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**Operator:** Greetings and welcome to the Graham Corporation Second Quarter Fiscal Year 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ms. Karen Howard, Investor Relations for Graham Corporation. Thank you, Ms. Howard, you may begin.

**Karen Howard:** Thank you, Michelle, and good morning everyone. Thank you for joining us to discuss the results of Graham's fiscal 2018 second quarter and first half year results. 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 on 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 first half of the fiscal year, 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](http://www.sec.gov).

I also want to point out that during today's call we will discuss some non-GAAP financial measures, which we believe are useful in evaluating our performance. You should not consider the presentation of this additional information in isolation or as a substitute for results prepared in accordance with GAAP. We have provided reconciliations of comparable GAAP to non-GAAP measures in the tables accompanying today's earnings release.

And with that, it is my pleasure to turn the call over to Jim to begin. Go ahead, Jim.

**Jim Lines:** Thanks, Karen, and good morning everyone. Thank you for joining our second quarter earnings call. Please refer to slide 3, as I begin my prepared remarks.

Revenue in the second quarter was down 18% when compared to last year. Revenue for the quarter was \$17.2 million. The decline in revenue is correlated to a poor order environment in refining, chemical and power markets during the last 18 months.

The management team maintained profitability, while facing stiff revenue headwinds. Prior to restructuring, net income was \$200,000. Including the impact of restructuring, our second quarter was breakeven.

With respect to adjusting operating costs, the restructuring decision was difficult. However, it was unavoidable for operating in future quarters at revenue levels commensurate with the recent softer new order environment.

We held commitment and investment related to our naval strategy, balanced near term realities and recovery perspective within our traditional markets and substantially reduced the cost basis of our nuclear strategy.

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Quarter-end backlog of \$73 million held steady on a sequential basis. However, as a result of order levels, backlog is down approximately \$30 million from one year ago.

Full year revenue guidance is lowered and we adjusted downward our gross margin expectation. We now have a more clear view of the full year and have assessed the impact of customer delays in placing new orders, which has led to a guidance revision. I'll cover guidance more thoroughly with a subsequent slide.

Please move on to slide 4. Revenue breakdown by key end markets illustrates lack of demand in the refining markets during the past 12 months. Refining industry revenue was down 30% compared to last year.

Similarly, the nuclear power industry has dramatically reduced capital spending, and consequently power market revenue declined measurably, a near 70% reduction compared with last year.

Positively, there was a greater than 50% increase in revenue to our commercial and defense markets, driven principally by work for the U.S. Navy, as we convert backlog that is for submarine programs and we also execute incremental releases of orders for the next aircraft carrier.

Chemical and petrochemical industry revenue was up as well, as we completed backlog that was for an Asian new fertilizer plant. Domestic revenue continued to dominate our geographic mix at 65% of total revenue in the quarter.

Let me pass it over to Jeff, who will do a more thorough review of the quarter and year-to-date results. Thanks, Jeff.

**Jeff Glajch:** Thank you, Jim, and good morning everyone.

Turn to slide 6 please. As Jim mentioned, Q2 sales were \$17.2 million, down when compared to \$21.1 million in the same quarter last year. Sales in the second quarter were 65% domestic and 35% international, compared with last year's second quarter, when the split was 73% domestic and 27% international. Domestic sales were \$11.1 million. International sales increased 7% to \$6.1 million.

Gross profit in the quarter was \$3.8 million, down from \$5.0 million last year, primarily due to lower volume, as well as working through some pretty rough projects which were booked over the past 12 to 18 months. Gross margin dropped nominally to 22.2% from 23.7% last year.

Adjusted EBITDA margin decreased to 4% from 11% in last year's second quarter, driven by the lower gross profit margins, as well as higher SG&A cost. Please note that SG&A in the second quarter of last year benefited from the receipt of \$759,000 of insurance proceeds.

Adjusted net income decreased to \$200,000 from \$1.4 million last year, or \$0.02 per share, down from \$0.14 per share. The net income number was adjusted for a \$224,000 net-of-tax restructuring charge in the quarter.

Please move to slide 7 to look at the results of the first six months of the fiscal year. Sales in the first half of fiscal 2018 were \$38.1 million, down when compared to \$43.5 million in the first half of last year. Year-to-date sales were 68% domestic and 32% international, compared with 73% domestic and 27% international last year.

Domestic sales decreased 18% to \$25.9 million, compared with \$31.7 million last year. However, international sales were up slightly to \$12.2 million from \$11.8 million last year.

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Year-to-date gross profit was \$8.7 million, down 4% from \$9.1 million last year. Year-to-date adjusted EBITDA margins were 6.4%, down from 7.9% in the first half of last year.

Net income adjusted for restructuring was \$1.2 million, down from \$1.8 million last year, or \$0.12, down from \$0.19 per share.

Moving on to slide 8. Looking at our operating cash flow and our cash position, we have positive cash flow over the first half of the year. However, we paid out \$1.8 million in dividends, and our overall cash balance position is down 2% this year to \$72.1 million, or \$7.38 per share.

We continue to be pleased with our expanding acquisition pipeline and hope to be able to utilize some of this cash to grow our business inorganically in the future.

Capital spending in the quarter and in the first half of the year has been fairly light at only \$400,000 through the first six months of the year, compared with \$200,000 in the first half of last year. However, this year we do expect to spend quite a bit more in the second half of the year, and believe that we will be spending between \$2.5 million and \$3 million in total capital for the full fiscal year.

Jim will complete our presentation by discussing the market outlook and our updated guidance.

**Jim Lines:** Thank you, Jeff. I now refer to slide 10. The trailing twelve months net order chart that tallies new orders less the impact of cancellations, describes the unprecedented severity and span of the current disruption to our refining and chemical markets, along with the atypical period that the nuclear utility market is experiencing.

I want to review what we are doing in response to this. We are aggressively pursuing the work that is available. We are attempting not to break pricing discipline, as that is very important long term. However, we will step in to protect share, win strategic orders and take work sensibly to load our asset base.

Also, we are focused on expanding market share. We cannot control the direction of our markets, however, I do strongly feel, we can always control market share and be aggressive to pursue the work that is available. I don't feel that our market share, with the work that was awarded in the recent past, has moved downward by any measure.

We are also directing resources into our customers' plants. We will identify opportunities early and potentially create demand for our products by working at the plant level, rather than remaining as focused as we usually are on the EPCs. It is here that we feel capital spending will begin to pick up first.

We have clear focus on our M&A pipeline in order to add products, go into new markets or enable us to leverage our assets to drive growth. Lastly, we are engaging outside consultants to work with management to identify what unrelated markets we could enter and add value for those customers.

Moving on to slide 11. Backlog at quarter end held at \$73 million. This has a large percentage tied to the US Naval market, and we project 50% to 55% of our backlog will convert over the next 12 months, 35% to 40% of our backlog is projected to convert two years or later from now.

Moving on to slide 12. Fiscal 2018 full year guidance is for revenue to be between \$75 million and \$80 million. Gross margin is projected to be between 21% and 23%. Our SG&A expense is projected to be between \$15 million and \$15.5 million, and our effective tax rate between 28% and 30%.

Michelle, I would ask you to now open the lines for questions.

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**Operator:** Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Joe Mondillo with Sidoti & Co. Please proceed with your question.

**Joe Mondillo:** Hi guys! Good morning.

**Jim Lines:** Morning Joe.

**Jeff Glajch:** Hi, Joe, good morning.

**Joe Mondillo:** Jim, I wanted to clarify two initiatives that you mentioned at the tail end of your prepared remarks in terms of trying to find growth and be prepared for the upturn. First, you mentioned that you hired some consultants to investigate if your product offerings or your capabilities could be used for other customers. Could you expand more on that, if there is any sort of outcome, or any sort of feedback with the consultants yet? Then secondly, you also mentioned that CapEx is coming back, first at the plant level, before the major EPC work. If you could expand what you meant by that, it would be helpful. Thanks.

**Jim Lines:** Joe, we are in the early stages of working with the consultants. I would expect over the next few quarters to be able to talk more definitely about their views. Our view is that we have some very unique capabilities. Unique capabilities that relate to fabricating very complex weldments and large vessels to very close tolerances.

We have an operations model that's unique to a very customized, low-volume type of product flow. We have some very unique engineering capabilities around heat transfer, fluid flow, and equally important, the chemical design and fabrication expertise. We also have a strong team on the customer facing side that can work with our customers on how best to integrate our know-how into their processes. It is possible there are additional markets that we haven't moved into and that would value what we provide, and more importantly, we can create value for them. We've engaged some outside resources that can help us open our thinking to where else we can take our very unique capabilities to diversify our revenue streams, and provide a more long-term stable level of top line and bottom line. So, we are in early stages of that. I can't comment too much further on that, other than that I did want to share that we've got that exercise going.

Answering your second question, Joe, we've been focused on the plant level for maybe about last two years, as we got in this downturn. We understand and feel very firmly that where the focus lies right now is on asset base maximization, getting the most out of the current installed base that our end markets have. Then, we see it in the chemical industry and refining industry that there will be brownfield investments, or investments in existing assets in order to get more out of them, to improve the quality of the product that they deliver to their customers, to operate more efficiently. By having our technical resources in the plants, having the important conversation, diagnosing and identifying opportunity to unlock capability at the plant level, we think that can drive quicker returns to CapEx that will move quicker than long cycle, large project, and new capacity work. We have seen some positive signs there, and I'm still very strongly convicted towards the fact that this is the right strategy during this downturn. Has it manifested into a strong uptick in business, new orders to shed? No, but there is lot of positivity in the work that we are doing and the closer that we are getting to our customers the better, and we do feel all of this will pay off.

**Joe Mondillo:** Related to that and in terms of the overall business, or at least the core energy part of your business, with the industrial sectors seemingly improving, not just in the U.S. but globally, I would certainly think chemical processing is picking up. Are you beginning to see this

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in terms of your bidding and quoting activity? Are things picking up at all, or is it still slow and at the bottom, and maybe that will come in the future?

**Jim Lines:** Joe, regarding our business sense on the direction, or on those lead measures that foretell the direction of our business, we have strong positivity about those lead measures and early indications. We tend to be a later cycle business in terms of recovering, relative to what you might see upstream, midstream or the industrial space. However, our markets serve our refining, our chemical industry markets, they serve the industrial segment, so as we see that beginning to show signs of improvement, as it had in the past, that has been a great lead measure for the direction of our business a few years forward. So, with that we have positivity.

It has not yet shown up, in a material way, into our bid pipeline, other than the fact that we still have a very strong pipeline. It is rather diverse, but importantly the pipeline hasn't moved from concept, or early engineering activity to EPC bid, or closer to procurement. Although, the great thing is that we're involved in these projects, we're involved early as we always are, and again we are seeing the lead measures suggesting that things are improving, we would expect to see our pipeline move to the right, with the right being more towards procurement over the next several quarters. I can't call that we are at the bottom, I can't call that the pickup is next quarter or the quarter thereafter, other than our lead measures are telling us that things are starting to improve.

**Joe Mondillo:** Okay. Is that for both refining and chemical processing, or would you weigh one better than the other? Do you see the orders of either of those sectors improving in the next couple quarters? I know you said you may not be able to tell, but just related the two sectors, which one do you feel better about?

**Jim Lines:** I'm going to answer this way... I feel that new capacity for petrochem will come first, and then more global new capacity refining will come in second. However, we do see some existing refining plant investment that's right in front of us. We also see some petrochem work that's right in front of us. Most of them in front of us over the next few quarters, there should be some projects that close. They have some global diversity, however, by no measure am I suggesting that a strong wave is in front of us, but we are seeing some opportunities that are presenting themselves that should close this quarter or next quarter.

**Joe Mondillo:** Okay, I have a few more questions, but I'll let someone else have a chance. Thanks a lot.

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

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

**John Bair:** Thank you. My first question was regarding CapEx, you've addressed that. My second question is, given the difficulty in the last couple of years in your marketplace, has that changed your parameters or your outlook on the size of a potential acquisition that you would consider at this time?

**Jeff Glajch:** John, this is Jeff. It has not changed the outlook on the size that we would consider. We're still considering, as we target, in the \$20 million to \$60 million range, but very willing to look below that, or above that range.

**John Bair:** Okay. All right, thank you very much.

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

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**Operator:** [Operator Instructions] Our next question comes from the line of Bill Baldwin with Baldwin Anthony Securities. Please proceed with your question.

**Bill Baldwin:** Good morning, Jim and Jeff.

**Jeff Glajch:** Morning, Bill.

**Jim Lines:** Morning, Bill.

**Bill Baldwin:** Congratulations on the way you've managed the balance sheet and your company during these tough times.

**Jim Lines:** Well, thank you for that compliment.

**Bill Baldwin:** You've got yourself positioned to take advantage when the green shoots start showing up. You indicated that you're feeling pretty comfortable that your market share has held in there during this tough period. Jim, can you offer color from a product standpoint? When you are talking about investing in productivity equipment, existing asset base and so forth, which of your important product lines are most impacted there? Do any of those product lines that we are going to talk about have much variance in their individual profitability, or are they all pretty much similar, whether it's ejectors, condensers or heat exchangers, or others of that nature?

**Jim Lines:** The focus that we have on the installed base, which is quite rich being an 80-year old company, we feel that will drive ejector systems sales both into the refining and possibly into the petrochem area. What is nice about the ejector system product line, is that it drives aftermarket in the long term, because the uses of ejector systems are in corrosive and erosive environments, and there is a wear aspect to their performance. So, therefore we like to drive ejector sales because they feed our aftermarket stable base over the long term.

In the chemicals area we tend to see more surface condenser activity, because those are critical for the most important process units in the chemical industry. They have a longer life, it's a great product, a great quality, and it lasts a long time. We tend to typically see a replacement of the unit as a capacity expansion, or after 25 to 40 years they want to replace the unit entirely.

It doesn't drive the same amount of aftermarket, but again, with our installed base and the fact that our company was basically built around the U.S. chemical industry in the '60s and the '70s, there is a richness in our condenser installed base, that's mature, ageing, and as these plants benefit from low cost natural gas as their feedstock, we're looking to eek up more capacity, or restart some idle plants, and we're seeing some strong opportunity for condenser work. On the overall margin profile, I don't want to get too granular on that, we tend to think of our ejector systems as having a higher margin potential than our surface condensers product line.

**Bill Baldwin:** Regarding the "non-traditional market", I know that in the past you had some sales into the pharmaceutical area. Some of your products have a good opportunity there, there seems to be pretty good CapEx going on in that segment in the economy worldwide.

**Jim Lines:** We have been in the pharma markets over the history of Graham. It's our products that we classify as our short cycle or less project oriented products, our heat transfer products with some of our smaller ejector vacuum systems. They don't tend to drive the same margin potential because, believe it or not, the applications are less critical in the pharma industry. So, we do play there, it's a segment of our business, we generally do not find it to be a large needle mover because the average selling price of a pharma order for us is under \$100,000, whereas the average order in the refining or chemicals is \$500,000 or more.

**Bill Baldwin:** Right. Okay, thank you very much for your time. Best of success. Thank you.

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**Jeff Glajch:** Thank you very much.

**Operator:** Thank you. Our next question comes from the line of John Sturges with Oppenheimer & Co.. Please proceed with your question.

**John Sturges:** Good morning. I have to tell you, I remain impressed with how you've handled this prolonged period that's been so difficult for your industry. I am curious about the hurricanes that we have seen in the last couple of months, whether they in fact have redirected some of the attention from your customer base towards emergency repairs as opposed to capacity improvements or expansion?

**Jim Lines:** We haven't seen in the past where an event such as that, has created significant demand for repair or replacement. Our equipment has large weldments, static equipment. It doesn't necessarily get affected by being flooded. It's too early to make this call, but what I am hopeful for is perhaps a rethinking of the way the industry went in refining, and the turbine exhaust application they have elected to go to motor drives for most of the services over the last 10 or 15 years, rather than steam surface condensers, one of our product lines. When a plant floods and electrical motors are immersed in water, those plants shut down for a long time and there is a very significant capital program to get those plants up and running. Whereas a turbine driver that requires a condenser, when there is a hurricane, they behave differently than electric motors do.

So, I am hoping that reshapes the thinking in the industry and returns to the desirability of surface condensers. Starting to get a little too detailed, but some of the customers we have spoken to actually value the turbine service with a surface condenser because it's more reliable during power outages, which happen with floods or other events that shut the whole plant down, ruin the catalyst bed. It's a very costly process, whereas the turbine exhaust condenser and a turbine just keeps running for several minutes without the severity of what happens with the short notice loss of power. So, I'm hopeful of a mindset change.

**John Sturges:** Is that more of a shorter term cost issue? Is that what the factor is in the thinking?

**Jim Lines:** We thought it was a bit more of reliability, and also it has a different environmental impact potential.

**John Sturges:** All right. It sounds like it is possible for a larger capital expense after a disaster that, in fact, varies reliability and the overall environmental expense could be higher for the electric motor option.

**Jim Lines:** Again, I am not making any calls here. I'm just sitting back thinking that there's a derivative of this that would benefit us and I just shared that.

**John Sturges:** I appreciate it. Thank you, nice work.

**Jim Lines:** Thank you.

**Operator:** Thank you. Our next question is a follow-up from Joe Mondillo with Sidoti & Co. Please proceed with your question.

**Joe Mondillo:** Hi, guys. Thanks for taking my follow-ups. You mentioned market share in your prepared remarks, I was just wondering if your competitors are aggressively under-pricing you guys, and if so are you losing any market share in the near term of this recovery at all? Do you see that happening?

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**Jim Lines:** We offered that in our prepared remarks, and this is a very important element of our product positioning, our brand strategy. We try to not disrupt our pricing discipline, however we are seeing it at times but this not pervasive. So, please don't overreact to it. But, we are seeing some international competition trying to find entry into our markets and their pricing structure is ridiculous. We don't believe it is sustainable, it might be an entry point decision, and it makes no sense to us. The amount of money they are prepared to leave on the table makes us think that they're bad managers, and I don't think it's enduring. However, we are seeing some people try to snipe and win business with leaving large sums of money on the table.

**Joe Mondillo:** What I'm trying to get at is that the environment may be a little better than what your results are portraying in this very early part of the recovery, at a very severe bottom of the downturn. Maybe you are experiencing a challenge with pricing and the environment is actually a little better than what your results are showing, and maybe in a couple of quarters down the line pricing will eventually normalize and you can see that recovery. Is that happening or am I overstressing that?

**Jim Lines:** No, I don't think you are. Thanks for clarifying, because that's a relevant consideration. When you look at our business and our backlog conversion, what is reflective in the earnings of our business today is the pricing environment 6-12 months ago. I think, Jeff made a remark in his prepared commentary that we're working through some tough orders that were taken 9-12 months ago, as we defended share or fended off someone trying to find an entry point into a critical market. I can say this directionally, from one of our profitability measures, what's running through backlog now in revenue, what's in future backlog has a higher profit potential.

**Joe Mondillo:** Okay, so then that would insinuate that pricing is actually starting to already normalize, or you're just being a little more disciplined, while orders continue to remain weak. Maybe you're just being more disciplined with pricing in an improving environment so that your backlog's improving in terms of a margin standpoint. Is that correct?

**Jim Lines:** I don't think we have the abundance of opportunities where we can be selective. It is just a qualitative reflection and from that profitability measure of the revenue cycle versus what's in the backlog, that the environment is more favorable to improved profitability on what is being booked versus what was booked 12 to 24 months ago.

**Jeff Glajch:** Joe, this is Jeff. If you were to go back and listen to some of the prepared remarks from three, four or five quarters ago, I believe you will find that we made some commentary around some pretty rough orders that were booked at the time. Some of them were orders where perhaps we had competitors that were being overly aggressive on pricing, and I'm not sure if we used the word crazy pricing, but we probably were thinking that.

Those are orders that are currently working through backlog, and have depressed our profitability level. As Jim has said, the orders that are coming into the backlog are better than the orders that are working out of the backlog right now, which is why we believe that perhaps you'll see a little bit of an improvement going forward. But again, it's not the quantity of orders that are improving, it's the pricing level of the ones that we're taking in versus the ones that we're converting right now.

**Jim Lines:** It's also an important consideration that we monitor the direction of our bid pipeline and trying to discern when there is a turn, when we meet or hit the inflection point, so we don't miss a stronger pricing environment simply by just not being alert to what is going on in our marketplace.



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I have experience because we missed this upturn in 2005 that ran through our profitability and revenue cycle in 2006. You probably won't go back 12 years ago, but I made the comments at that point in time that we missed it, and we took some orders not fully appreciative that we had hit the inflection point, and things were marching forward in a more positive way. I can't guarantee we will hit it exactly correct, but we are watching those very carefully, so we adjust our pricing discipline and the assertiveness that we'll put toward our value proposition, so we don't fully miss the up-turn, and we are ready for it.

We are watching this, our sales folks are watching very carefully, because it's so critical. An order decision in our business that we've taken today, if it were a rough order, it shows up 7 through 12 months after that decision, when the market observably is already turning around and the question is what's happening here. We are very judicious and mindful of watching that quality and direction of our bid pipeline, so we don't miss it and so we're ahead of it.

**Joe Mondillo:** Okay. One last follow-up clarification question related to the pricing environment. Have you started to see the environment, your competition, adjust a little bit differently compared to what you saw a year or two ago, when pricing was below normal and out of whack, or are you still seeing those pressures?

**Jim Lines:** I'm going to respond this way... In our view, from us watching them and our competitive intelligence, most of our competition is formulaic. They have a standard margin they try to hit and they don't alter. We have a different model. We situationally assess and we situationally price; we price differently by situation. In case of our competition, they want margin X and they price for margin X, notwithstanding the competitive situation and the market environment, generally. So, we've seen them to be more formulaic. We threw that process out of our business 10-12 years ago.

**Joe Mondillo:** Okay. I also wanted to ask you about the Navy business. The orders in the quarter for Navy and Other seem very strong. Could you comment on what entered the backlog in terms of orders for the quarter? Then, I also wanted to just clarify your outlook for the Navy business for the rest of this year and into next year. I have it in my notes that in the past your outlook was that the Navy revenue was going to be off a few million dollars in fiscal 2018 relative to 2017, and then potentially almost double to the \$20 million range or so in fiscal 2019. I just wanted to see if that outlook is still what you're anticipating relative to what you see in the backlog.

**Jim Lines:** What we are seeing with our Naval work is revenue starting to climb to where it will be this year compared to where it was last year. So, we are expecting revenue growth for fiscal 2019 compared to fiscal 2018, and fiscals 2018 and 2017 will be comparable. What we can begin to talk about just in general terms, and I will not and cannot get in too much detail here, is that we have begun to get some initial work for the next carrier order that we've been chasing for a while. We won some of this incrementally over the last year. It's been through our revenue cycle, it's in our revenue cycle, so positively it appears as though we will be the victor of condensers for the next carrier. Again, that strategy has been playing out very well. We don't have the order fully finalized, however, we have received incremental releases and that's what you have identified in the last quarter, and then also that is what came into Q2 of fiscal 2017.

**Joe Mondillo:** Okay. Then I just have one last question from me, related to the Navy. I believe, in the past, you have looked at the profitability of the Navy work as less than your average gross margin, but requiring much less SG&A, so net-net at the operating income line it should be sort of similar with the rest of your business. However, over the last year or so, obviously, your operating margins have dramatically changed a little bit. So, just wondering if

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you could talk about the profitability of the Navy work, and if you could help us understand how that flows to the bottom line relative to other types of work, relative to the cost structure that you now have?

**Jim Lines:** The Navy work, on average at the gross margin line, will go a bit below what our ordinary work is, however, as you said, Joe, at the operating margin line it tends to average in similarly. What you might be observing with respect to our operating margin and where it had been historically, that's just the nature of the low revenue that we have as a company relative to a fairly fixed cost and G&A. So, therefore operating margin is down because we haven't been able to peel cost out of there, commensurate with the decline in revenue. But, if we look at it from the way we measure profitability of an order, as we've said previously, Joe, the Naval work will come in a bit below our average gross margin and come in just fine at the operating margin line.

**Joe Mondillo:** Fine. I know it's a little early to tell, but with the large amount of work that you are going to be flowing through in fiscal 2019, is it fair to say that maybe your gross margins are going to be fairly comparable to fiscal 2018 due to the fact that Navy does carry lower margins?

**Jim Lines:** Our view right now as we mentioned in earlier remarks, and we are not making quantitative commentary around 2019, is that the backlog appears to us in our profit projections to be sitting with a higher profitability than what has been running through the revenue cycle over the last 12 months. So, that work is richer in margin than what we've been running through revenue. Should we be able to be successful with our bid pipeline and loading up our asset base, I think, directionally, your thinking is incorrect. We would expect to see gross margin improve in 2019 relative to 2018.

**Joe Mondillo:** Okay.

**Jeff Glajch:** Joe, just to clarify your thinking on the profitability of the Navy business, when we speak of the Navy being less profitable at the gross profit level and equivalently profitable at the operating income level, our reference point is for more of a normalized business environment. Obviously, in a depressed business environment as we've seen, depressed on the core business, the refining and petrochem side, those margins are significantly depressed from what we would consider normal or an average across the cycle. Our Navy margins are not affected by that, so while they might be at a lower level than at an average point in the cycle, there may not be as big a difference compared to where we are today because of the depressed margins in the refining and petrochem sector because of the lack of volumes. Hopefully that helps a little bit.

**Joe Mondillo:** Okay. Yes, that does. Okay. Thanks a lot, appreciate that.

**Operator:** Thank you. And our next question is a follow up from John Bair with Ascend Wealth Advisors. Please proceed with your question.

**John Bair:** Thank you, appreciate you taking this follow-up. First off, I want to echo others' comments about your ability to maintain a really strong balance sheet through this tough time. I wanted to circle back to the comments about the post-hurricane recovery situation, and wondering if you're able to provide a cost comparison to try to encourage a shift back to your condenser product line versus the electric. Is that something that you can do or is that something you are pursuing, or considering making those arguments to your customer base?

**Jim Lines:** Indeed, what we have identified through some interviews is that this is a reality. The consequence of those decisions, refiners situationally view them through different lens, but

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in general, the loss of power, the way a motor shuts down and refinery shuts down, has a consequence of difference than when a turbine shuts down. Loss of catalyst and loss of product is different, so we need to develop the marketing information so we can have the right conversation.

It's just something we have become aware of following some of these recent events. We need to dig in and make sure we have the technical pitch and the value proposition correct, and start to influence thought in this direction because our judgment is that it's real and perhaps we can sway the thinking.

**John Bair:** Is that something that you could apply to other areas, not just in the Gulf Coast, but in the Caribbean, in general, or even in the Asian regions, where they have their own weather conditions and issues?

**Jim Lines:** Petrochem has typically stayed with a steam turbine with a condenser. Refiners, again depending upon refiner and depending upon the region, may have moved a decade or a decade and a half ago to be more committed toward motor drives. This is a recent event. Again, we are going to develop the technical marketing information, do more customer interviews and see if we can build a case to change the way they think about this, the reality of what's just occurred.

**John Bair:** Leverage that global warming issue. Thanks a lot, guys, good luck.

**Jim Lines:** Thank you.

**Operator:** Thank you. Our next question is another follow-up from Bill Baldwin with Baldwin Anthony Securities. Please proceed with your question.

**Bill Baldwin:** Okay, just quickly, Jim and Jeff. I don't know whether you gave color on this or not, if you did I apologize, but is the main reason for the revenue guidance reduction related primarily to the spending in the nuclear power sector of your market?

**Jim Lines:** Not mainly. It's primarily due to the lack of orders over the last 12 months in the chemical industry and the refining industry, and I would give that a weighting that's over 75%, and there was some contributing factor tied to the nuclear market, but it's not the overweighting factor.

**Bill Baldwin:** Okay, thank you.

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

**Operator:** Thank you. There are no further questions at this time. I would like to turn the call back over to management for any closing remarks.

**Jim Lines:** Thank you, Michelle. And thank you everyone for your time this morning on our conference call and for the Q&A session. We appreciate your interest and the detail of you probing into our business and we look forward to updating you in January. Have a good day.

**Operator:** Thank you. This concludes today's teleconference. You may disconnect your lines at any time. Thank you for your participation and have a wonderful day.