

Operator: Greetings, and welcome to Graham Corporation's First Quarter and Fiscal Year 2017 Financial Results Call. 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, Ms. Karen Howard, Investor Relations for Graham. Thank you. You may begin.

Karen Howard: Thank you, Adri, and good morning, everyone. Thank you for joining us to discuss the results for Graham's Fiscal 2017 First quarter. 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 don't have the release or the slides, you can find them at the company's website at 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 as well as our outlook. We will then open the lines 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.

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

James R. Lines: Thank you, Karen, and thank you, everyone for joining our first quarter results conference call. I will begin my prepared remarks starting with slide three. \$22.4 million of revenue in the quarter was down 19% compared with the same quarter last year, and flat on a sequential basis compared with the fourth quarter of fiscal 2016. The revenue decline was due to weak market conditions in oil refining and petrochemicals sectors. Revenue was also negatively impacted by timing of backlog conversion for our improved nuclear utility backlog and long-lived large naval orders that don't meaningfully contribute to revenue until the second half of fiscal 2018.

Short cycle sales in the quarter were down approximately 20% from the same period last year and about 10% down sequentially. Reported net income was \$0.01 per share in the quarter. Without the impact of non-recurring restructuring expenses, earnings per share were \$0.05.

The management team implemented restructuring activities at both our Batavia and Lapeer operations. Each of these operations reduced headcount to more appropriately align capacity with demand, which is anticipated to cross in the next several quarters. Batavia restructuring expenses appear in our first quarter income statement, Lapeer completed their reductions in July, resulting in minimal expenses that will impact second quarter results.

In both cases, headcount was reduced by approximately 10%. We did not change our commitment to our growth strategy because of the importance of diversification strategies into the naval and nuclear markets. Therefore, we were judicious about reductions that supported these strategies. Approximately 75% of the expense reduction is in cost of goods sold and the remainder is in SG&A. On an annualized basis, the savings are \$2.7 million. There are other belt-tightening actions occurring, which are reflected in our guidance that I will talk about later.

Backlog on June 30th was \$99.9 million. We had \$18 million of orders in backlog cancelled during the past six quarters, coupled with weak oil refining and petrochemical markets which resulted in backlog contraction.

Now please turn to slide four. Out of the \$22.4 million revenue in our first quarter, 32% was from the oil refining market or \$7.2 million; 23% from the chemicals markets or \$5.2 million; 21% from the power market; and the remaining 24% was from the defense and other industries. Power sales in the quarter were up 27% compared with the same period last year. Sales in the defense and other industries were up 10% compared with first quarter last year.

Jeff, I'm passing the call over to you to review detailed financial results. Jeff?

Jeffrey F. Glajch: Thank you, Jim, and good morning, everyone. I'm on slide six. As Jim mentioned, sales in the first quarter were \$22.4 million, down from \$27.6 million in the first quarter last year, reflecting the weakness in the commercial order environment over the past 18 months. Sales in the first quarter were 73% domestic and 27% international, compared with last year's sales with a split of 64% domestic and 36% international.

Gross profit was cut nearly in half to \$4.1 million due to lower volumes. Gross margin was 18.4% in the quarter, down from 29.1% in last year's first quarter. This year's margin was unfavorably impacted by the lower short cycle sales, as Jim mentioned earlier, lower overall volume, which of course resulted in under-absorption of cost. We do expect gross margins to pick up from this suppressed level as the year continues.

EBITDA margin decreased to 5% from 15% in last year's first quarter, driven by the low gross profit margin. However, SG&A spending was down by \$1 million, or 21%, primarily due to lower volumes, lower compensation costs, and the cost-saving actions which were taken last year. As Jim mentioned, we incurred a pre-tax charge of \$555,000, approximately \$383,000 after taxes, to right-size our business based on current market conditions. As Jim also mentioned, there will be a small charge in the second quarter, this will be less than \$100,000 on a pre-tax basis.

Net income excluding the restructuring charge was \$468,000, or \$0.05 per share, compared with \$2,361,000 or \$0.23 in last year's first quarter. Also included in this year's results there was a \$100,000 non-repeatable tax credit.

We can move to slide seven. We had positive cash flow in the first quarter, increasing our net cash position by \$2.6 million to \$67.7 million, or approximately \$7 per share. The step-up in the quarter was aided by an increase in customer deposits related to our navy jobs, offset partly by accounts receivable and unbilled revenue. We expect cash flow to remain positive over the remaining nine months of the year, especially in this next quarter or so, as the accounts receivables and unbilled revenue increases which occurred in the first quarter will unwind. We continue to look aggressively for acquisition opportunities to utilize a portion of our cash position.

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

James R. Lines: Thank you, Jeff. I'm now referring to slide nine. Just like the sales slide discussed previously, here too, the severity of the energy market downturn is noticeable in the trailing twelve months net order rates. Net orders reflect the \$18 million in cancelled orders in the past six quarters, including \$12 million cancelled in the past 12 months.

Our bidding pipeline, measured by the aggregate total of trailing-twelve-months bidding activity, has contracted approximately 20%, and that is being directly reflected in the order rates. First quarter orders were \$14.6 million. This is a particularly difficult downturn in the energy-related markets. These markets

always experience the harshest impacts in the middle of a downturn; however, this current downturn is more severe than the last one in the late 2000s or the one prior to that in the late 1990s. It may be even worse than the downturn in the early 1980s.

We won't be sitting back waiting for the eventual recovery. We will fight aggressively for every order and defend our market share vigorously. We are also deploying sales resources into customer plants. Customers delayed maintenance and turnaround spending over the past 12 months to 18 months. We believe spending at the plant-level has to come forward, as they cannot risk unscheduled shutdowns or safety issues. Our early involvement will be important in capitalizing on revamp, turnaround and ordinary maintenance spending.

Market diversification actions have certainly helped on a consolidated basis deal with this energy sector pullback. We continue to experience improvement in our pipeline of opportunities and orders for the nuclear utility market, and strategies to secure market share within the U.S. Naval Propulsion Program have delivered positive results. We are diversifying what we are bidding to the U.S. Navy, some of which is expected to close in fiscal 2017.

Our bid pipeline overall has contracted 20%. Trailing-twelve-month quotation activity is about \$600 million to \$800 million, rather than \$800 million to \$1 billion as it had been in the past. More importantly, procurement decisions have slowed. Our bid pipeline size and quality has remained a strong leading indicator. We will continue to monitor our pipeline closely to be ready for the eventual recovery within energy markets.

Please move on to slide 10. The importance of diversification strategies is shown in the top left chart. Naval and nuclear market backlog is approximately 60% of total backlog. These are markets or customers that we did not serve in a meaningful way prior to fiscal 2011. This has provided backlog stability and will result in reduced financial volatility over time.

Our backlog has a longer conversion duration than five years ago, when 80% to 90% would convert over 12 months. We project current backlog will have 45% to 50% convert within 12 months, 5% to 10% between 12 months and 24 months, and the remainder converting longer than two years out.

I'm now on slide 11. We are operating in a challenging period with a great deal of uncertainty surrounding our energy markets. We aren't intending to play defense or simply weather this downturn waiting for the eventual recovery. What we do during this cycle bottom will set the stage for future growth. We have structured costs with long-term growth as our top priority, while managing an acceptable profit level considering the realities of where we are in the cycle.

We cannot meaningfully effect demand for our products or control external market forces. We have clear focus on those aspects of our business that are within our control, such as managing order opportunities and pricing to secure work that is available to leverage the capacity that we have; improving customer value drivers, including our selling process, order management processes, product and process quality, and overall service provided to customers; more importantly, developing our workforce and unlocking their capabilities to drive productivity, quality, lead-time improvement, safety improvements, overall customer service improvement; and lastly, deploying capital, as Jeff had mentioned, to expand and diversify revenue opportunities.

We are experiencing greater receptiveness of owners to engage in M&A discussions. We are not on solid footing for developing guidance or near-term projections due to much uncertainty within energy markets. There will be unevenness to quarterly revenue and income. We have developed a range of potential outcomes bounded by revenue between \$80 million to \$95 million; gross margin between 24% to 26%; SG&A between \$16 million and \$17 million; and an effective tax rate that is projected to be between 30% to 31%.

Adri, I now ask that we open the line for questions. Thank you.

Operator: Ladies and gentlemen, at this time we will be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Brian Rafn with Morgan Dempsey Capital Management. Please state your question.

Brian Rafn: Good morning.

Jim Lines: Hi, Brian.

Brian Rafn: Yes. Give me a sense, you talked a little bit about the headcount reductions. How many employees does that 10% represent at Batavia and Lapeer, and what specific areas were they from?

Jim Lines: In total, it was about 40 employees, about 10% of the workforce, and it crosses both direct labor, some engineering personnel and administrative personnel, and other functions within the COGS area of our business.

Brian Rafn: Okay.

Jim Lines: It was roughly half between direct labor and indirect personnel.

Brian Rafn: Yes. Okay. From the standpoint of your two markets, Jim, what is the skill set recovery rate when markets turn around? How tough is it when you're rebuilding that from a loss perspective? You obviously heard the discussions with Boeing, that when they lose their production people, they go to Four Winns. How is it for your company and markets?

Jim Lines: I think that probably more than five years ago, it was very challenging. I'm very impressed and proud of the work that our HR team has done to create greater interest in Graham as an employer, and the ability to acquire the talent that we need and when we need it. We've seen a very nice improvement through HR activities that were implemented a few years ago.

Secondarily, to the credit of our management team, we've rethought the onboarding process and the training process, and the time to proficiency when we bring someone onto the team, in welding, machining or the production areas, as well as in the office for engineering or other critical functions that have been reduced appreciably. Therefore, we have improved our ability to acquire talent, and our ability to get them into our workforce and add value quickly. With those two things, I feel much differently today than I felt, or the management team felt, four or five years ago. It was going to be a constraint to growth. We worry less about that today than we did in the past.

Brian Rafn: Okay. All right. From a top-down strategic viewpoint, the roll-off in the energy markets from spot over 150 into the 30s, and gyrating around, taking into consideration some of the instability that we see in the world, such as China and the South China Sea, Russia sabre-rattling with NATO, approximately 43 ISIS attacks in 29 countries in the last month, how much of this terrorism and politics impact your business and the energy industry?

Jim Lines: It's hard to discern. None of us can believe that it doesn't have an impact, because of the uncertainty that surrounds that. But if we think about our energy market, which is one of the most impacted by contraction at this point in time, I believe, it's less sensitive to those issues. And then if I think about the defense side or our naval strategy— I don't want this to happen - but perhaps there will be an increase in demand that might come from that uncertainty and risk around the globe about terrorism and the associated concerns with that. Again, we are hoping that this won't happen.

Brian Rafn: Yes. Okay. You jumped forward to my next question about the naval industry. There have been some modest issues with first-of-class USS Ford, I think it's called the Advanced Arresting Gear now. Has that delayed CVN-79 or CVN-80, that they used to build carriers on a four-year, now five- or six-year cycle, because of budgeting issues. Have the Ford sea trials impacted anything that changed the Navy's procurement of the Kennedy or the Enterprise?

Jim Lines: Certainly. As you said, the first-in-class vessel that came out had some issues, exactly because it was first-in-class. These weren't associated with the delivery of our products, as we did not have to deliver anything to that particular vessel. However, it has affected the progress on CVN-79. We've delivered our scope of supply through our backlog. As you had mentioned Brian, we are noticing that the centers are moving from five-years to perhaps six- or seven-years. We believe CVN-80 is staging now for procurement activity. You may have read about the procurement funding release by Huntington Ingalls, about \$150 million for that long-lead procurement activity. So, that's all very encouraging. We tend to think of carriers nowadays probably between a five-year and seven-year center, rather than a five-year fixed center.

Brian Rafn: Right. I got you. You talked a little bit about your short cycle work. Has the composition in that changed? Is it just dried up? And when you look at some of the work specifically in the energy sector and your longer duration work, do you get the sense that the backlog cancellations are projects that will be terminated, or do you think these are just delayed pent-up demand?

Jim Lines: I have to bifurcate that a bit. One of the projects that was cancelled, representing roughly 40% of the \$80 million that have been cancelled, was for the oil sands. I think that's less predictable in terms of the timing of recovery and more correlated to the price of oil. If I think about the other backlog that was cancelled, it's more for the classic refining sector, and, as we heard from our customers when they made these cancellations, they were very apologetic, it was just timing, and to let them get their feet back underneath them. So they had a different perspective, and so do we in the oil sands area. So I believe roughly 60% comes back into the pipeline at some point. The 40%, which is the oil sands, we're less clear about that.

Brian Rafn: Okay. I'll get back in line. Thanks.

Operator: Our next question comes from Paul Dircks with William Blair. Please state your question.

Paul Dircks: Good morning, Jim and Jeff.

Jim Lines: Hey, Paul.

Jeff Glajch: Hi, Paul. Good morning.

Paul Dircks: So, first question from me. Jim you have mentioned it earlier, the year-over-year and sequential decrease in the short cycle market. How did your view of that market change as we've gone into the midway point of calendar 2016? And do you have confidence in that market bouncing back either over the balance of your fiscal year or is this something where we need to look forward to fiscal 2018 in order for that market to begin to recover?

Jim Lines: Paul, we had mentioned during several prior conference calls what we had observed as a change in the buying pattern from our energy markets for spares and replacements. Actually, they have slowed down appreciably. We felt at that time, and we still feel today, that it is a discretionary point in time decision that cannot be enduring. So therefore, we are expecting to see improvements. We have not yet begun to see it improve in our bid pipeline and in our order pipeline. However, most of the contraction is in the spares and after-market area. And I think that's going to recover as we move forward. I don't

believe we see the inflection point in our bid pipeline just yet or in the corresponding order pipeline. However, we do still feel very strong that it's a decision that can stand the test of time.

Paul Dircks: I appreciate that color. Are you guys allocating any additional internal resources to focus on that part of the market, given the fact that some of the large projects in refining and other markets are a little bit beyond the way?

Jim Lines: Actually, some time ago, we focused our next investment of personnel and energy into the plants, because it's where we think the recovery will occur first. It's there where we feel the delayed spending for maintenance and normal rebound – replacement of parts has to return first, ahead of the overall recovery. So, we want to be there first. We have strategies in place and resources deployed to get into the plants to make sure we are identifying those opportunities early. We're influencing those outcomes. And again, our view here is that we will lead the way to an energy sector recovery. We'll first see spending there, because it has more urgent needs, and it also has very good payback versus a long payback period of new capacity.

Paul Dircks: Right. Okay. Makes sense.

Jim Lines: Now, we have taken that action to put our technical and sales resources toward the plant level, the installed base.

Paul Dircks: Okay. Understood. Is that what you've been doing on the nuclear aftermarket side? You had said that the bid opportunities are growing and while the backlog and the earnings benefit may not be seen for some time, I feel like your tone was pretty positive there. So, what exactly is going on in the nuclear aftermarket business that's given you some seeds of optimism?

Jim Lines: We're elevating our presence at the plant level. You said it very appropriately; the nuclear strategy is principally an aftermarket strategy supporting the installed utility base. And it's elevating our focus, it's diversifying and opening the funnel of what we're bidding, and we're pleased by the degree to which we've been able to expand the number of opportunities and diversify those. So that strategy that was implemented about two years ago, maybe 18 months ago, actually is bearing fruit in terms of the composition of our bid pipeline, and some of it has translated into backlog expansion. Generally, we're very positive about those lead measures.

Paul Dircks: That's helpful. I guess maybe more near-term, over the rest of fiscal 2017, your maintained outlook suggests that there's a pretty significant ramp in gross margin. Obviously, there are a number of factors that affected the gross margin performance here in fiscal first quarter. So, understanding the restructuring benefit that you will be able to enjoy in the future, what other factors are going to contribute to this sequential increase in gross margin over the next few quarters from where you started the fiscal year, and what level of confidence do you have in achieving them? I certainly appreciate the difficult energy market conditions and as you said, the ground is a little unsettled. But what gives you the confidence to be able to achieve the ramp that you guys are continuing to expect over the rest of the fiscal year?

Jim Lines: Well, our confidence comes from a couple of considerations. Let me just chat through those with you. Firstly, is that we're at a point now where we've moved a fair amount of our nuclear backlog through the engineering functions into production. This was a drag on gross margin for the last several quarters, as we have the backlog and we'll start having corresponding revenue. We should begin to see our nuclear revenue improve, and therefore, our margin lift improve in Q2, Q3 and Q4. The confidence there, Paul, is that it's moved now into production. It's out of the engineering area and it's in production, and there is a good amount of that work that's been released into fabrication. That provides a greater level of revenue predictability than when it sits in the office, the way the nuclear orders flow and the regulated way in which we can actually not begin production until certain milestones are met. So the fact

that it's out, launched into production, or being launched into production very shortly, gives us that confidence that we're now at a go for revenue generation and profit generation. So, that's positive.

And then secondarily, we had taken some very aggressive positions on orders to win business that was available to protect market share, to make sure we were giving our teams a chance to exercise their capabilities and a chance to enhance margin. We had some pretty tough orders that were coming through Q1 in terms of margin. I don't regret those decisions, but we have to deal with those. We feel the mix of work as we go into Q2, Q3 and Q4, while there are still some tougher orders in backlog, on average that mix of work, should average up margins. So there are two factors here, the release of the nuclear work and then the mix of the orders that are converting across Q2, Q3 and Q4 and have the probability of a richer margin.

Paul Dircks: That's a helpful color. One more question from me. Over the last three quarters, your customer deposits have been a nice driver of your cash flow, and Jeff you certainly added some nice color there as well, that suggest there'll be further improvement in the next quarter. Regarding this level of customer deposits can we expect more over the next several quarters as Navy work begins to come in? And perhaps, if you're successful on achieving some of the Navy award opportunities over the next few quarters should we expect that inflow to wane over the course of fiscal 2017?

Jeff Glajch: Paul, this is Jeff. With regard to the customer deposits that have stepped-up over the last couple of quarters, particularly this last quarter, we actually expect that over the rest of the year, they're more likely to go down than go up at this point in time. But the cash flow for the year, we still think it'll be positive for the remaining three quarters. And the reason for that is, while the customer deposits will come down a little as we start procuring some long lead-time materials through some of the Navy production that will be in place in fiscal 2018, we believe that the step-up in the quarter in receivables and in unbilled revenues will reverse itself. So, all in all, cash flow will be positive, but the deposits we actually expect will go in the other direction based on what we know today.

Paul Dircks: I appreciate the time. Thanks.

Jeff Glajch: Thanks, Paul.

Jim Lines: Thank you, Paul.

Operator: [Operator Instructions] Our next question comes from the line of Brian Rafn with Morgan Dempsey Capital Management. Please state your question.

Brian Rafn: Yes. Jim, obviously, we've seen this impairment in the energy markets and the duration of the cycle is elongated. But regarding your peak cycle \$200 million in sales, has this at all changed any of the dynamics of your strategic plan?

Jim Lines: No. It really has not when we think about it in a longer term context. It certainly is putting greater emphasis on deploying capital in the M&A segment of our strategic plan. We felt that when we set that milepost marker of \$200 million a couple of years ago, we were standing in front of a very strong wave of petrochemical refining bid opportunities, that clearly has been altered over the last 12 to 18 months. So when we put that milepost marker out, we felt that was largely organic; we now think it must have come from both organic and external growth initiatives.

Brian Rafn: How much of that anticipated bid pipeline in the petrochemical area was new capacity versus spares, replacements and general maintenance?

Jim Lines: When we think about the bid pipeline in the context of the chemical sector, while there is some investment in revamp and in debottlenecking existing facilities, much of the bid pipeline from the

chemical sector going back one, two and three years ago, was what we classify to be new capacity, incremental capacity or brand new plants. This is a little bit different from the refining mix which can have a greater percentage of investment in existing facilities versus new capacity. Chemical is largely new capacity.

Brian Rafn: Okay. On the Navy side, any updates on Virginia Replacement Class or the follow-up to the Ohio boomer class? Anything specific to you guys in the submarine development?

Jim Lines: Nothing that we can comment and tell about, other than from a qualitative point of view – and I did mention it in the prepared remarks – we have been able to successfully diversify what we're seeing and what we're bidding, which I view as a positive lead measure to hopefully being able to secure more diverse types of components for the submarine programs and the carrier program. So, it's great to see their receptiveness to considering Graham for more scope.

Brian Rafn: Yeah. Okay. Awesome. From that standpoint, you guys have certainly done a lot with your rough line-up in Batavia. As you see a weakness in markets, how much do you draw-in your capital expenditure budgets? With perhaps a softness in business, are there any internal property, plant and equipment projects that you might undertake while business is a bit tepid?

Jim Lines: Not even with the downturn, but with the roof line expansion that we had, our focus turns to leveraging what we have, how do we gain productivity, how do we reduce lead time, how do we have better control over the execution. That's where the CapEx and the focus would be, rather than classic capacity expansion via roof line expansion. I don't envision that we'll expand our roof line for some time. The teams got to figure out how to grow...

Brian Rafn: Thank you much guys.

Operator: Our next question comes from the line of John Koller with Oppenheimer. Please state your question.

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

Jim Lines: Good morning, John.

Jeff Glajch: Hi, John. Good morning.

John Koller: Hi. A quick question, as I guess this hasn't been touched on the call this quarter, so I'll bring it up. On the M&A front, are you seeing a plethora of opportunities or rather is it limited opportunities? And then, whether or not you're seeing realistic bid-ask spreads?

Jim Lines: John, I think, it's probably somewhere in the middle, but maybe a little bit more towards the decent quantity of opportunities. We've noticed over the past couple of quarters that there are more opportunities out there than perhaps a year or two ago at more reasonable prices. So, there are good amounts of opportunities out there. And maybe part of it is that we have been more aggressive in looking to do so. Pricing seems to be a little bit better, it's better than it was a year or two ago.

John Koller: Okay. And is this mostly in adjacent areas, are you still servicing the same industries, so that they're potential targets, or just feeling the same pressure of these different markets all together?

Jim Lines: Both.

John Koller: Okay. Great. Thanks so much.

Jim Lines: Thanks, John.

Operator: I'm showing no further questions at this time. So I will turn it back to management for closing remarks.

James R. Lines: Thank you, Adri, and thank you, everyone, for listening in on our first quarter conference call. We will look forward to updating you on our second quarter results in about three months. Have a good day.

Operator: This concludes today's conference. Thank you for your participation. You may disconnect your lines at this time.