

**Operator:** Greetings, and welcome to the Graham Corporation Second Quarter Fiscal Year 2016 Financial Results teleconference. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host Karen Howard, Investor Relations for Graham Corporation. Thank you Ms. Howard, you may begin.

**Karen L. Howard:** Thank you, Tim, and good morning everyone. Thank you for joining us to discuss our results for the second quarter and the first half of fiscal 2016. We certainly appreciate your time today. You should have a copy of the news release that crossed the wire this morning detailing Graham's results. We also have slides associated with the commentary that we're providing here today. If you do not have the release or the slides, you can find them at the company's website at [www.graham-mfg.com](http://www.graham-mfg.com).

On the call with me today are Jim Lines, our President and Chief Executive Officer; and Jeff Glajch, our Chief Financial Officer. Jim and Jeff will review the results for the quarter and the first half of the fiscal year as well as our outlook. We will then open up the line for Q&A.

As you are aware, we may make some forward-looking statements during this 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, which could cause actual results to differ materially from what is stated on the call. These risks and uncertainties and other factors are provided in the earnings release, and in the slide deck, as well as with other documents filed by the company with the Securities and Exchange Commission. These documents can be found on our website or at [www.sec.gov](http://www.sec.gov).

With that, I am going to turn the call over to Jim to begin. Jim?

**James R Lines:** Thank you, Karen. Good morning, and welcome to our second quarter conference call. Jeff and I will update you on our performance in the quarter, and on our outlook.

Please refer to slide three. Revenue in the second quarter was \$22.8 million. This reflected timing of backlog conversion associated with weakened fundamentals in our refining and chemical markets that were particularly challenging starting in our third fiscal quarter of 2015. Revenue declined 36% on a comparable basis from \$35.6 million a year earlier.

Backlog at quarter-end of \$108 million continued to be strong. Gross margin in the quarter at 31% was above what is expected at \$22.8 million of revenue. We have a higher basis in cost of goods sold than the 31% gross margin would infer. In the quarter, gross margin was positively impacted by a vendor back-charge settlement and by productivity gains as we near completion of the CVN-79 U.S. Navy order. Gross margin in the mid-to-upper 20% range is what should be expected at that revenue level.

Income in the quarter was \$2 million or \$0.20 per share. This is down from \$4.2 million a year earlier. Approximately 187,000 shares were purchased for \$3.4 million as of the end of September. We've continued to repurchase shares in October.

I'm now referring to slide four. Weakening in refining and chemical markets tied to reduced crude oil pricing that took hold about one year ago has affected order pattern and revenue. As the top bar chart indicates, there has been a downward trend from fiscal 2015 quarterly sales to the past two quarters of fiscal 2016.

Sales to the refining industry were \$7.2 million, and that compares to \$12.3 million a year earlier. We experienced the same for chemical industry sales that were \$7.3 million in the quarter versus \$12.9 million last year. Power industry sales were \$3 million and sales to our other markets, including the U.S.

Navy were \$5.3 million. The lower bar chart provides detail for annual sales levels and you'll note that fiscal 2016 revenue guidance remains between \$95 million and \$105 million.

Jeff, let me turn it over to you for a more detailed review of results in the quarter.

**Jeffrey F. Glajch:** Thank you, Jim, and good morning everyone. On slide six, you can see Q2 sales were \$22.8 million, down 36% compared with \$35.6 million in the second quarter last year. Sales in the quarter were 67% domestic, and 33% international and represented a balance between domestic petrochem and refining orders which occurred in the first half of last year, as well as the near-completion of the CVN-79 Navy project.

Last year's second quarter sales were split 61% domestic, 39% international. Domestic sales decreased 30% to \$15.2 million, while international sales decreased 45% to \$7.6 million. Gross profit decreased to \$7.1 million from \$11 million last year due to the lower volume. Gross margins were nominally flat, up 40 basis points to 31.3%. This year's margin was favorably impacted, as Jim mentioned previously, by both productivity improvements as we near completion of CVN-79, as well as a vendor settlement.

EBITDA margins decreased to 15% in the quarter, down from 19% in last year's second quarter, driven by the lower volume, and therefore less absorption of fixed cost. Actual SG&A spending was down by \$500,000 or 11%, primarily due to the benefit of the restructuring activity that we undertook in Q4 of last year. Net income decreased to \$2 million from \$4.2 million, or \$0.20 per share down from \$0.41 per share.

Moving on to slide seven. Results for the first half of fiscal 2016 were impacted by sales and absorption reductions in Q2. If you recall, Q1 of fiscal 2016 was fairly comparable to Q1 of last year. Sales in the first half of fiscal 2016 were \$50.4 million, down 21% when compared with \$64.1 million from the first half of last year, with almost all the shortfall coming in this quarter.

Year-to-date sales were 65% domestic and 35% international compared to 69% and 31%, respectively, last year. Domestic sales decreased to \$32.8 million compared with \$44.1 million last year, while international sales were \$17.6 million this year compared to \$20 million last year.

Year-to-date gross profit decreased to \$15.2 million, down from \$18.9 million last year. As with Q2, the decrease was driven by lower volume, partly offset by a 60 basis point increase in gross margins, again due primarily to one-time items in Q2.

Year-to-date EBITDA margins were 15%, down from 17% in the first half of last year. Net income decreased to \$4.3 million from \$6.6 million, or \$0.43 per share down from \$0.65 per share.

On slide eight, we had strong operating cash flow in the first half of the year at \$7.7 million, which was a mix of earnings and some unwinding of working capital, which we discussed on previous calls.

We returned \$5 million of this to shareholders, \$3.4 million in share repurchases as Jim mentioned, as well as another \$1.6 million in dividend payments. Our cash balance is up approximately \$2 million from the end of fiscal year 2015 at \$62.4 million. We expect some further working capital gains in the second half of the fiscal year, most likely in the third quarter, as we further unwind our working capital, which was at an elevated level at the end of fiscal 2015.

Jim will complete our presentation by discussing the market outlook and our full-year guidance. Jim?

**James R. Lines:** Thank you, Jeff. Please turn to slide 10. Our order pattern from refining and chemical markets, as I noted in earlier remarks, changed dramatically, starting in our third quarter of fiscal 2015. During this most recent quarter, gross orders were \$24.5 million, or \$20.6 million net of a \$3.9 million

order secured in our second quarter of 2015, that went into delayed conversation shortly thereafter and that now has been canceled.

Refining and chemical industry orders are expected to remain volatile due to immediate industry reaction to dramatically reduced crude oil prices. We believe this has a short-term impact on orders.

Longer-term, the global demand drivers that ultimately impact orders from these markets, such as expanding population and increasing standards of living, and thus corresponding increased global energy consumption, will spur investment in new oil refining and chemical industry capacity along with spurring investment that keeps current capacity operating efficiently. We have higher weighting for orders for U.S. end users represented 59% of total orders in the quarter. Our sales personnel are quite active as there was currently a significant amount of bidding work ongoing.

Slide 11. We have built a terrific backlog of work that stood at \$108 million on September 30. Due to the strength of our naval strategy, coupled with weakened refining and chemical markets, the percentage of backlog planned to convert during the next 12 months is 45% to 50% of total backlog. 55% of backlog is from markets or customers not served by the company five years earlier. Action taken to diversify markets served has dramatically improved backlog and long-term outlook for revenue and profitability. 47% of backlog is for the U.S. Navy, 27% is for the refining market. Power and chemical industries each represent 10% of backlog. Our backlog composition has a different conversion schedule than it has had historically. Around 45% to 50% converts within 12 months, 5% to 10% converts 12 months to 24 months, and the remainder, which is 40% to 45%, converts beyond two years from now.

I now refer to the guidance slide. Current guidance for revenue is unchanged at a range of \$95 million to \$105 million. We have narrowed gross margin to a range of 27% to 28%. SG&A holds at 17% to 18% of sales. Full year effective tax rate is anticipated to be between 32% and 33%.

Our vision and strategy, which is to expand Graham's revenue base, hasn't changed as we implement and execute strategies intended to drive top line to \$200 million or greater. It is important to point out that we are now carrying \$1.5 million to \$2 million of pre-tax personnel expense necessary to support longer-term growth initiatives, such as our naval and nuclear market strategies. This expense is included in our guidance, and is primarily in cost of goods sold.

It is our intention to stay committed to long-term growth initiatives that require between \$1.5 million and \$2.5 million of pre-tax investment expense in personnel at a corresponding revenue or offsetting profit, while managing across challenging quarters during the short-term. Investment expense will be added prudently. However, we are more focused on long-term earnings than maximizing short-term quarterly profit.

Tim, please open the line for questions. Thank you.

**Operator:** Excellent. [Operator Instructions] Our first question comes from the line of Joe Mondillo at Sidoti & Company. Please proceed with your question.

**Joe Mondillo:** Regarding gross margin, how much did that vendor settlement amount to in the quarter?

**Jeff Glajch:** It was a couple of hundred thousand dollars.

**Joe Mondillo:** Okay. In terms of the increased guidance, narrowing into the high-end of the gross margin guidance, was that mostly related to that vendor settlement, or was that something else?

**Jeff Glajch:** Well, as we got to the mid-point of the year, taking into consideration the benefit of the stronger gross margin in the second quarter tied to the things that we had mentioned, we did feel it was

necessary to tighten the guidance to reflect where we think the second half will be. Absolutely, our narrowing was correlated to a strong performance in the second quarter.

**Joe Mondillo:** If I take out \$200,000 in the second quarter related to that vendor settlement, it's almost 100 basis points, was the narrowing of the guidance largely to do with that or was it a combination of that, as well as determining how the backlog was going to fall in the back half of the year, and how that gross margin will look?

**Jim Lines:** Joe, our view of the second half of the year margin isn't changing from what it's been, but if you look at the first half between the vendor settlement and the productivity improvements that we saw in CVN-79, our margin through the first half of the year is 30%. And so our range of 27% to 28%, obviously would suggest margins will be lower in the second half of the year to get down to the 27% to 28% range. But we felt if we kept the range at 26% to 28%, that would suggest a really low potential margin in the second half of the year. And while it's going to be lower than the first half, it won't bring our overall margins down south of 27%.

**Joe Mondillo:** Okay, perfect. Thank you for that. Next, in terms of the orders, I was wondering if you could walk me through the several different end markets and give a little more color on what you are seeing or feeling. Oil refining actually was the strongest quarter of orders in four quarters now, but chemical and petrochemical was probably the worst in over 18 months or so. So if you could walk through the four different end markets and give us your take on how you're feeling about them, that would be helpful.

**Jim Lines:** Sure. As it relates to the refining market, you are correct, we did have strong order intakes in the quarter, and that was encouraging. We do remain long-term optimistic about the refining sector, although we have to respect the short-term challenges that market is going through. If we separate the refining market into new capacity and investment in keeping existing facilities running, we do expect to see stronger quarterly orders on the latter segment of the refining business, which is keeping the existing facilities running, and investments in, as we call them, brownfield investments.

For new capacity, that's a little more difficult to predict. We have a fairly substantial pipeline of bidding activity. We've had a fairly substantial pipeline of bidding activity for new capacity for a couple of years now. Fortunately, one of those orders fell into the quarter. Our team did a great job to be in a position to pull that in. It's difficult to predict it, Joe, if that will be repetitive or if it is signaling a change in the refining market, and we don't think it is at this point in time. But overall, forgetting about the immediacy of what's going on in our refining market, we're very positive about the long-term direction in the refining space.

In the North American chemical sector, we have begun to see the second wave of new petrochemical capacity enter into the bid pipeline. The first wave was the summer of 2013, in which we secured a fair amount of work.

But the second wave is starting to set up now, and secondarily, and also importantly, we've begun to see some of the downstream investments that follow the first wave of new capacity enter into our bid pipeline. We're beginning to see that segment show some signs of activity, which we hadn't seen for about the last four quarters to five quarters, quite honestly.

That is encouraging, but I do want to couch that optimism with the remark that is important to bear in mind that the first wave of new chemical capacity in North America was predominantly from domestic end users. This next wave has an international aspect to it, whether it is an international end user or an international EPC being involved in the projects.

That does have a tendency to put pressure on margins, and changes the competitive landscape for who we might be competing against. And that could affect our capture rate and/or the margins which will win

that work. However, all-in-all, it's good to see the second wave of new capacity entering into the bid pipeline, as well as the downstream activity from the first wave.

On the nuclear market side, we're very encouraged there with the work that our team leading our nuclear strategy is doing to build our pipeline. We've brought a new general manager into that business, nuclear market engineering and project management specialist, as well as a new sales manager, and we're beginning to see the pipeline start to diversify and expand, and we expect that to translate into stronger bookings, and then correspondingly stronger revenue some quarters out from now. As as we look at what that team has done, it's very encouraging.

On the naval side, that work has intermittency to it. We think over the next 12 months to 15 months, and this is a broad range, but there'll be \$30 million to \$50 million worth of activity that should close that will be in our addressable product scope.

For the smaller segment of our business that we call short cycle, that's actually fairly steady. We haven't seen much erosion in that level of business there.

**Joe Mondillo:** Great. Thanks a lot, Jim that was very helpful. Lastly, I'm wondering if you could comment on the M&A market, now that we're 15 months into the downturn in oil prices and the weakness that we're seeing overall in the industrial sector worldwide.

**Jeff Glajch:** Joe, we are continuing to look at opportunities. The market is still a little pricier than one would think it would be this far into what would be clearly a downturn, but we are continuing to look at opportunities, and we certainly are active there. But I can't say I'm encouraged that prices are coming down, so we must take that into account as we continue to move forward.

**Joe Mondillo:** Okay. Does that change your way of thinking about capital allocation at all? I noticed that you did buy back some stock in the quarter. Does that imply that, if you're not able to get something done, you'll be participating in that?

**Jeff Glajch:** Not at all. We're still very encouraged at the opportunities that are out there from the acquisition standpoint, you just have to find the right one. Our buyback is a separate activity, and we're not intending to increase it or decrease it relative to our need for capital for acquisitions. When we laid the buyback plan out upfront, even if we execute on the full buyback, we have more than enough dry powder to also go through our acquisition program as we plan to. So while they're obviously related, in reality, they're distinct uses of capital. Clearly, the acquisition is at the top of that list, and the buyback is second on the list, but we believe we can do both without impacting either one.

**Joe Mondillo:** Okay, great. Thanks a lot.

**Operator:** Our next question comes from the line of Chase Jacobson of William Blair. Mr. Jacobson, please proceed with your question.

**Chase Jacobson:** Hi, good morning.

**Jeff Glajch:** Hi, Chase.

**Chase Jacobson:** Staying on this acquisition topic, I understand you've had a lot going on internally and that the prices are still hot. The weakness in the market is known by all the players and the seller expectations have stayed high. My question is, what gives you the confidence or the feeling that, eventually those prices are going to come down?

**Jeff Glajch:** Chase, this is Jeff. A couple of things. First-off, this is a bit similar to what we saw back in 2009 and 2010 where prices stayed elevated a little bit longer than one would have thought they would, and they did eventually come down.

But secondly, we're looking for one transaction, and if we can find that one transaction that perhaps has a little more reasonable expectations, we'll proceed down that path. This is a process that does require a little bit of patience on our part, but we're willing to have that patience and we do believe that we will find an acquisition opportunity going forward.

**Chase Jacobson:** Okay. I guess we'll have to be patient then, too.

**Jeff Glajch:** Exactly.

**Chase Jacobson:** On the gross margin, I understand where your revenue is, and that you have some under-absorption as you're positioned for the longer-term. I know we're not going to get back to the levels of fiscal 2009 and 2010. But just going back over a year, you were pushing 31%, to 30% – maybe going to 32%, is there a structural change in the market that's going to keep you from getting the gross margin back over 30% as we go forward or is this going to be a situation where it's going to stay highly competitive? The global market is not as strong, but you have pockets of strength here and there, and you seem to get stuck in the high-20% range.

**Jeff Glajch:** Chase, let me start answering this question, and then I'll pass it over to Jim, because I think he can give you more color on it. If you look at this year's gross margin in the range of 27% to 28%, and if you recall in Jim's prepared remarks, he mentioned the additional costs that we are incurring to drive some of our growth initiatives.

That is depressing margins in the neighborhood of 150 basis points to 200 basis points. Excluding that, we would be touching up pretty close to the 30% gross margin level even in this down cycle. With that as a basis point start-up, I'll let Jim give you more color around his view of where the markets are longer-term and where the margins perhaps are.

**Jim Lines:** Certainly, at this particular point in time, there is pressure on margins and the order environment is hyper-competitive for what's available to go after, and that has the tendency to compress margins. We're also seeing more flexibility to allow other suppliers into the bid process. I can speak more from a historical point of view, and then I'll give you my theory.

Every down cycle, we see pressure on project cost, more focus on price, and we see in the near-term some new entrants come in and take some business. We're very judicious, and we're very disciplined in how we protect our turf and our pricing decisions, and we expect the extent of the immense value that we provide to this marketplace, and we expect to be paid for that.

As we watch some of these price leaders take work, it's tough, but those decisions sometimes manifest themselves in wrong decisions to the end-user, three years or four years out; and that gets recognized. That happened in 1997 and 1998, and then it showed up in 2000. It happened again in the last downturn in 2010 and 2011 and it went away a couple of years later.

Speaking historically, we deal with this every time, and it has a duration. If it's irreparable, if it has changed the structure of our markets, which is not immediately evident to me, then we're planning on a new landscape, and Graham needs to change its value proposition and its cost basis. I don't believe that to be the case at this point in time.

**Chase Jacobson:** Okay, that's extremely helpful. I noticed an increase in receivables in the quarter, I think it's timing, I think it moved from unbilled revenue. Does that convert in the second half of the year,

and can you give any color if that's just a couple of big projects there or it's just a coincidence of timing on a lot of small things?

**Jeff Glajch:** Chase, you are correct, it moved from unbilled revenue to accounts receivable. In fact, if you were to go back a couple of quarters, end of March, you would see our unbilled revenue has dropped from \$18.5 million to about \$8.5 million, so down by \$10 million. Receivables have gone up by \$5 million and that's exactly what's occurring. It's the number of orders, but there are certainly a couple of big ones in there. Our expectation is that the receivable number will come down pretty meaningfully over the next quarter or two. I think a good portion of it will probably come down in the quarter ending in December.

**Chase Jacobson:** Perfect, thank you.

**Jeff Glajch:** Thanks.

**Operator:** Our next question comes from the line of John Bair of Ascend Wealth Advisors. Please proceed with your question.

**John Bair:** Thank you. Good morning. Couple of questions, in the acquisition outlook, would you probably use full cash or would you consider some stock as part of that?

**Jim Lines:** John, our expectation in order is to use cash first. If by some scenario, there was a large enough acquisition that has absorbed all of our cash, we would likely use a prudent amount of debt second, and prudent amount would be no more than 1 time to 1.5 times EBITDA. And then stock would be the third. It would have to be a pretty darn big acquisition for us to get to that stock, given the fact that we have over \$60 million of cash.

**John Bair:** All right, okay.

**Jeff Glajch:** The short answer is we do not want to use equity.

**John Bair:** Right, okay. Very good. The other question I have is, I saw announcement of a large Kuwaiti refining award, I think it was 600 plus thousand barrels a day. When those awards are made, how long of a timeline is it before you folks might be involved in the build out process of that?

**Jim Lines:** You're referring to the Kuwait National Petroleum Corporation Al Zour Refinery.

**John Bair:** Yes.

**Jim Lines:** We've been chasing that refinery project, we've been involved in the bidding process and the concept and FEED projects and EPC work since 2006. We've been on the hunt for this. It fell off the table at the end of the last cycle in 2009. It's been reactivated. There are four or five EPC modules that have been awarded. This has been on our radar screen for quite some time, and we've invested a great deal of energy to be participating in it.

**John Bair:** Okay. Are you saying that you're going to be part of that project or you're still in the award process? How does that work?

**Jim Lines:** Yeah. We're still bidding it. The EPCs have just been selected and the awards with the five models to the EPCs has occurred over the last two quarters to three quarters. We would expect the active bidding for purchase to begin in the next 6 months to 12 months.

**John Bair:** Okay. Okay, very good.

**Operator:** Our next question comes from the line of John Koller of Oppenheimer + Close. Please proceed with your question.

**John Koller:** Good morning, gentlemen. How are you?

**Jim Lines:** Doing real well.

**John Koller:** Great. The vendor settlement, that \$200,000, I'm going to assume that was pre-tax, since it was a reference to the expansion of gross margin?

**Jim Lines:** Correct.

**John Koller:** Okay, great. Can you also give any color or quantify whether your refinery orders were primarily large independents or global integrators or SOEs? Any type of breakdown would be helpful.

**Jim Lines:** The large order in the quarter, I'm unable to say who the refiner is, but it was a state-owned refiner that we got the new capacity order from. That was the majority of the orders, but there is underlying work that crosses all sectors, state-owned, multi-national integrated as well as the smaller independent refiners. But the large order that impacted the refining orders in the quarter materially was from a state-owned refiner.

**John Koller:** Okay, great. Are your customers still cautious and waiting for oil to settle down, or are you seeing a little more confidence? Could we potentially see a calendar Q4 budget flush?

**Jim Lines:** We feel that our aftermarket-type orders for existing refining capacity should begin to pick up. Those come out of the maintenance budgets and it's imperative to keep those facilities running well. Discretionary decisions to not invest in that manner for a couple of quarters is possible, but it can't be done for a long period of time and so we think that will be stepping up over the next several quarters.

In terms of investment in new capacity, those are very significant sums of money for the end-users. We would expect these companies to first get through their board meetings in January with the year-end results. If you recall, what happened when there was the dramatic change in the markets in November and December of last year, the real direction wasn't set until January, when the board meetings were held with the Boards of Directors, and they decided how to deploy their capital, and what projects were going to proceed. I anticipate the same to be true as we get through this upcoming first calendar quarter.

**John Koller:** Okay, great. Glad to see that there's the opportunity to repurchase stock and hopefully that opportunity may be short lived. Thanks very much.

**Operator:** Our next question comes from the line of Joe Mondillo of Sidoti & Company. Please proceed with your question.

**Joe Mondillo:** Hey, guys. Thanks for taking my follow-up questions. I just had two additional questions. Hopping on the question in regard to new capacity in oil refining, do you have any sense of how we can continue at the capacity that we're at? In other words, earlier this year, we were at 95%, 96% utilization rates at our refineries domestically, the highest level since I think 2005. Do you have any idea if that's sustainable, and they'll just continue to run at 95%, 96%, 97% utilization rates or do you get the sense that over the next couple of years that they are going to have to expand capacity to some extent?

**Jim Lines:** We have the view that they can't run that hard forever. That just doesn't make sense. If you look more long-term, the utilization levels in the refining market have been nearer to 85% to 90%. At times like this when they have a chance to maximize cash generation from the refining assets, they do that and they harvest, but they can't do that continually, because ongoing investment has to be made to



keep these facilities running, and then secondarily, there is global energy demand growth. There's also capacity destruction that has to be replaced.

There's been 5 million barrels per day taken out of capacity. While holding refining capacity constant, that means it was replaced by 5 million barrels of new capacity, and that doesn't necessarily get mentioned in any of the industry statistics. To us, that's incredibly meaningful, and there's another plan, \$3 million to \$4 million of refining capacity to be taken offline this decade, that will be replaced just to hold the line, just to hold the refining capacity. Again, those aren't reported in industry statistics, but they benefit Graham very much. I think new capacity in one form or another, either replacing capacity destruction or just pure new capacity, is coming. They can't run this asset base at this utilization level continuously.

**Joe Mondillo:** Okay, thanks. Secondly, on the \$46 million or so in backlog that's supposed to hit 2018 and beyond, I believe that's a three-year project, three years or four years. I was just wondering how that hits on an annual basis starting 2018, is it sort of evenly over a three-year, four-year period or is it going to be more lumpy over that period?

**Jim Lines:** It's about a five-year conversion cycle, and the first year and the fifth year are not as strong as years two through years four.

**Joe Mondillo:** Okay, great. All right, thanks a lot.

**Jim Lines:** You're welcome.

**Operator:** There are no further questions in the audio portion of this conference. I would now like to turn the conference back over to management for closing remarks.

**James R. Lines:** Thank you, Tim, and thank you, everyone for your attendance on our conference call, and for your questions. We look forward to updating you on our progress during the January conference call, and have a good week.

**Operator:** This concludes today's teleconference. We ask that you disconnect your lines at this time and have a wonderful rest of your day.