

Graham Corporation
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Graham is a manufacturer of specialized equipment typically used downstream in the oil refining, petrochemical, fertilizer (industries) etc. There is also a power generation aspect to the company as well. From Upstate in New York and Buffalo, we have CEO, Jim Lines here. Jim has been with the company for 25 years, started out as an engineer, worked his way up and now he is CEO. Jim?

James Lines: Thank you, Rick, and good afternoon. I'll start with a brief overview of Graham. We are a publicly traded company on the New York Stock Exchange - Alternext. We've had a couple of stock splits over the past two years, a two-for-one and a five-for-four. Our current issued stock is ten million shares. We've increased our institutional ownership over the last four years from about 15% to 75% - 76% today.

Our vision is to be a world leader in the design and manufacture of engineered-to-order products to the process industries. We feel the process industries will value the equipment suppliers that can provide quality, strong engineering support and a consultative sales model, and decisions are made by the process end-users based on value rather than based on price. We think that's where our brand fits.

The drivers of our business are the ejector systems and steam surface condensers. Over a longer period of time, each represent roughly one-third of revenue. Today, ejector systems are about 34% of sales and condensers about 25% of sales because of the strength of the refining sector. We also have a very solid aftermarket business, which consistently provides about 16% to 18% of sales. Today it's 21% because of a couple of large capital sales that we received last year. We are an international company with revenue for the trailing 12 months at \$99 million, roughly two-thirds US, one-third international. Projecting our company forward two or three years from now, we would expect our sales mix to be 60% international and 40% domestic. We sell into refining, chemical processing and power generation markets. Also a variety of other end user markets. Again, over a longer horizon, a five or ten-year period of time, you think of our business as one-third, petrochem and one-third refining. Power generation has varied between 5% of revenue and 20% of revenue.

Adding a little more color on the markets that we serve, in oil refining, our equipment is involved in the processing of conventional crude oils, oil sands in Alberta, extra heavy crude oils in Venezuela, solid crude, lube oil fractionation; a variety of heat and mass transfer applications in the refinery sector require our equipment. Chemical processing is a very broad umbrella. We serve a number of end-use markets, including ethylene, ammonia, nitrogen, and methanol. Those are considered commodity petrochemicals or feedstock petrochemicals that provide feedstock for downstream value-add chemical producing facilities such as styrene plants, polystyrene, ethylene oxide, ethylene glycol, detergent alcohols. Chemicals that go into the use of consumer products, whether that be clothing, CD's or dashboards in the automotive industry. We also put under the chemical processing umbrella, coal to liquids and gas to liquids.

Power generation. We are mainly involved in a power cycle where the steam output is between 5-megawatts and 75-megawatts of power output. That would be for cogeneration plants, waste-to-energy plants, combined heat, power and

light, and geothermal. We also have in the past provided products to the nuclear industry. We will do so again in the future.

Other applications that we provide our products for include edible oils and oleochemicals. That would be Procter and Gamble, Colgate, Archer-Daniels Midland, those types of companies. Ethanol, biodiesel, heating, ventilating and air-conditioning are also markets for our products, along with industrial gases and cryogenic applications. This gives you a sense for our orders over the last nine months. We won a large ejector system for North African fertilizer project, \$2.5 million; refinery project in China, \$3.5 million, and a very large refining project in South Korea that was for a heavy oil upgrade project.

Middle East. A big market for Graham is in the Middle East. We've had a \$1.8 million ejector system for an oil refinery in the US that was for increasing diesel production, power generation in Turkey, \$2.6 million, and a petrochemical project in China. So as you can see, we sell into a broad geographic end-use market as well as refining, petrochem, and power generation.

Long-term demand growth. What is happening in the markets today, as brutal as they seem, are short-term issues. It has happened in the past. If we can think back to the late 1990s, the early 1980s, the mid-1970s where there was a very abrupt, very steep market correction. That's happened again, the duration of it is relatively short. Typically, one to two years. Although the one in the late 1990s was three or four years in duration. But we don't believe the long-term fundamental drivers that are creating additional demand for energy projects have changed at all.

Our view is that Graham is an excellent long-term supplier to the energy markets. We can navigate the short-term issues that are in front of us. But the drivers - environmental regulation requiring cleaner transportation fuel, less emissions from the plants, feedstock diversification, capacity creep as well as new capacity and ongoing demand for energy products increasing 1% to 1.5% per year - will create demand for our products over the next 5, 10, 15 years. That is significant when we look at the capacity increases forecasted to come on stream between now and 2015. We feel that creates demand for Graham's products from \$120 to \$250 million (through 2015) and, out to 2030, \$400 million to \$800 million of demand for our products and services.

Going over some financial highlights. We've expanded revenues 250% over the last five years from \$41 million in our fiscal 2005. Our fiscal year ends March 31st. Fiscal year 2009 will end March 31st, 2009. We've expanded from a \$41 million business five years ago to projecting to between \$99 and \$103 million for the year-ending March 31, 2009. Compound annual growth rate is just over 24%. While we are growing and there was strong demand for our products and services coming from the energy sector, we wanted to focus on a couple of key aspects during the growth.

One was to drive productivity and efficiency into our business to maximize what the market was offering while we were focused on improving our company. Our productivity measure that we look at is sales per employee. While our sales have gone up 250%, and our sales per employee have increased from \$150,000 to \$331,000 per employee, we've been

able to only increase our head count by about 20% to 25% over that period of time. That speaks to the productivity that we've been able to put into the business. Also, inventory turns have improved dramatically from somewhere between four to six times per year to 10 to 12 times per year today.

We've concentrated on improving the business, as I mentioned. Gross margin has improved from the mid to upper teens to upper 30s; we've eclipsed 40%. The trailing 12 months is at 41.4%. We've worked to invest in our plant with new welding equipment, new burning equipment, addressing quality issues, production flow, and tackling lead time to minimize the cost-of-goods sold as a percentage of sales, and that is showing up in our gross margins.

Net income has expanded significantly as we leveraged the capabilities of our business from a break-even in 2005, to the trailing 12 months net income of \$18 million. Last year, on \$86 million of revenue our net income was \$15 million. While we've grown, we've had a challenge to the management team to grow through operating cash flow and not take on debt during this growth. We've been able to achieve that. We currently have \$45 million of cash and investments on our balance sheet. No long-term debt. Our pension assets are in fine shape. Our balance sheet is very strong. As we entered the market correction we are experiencing right now, our company is in very fine position both operationally and from a balance sheet perspective. We put a priority on cash management. While the business grew 250%, our cash conversion cycle was reduced from over 100 days in 2004 and 2005, to less than 40 days today. We've done that by connecting the entire company from order-entry to shipment of the product to accelerating collection of cash, and connecting everyone to that objective. That's been significant.

Strategy and outlook. We are experiencing a dramatic short-term change in demand throughout the refining and petrochemical sector. What's caused that has been a change in the commodity price of oil going from north of \$100 a barrel to below \$40 a barrel today, an overheated supply chain, change in the credit markets and reduction in consumption of oil products, that has caused the utilization of the refiners to be at a lower level than it had been: from low to mid \$90s to mid \$80s today. That's effected a shift in demand. We've seen our backlog drop from \$75 million to \$52 million. As I said earlier, this has happened in the past. The typical downturn has had a 30% to 35% reduction in top line. We are entering this downturn with a comparable expectation.

What we've done, though, to modify the business's performance in a downturn has been dramatic. This graphic shows that with a hypothetical reduction in top line of 35%, which historically has been the top line reduction when the markets have abruptly changed. Again in the late 1990s, early 1980s, mid 1970s, our company would essentially break-even or move to a slight loss position. Projecting under this hypothetical scenario, a 35% top line reduction, we still expect to be profitable with gross margin in the range of 28% to 31%. This graphic analysis is based on 29.5%, with a positive operating margin of about 8%.

Strategy for long-term growth. We've concentrated on growing the level of fixed, less cyclical sales that our company has. We've been able to increase that by about 50% over the last four years. Equally important, if not more important, the gross profit generated by that increase has increased by about 75%.

We've also focused on geographic diversification. We established a sales and marketing office in Suzhou, China, to address the demand for our products in China, particularly in the refining market. As I mentioned earlier, we can project that going forward, two or three years from now, we expect our sales mix to be 60% international, 40% domestic. We've concentrated on the after-market revenue. We are a company that's 72-years old. We have a very rich install base of products. There are certain wear parts in our ejector systems, our heat transfer products and surface condensers that provide ongoing revenue opportunity. So, we focused on our after market revenue as well.

Broadening the markets that we sell into. We see nuclear as an opportunity and alternative energy as an opportunity for our products. We've also spent a great deal of time and energy focusing on optimizing our operational efficiency. That is showing up in our gross margin. As I noted earlier, we feel that sticks with us, up-cycle, down-cycle, and we will be a different company through this down-cycle than we were in the past.

We have a strong balance sheet, as I mentioned, with \$45 million in cash and investments. We view this downturn, as brutal as it feels, as an opportunity for a well-positioned company with operating cash flow and a strong balance sheet to look for opportunities to diversify through acquisition. Our acquisition criteria would be a company below \$80 million (revenue) that would diversify our sales by product or by market, be an engineered-to-order type product, be a company that's running well with a strong management team, with a management team that is intent on staying with the business, and allows us to either leverage our existing sales channel or move us into additional markets.

To give you a sense for the pipeline of projects that we are looking at, we see our pipeline as not changing one bit with what's happening short-term. There's a strong amount of projects that our sales and application people are working on, no different than it was six months ago. We see some US refinery work, China Refinery work, Middle East Refinery work, fertilizer work, and petrochemical work throughout the world. We see our pipeline being no different. So, what's happening short-term is just that; we view it as short-term. Our long-term fundamentals have not changed. We intend to capitalize on that, expand our market share and take full advantage when the markets recover.

Long-term future growth opportunities. We are in a great position financially, as I said, with a strong balance sheet and strong operating cash flow. We expect, even in the downturn, to have strong operating cash flow. We have an excellent brand, a global brand, a well respected brand in the energy market, whether that be in power generation, oil refining, petrochem, or alternative energy. The Graham name is known and respected throughout the world. We still feel we can continue to achieve organic growth. We can also evaluate acquisitions practically with our current financial position.

With that, I would be glad to open it up for any questions that you might have.

Q&A

Rick Hoss, Capital Partners: Jim, can you give us a little more appreciation in context of cancellation of a project. I think people automatically associate the price of oil going up \$40 a barrel as the cause or the reason why these are being canceled. However, it probably has more to do with the ROI's improving as the oil companies delay projects?

James Lines: That's a great point, Rick. One of the things we are seeing with respect to our potential bookings pipeline is our customers waiting on the side lines to watch as the markets cool down, as the supply chain softens. There is an expectation by our customers, whether they be a large integrated oil company or a nationalized oil company, that if they wait 6 to 12 months, the supply chain will slacken and costs will come down. A couple of projects that we referenced earlier were for the Middle East. They expect if they wait 6 to 12 months that their cost to build that new facility will come down 10 to 15%. We think those are understated. They might actually realize a greater cost savings. So the markets are prepared to wait, let the supply chain stabilize, let the cost come down and then re-engage in 6, 12 or 18 months from now. With respect to another question that we do get in regards to our backlog and are there cancellation risks in the backlog, we have had a project canceled from our backlog. It was short-lived; it was one from the end of September, canceled in early October. We have also identified that five projects have been put on hold in our backlog, representing about 10% of our backlog. They've been put on hold for 12 to 15 months. Four of the five are from the refining market and one is from ethanol.

Rick Hoss: Thank you. The M&A opportunity, you displayed in a cash flow rich environment and building of the cash flow, and you say, okay, we are not going to look at acquisition, we are just going to grow, we are going to ride this wave. We know it's going to end at some point. But now, as it looks like we are peaking for this in the near term, now you start shopping as valuations are coming down. Now you start shopping?

James Lines: That's correct. We felt while we were growing organically and we were improving our business' operating characteristic, we felt it was most important to do two things: address the demand for our products from our primary markets while we concentrated on improving the company. So, we've looked at it differently going into the downturn and through the downturn than we had in the past. As I mentioned, in the past, our company was not profitable in the downturn or right around a break-even while we were growing 2004, 2005, 2006, 2007, and our mind was preparing the business for the eventual downturn. So we didn't look aggressively at acquisitions over the last couple of years, because we thought the valuations were high. But also we wanted to be in a great position operationally and financially to consider acquisitions when the valuations come down, which is during the downturn. So we had a thoughtful process, and a controlled process, to prepare the business, to be ready for those opportunities, which we think will be in front of us over the next several quarters.

Rick Hoss: Can you describe what you are looking for? What are your targets?

James Lines: Sure. There are a couple of criteria that we are looking for. One would be to leverage better our existing sales channel, therefore selling into oil, petrochemical, a broader array of products than we currently have. Or diversifying and entering into new markets that we are currently not in, such as nuclear, such as alternative energy, where the

Graham brand is already known, but we don't necessarily have the product mix to effectively go into that market. So a part of it is a channel expansion or leveraging our channel. The second aspect of it is entering new markets.

Well thank you Rick. Thank you for your time.