of that project, there were some changes. In addition, we've had a slowdown caused by engineering change orders for a US-based refiner; two very large vacuum pump packages, that haven't been able to kick-off because of the engineering flux between us and the contractors. So we were anticipating a higher level of subcontracting, but due to the nature of our business, we came in at 6%.

James Bank: I did catch in the press release that the SG&A as a percentage of sales guidance of 15% - 16%, so with that I can assume higher profitability in the back half, especially if you have less subcontracted work. Can we then assume that maybe your gross margin will be on the higher end of the 39% - 42% range?

Jim Lines: I would maintain that it will be between 39% and 42%. However, remember what I just said. Our Chinese project will have subcontracting in Q3 and Q4. Also, there is other subcontracting in our work, as well, to bring us between 8% - 10% for an average for the whole year. I would caution that will be around the midpoint to the lower end.

James Bank: Even with the assumed profit-sharing in the back half of the year?

Jim Lines: Yes.

James Bank: All right, thank you. That's all I have.

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

Jim Lines: Thank you. I would just like to reiterate that our backlog is strong, at a near record level. We have taken steps to evaluate the quality of our backlog and any execution risks that there might be. Our quotation pipeline is robust and is still at a very high level. Our research and discussion with the end users and the contractors has concluded that the long term growth prospects for the energy sector are unchanged. I am confirming our prior guidance of revenue growth between 15% - 20% and gross margin between 39% - 42%.

Our managers and employees are continuing to execute our business improvement initiatives, and they are having a positive effect on our operating results. The company's balance sheet is excellent. We are carrying no debt. Our pension assets are in good shape. Cash utilization efficiency is excellent, and our cash and investments on hand are just under $43 million.

Thanks to the hard work of our managers and employees, Graham is in excellent shape. And I look forward to updating you on our progress during the January conference call. Thank you.