Joe Mondillo: Thanks, everyone, for joining us. We're going to get started. My name's Joe Mondillo. I'm one of Sidoti's general industrials analysts. I cover Graham as well as a handful of other names. Pleased to have with us Graham Corporation. Representing the Company here today is Jim Lines, CEO, and Jeff Glajch, CFO. We're going to get started with Jim. He's going to give us an overview of the company and hopefully finish with five or ten minutes of Q&A.

So with that, Jim.

Jim Lines: Thank you, Joe. Good morning. It's a pleasure to be here. I see a couple of familiar faces.

Before I get started, let me just point out that we will make some forward looking statements this morning so please be aware of our safe harbor statement.

Graham is an industrial company that provides engineered-to-order products, custom-fabricated to a couple of key different end markets, one being crude oil refining; another being chemicals and petrochemicals; third being to the US Navy or the defense industry; and finally, the power market, which can be nuclear, utilities, or renewable energy, as an example.

Our current market cap is about $200 million. We do pay a dividend, the yield is around 1.75%. We have about 10 million shares outstanding. Our ticker symbol is GHM. By end market, about half of our sales are to the refining market for the trailing 12 months ending December 31st. Petrochemicals are about 15% to 20%, as is Power, and the Navy and other markets were about 25% of our sales on the TTM basis.

The markets that we've chosen to participate in have some unique characteristics. In the applications where our products are used, failure and underperformance have a very severe consequence, very costly, very dire if you think about a nuclear power plant or a nuclear-propelled vessel. The expectations of our customers are flawless execution, flawless performance. Underperformance missing by a few percent, if they want 93% efficiency and we deliver 91%, it's a very big problem.

The relative cost of our equipment to the overall investment being made is relatively small—multi-billion dollar investments in a new refinery and we're maybe $5 million, $10 million, $15 million of the multi-billion dollar investment. Then, also, once installed, our equipment is very difficult to replace. Think about where it might be situated in a submarine or an aircraft carrier or nuclear power plant. It's very difficult to get our equipment taken out of the facility.

What this then drives is purchase decisions that are based not solely on price, but based on proven capability, quality, reliability, aftermarket support. These are the most important factors that prevent low-cost suppliers from coming into our end markets, because they might not have those attributes or capabilities.

How we deliver value, how we create value for our customers, is we have a particular sales process, a selling process which can be rather long. It can be a couple of years in duration sometimes, where we're helping a customer determine the best way to integrate our product into their process. We're not being paid for that. That's part of our service. That's part of the value add that we provide. While that can be a cost embedded in our business at times, we think that cost is paid for in many respects in terms of the margin that we will derive on a sale, the last look we might get, sole source that we might receive.

So our consultative selling platform is a huge value created for our customers and also for ourselves.

Complex project management—I can't underestimate the importance of this. It's almost a rite of passage today for a naval order, a refining order, a chemical industry order, and also a nuclear market order, in that the office processing of the order can be as complex, as complicated, as important to the end user as is the equipment. The CD-ROM of documentation, operating instruction manuals, the objective quality evidence they have to provide is also critical. Our customers are looking for vendors that have that infrastructure in their business. Many, many businesses don't.

There's a cost for this and it's all very critical. Again, part of that complex project management is an aptitude that, when projects get derailed—and they do—there can be a design change, there can be an end user who fails to consider something and we're halfway through fabrication and they need to stop and have something re-engineered—an aptitude and adeptness to handle those types of engineering change orders in a business is a very particular skill set that we have, and a necessary skill set and capability for the supply chain in the applications that we serve, for the end markets that I spoke to.

Our operating model is very much different from a normal industrial. A normal industrial, you might think of as a high-volume, low-mix operation building the same thing over and over again. Because of the nature of what we do, we're on the opposite end of the spectrum, a very low-volume, but very high-mix, a great deal of variability. We don't build too many things twice. We build custom equipment once, for a particular application. So it's a very unique operating model, very foreign to most industrials. But that's the operating model that's necessary for a naval market order or a refinery or pet-chem market or a nuclear market as well.

Then we build these massive weldments that can sometimes be as big as this room to very exacting tolerances. Our customers may want particular dimensions within a thousandth of an inch on these massive weldments of dissimilar metallurgy and of a very particular capability, a very unique art, that our people have that not many businesses have.

These are four distinct attributes that really create a very high moat, keeping the competition away. They are unable to enter into this type of application easily.

A bit about our order types: We segment our business a number of different ways, but an easy way that we segment it is by order size. Around two-thirds of our revenue comes from under 100 contracts that are an average size of $800,000 but could range from about $250,000 to $10 million. But there are only 100 or so of those a year. Then one-third of the revenue comes from about 2,000 orders that are under $10,000 on average.

The difference in duration is the small orders that can come in and out of our business in a week to maybe a quarter, and those large projects are in our business from order to completion between nine and 18 months. Certain Navy orders can be in our backlog for four or five years.

Both groups are very important and we have strategies for growing both of those groups.

Let's talk about these four markets with a little detail about what creates demand for Graham. In the crude oil refining sector, which is about a fourth of our revenues, maybe a third at times, we believe we have a global market share of around 25%, and there are three key demand drivers. One is the most common, which is global new capacity. That's really the international part of our business.

But then there are also two very important drivers from the installed base. One is revamps and retrofits, figuring out how to get more from the existing installed base. Our refiners are constantly searching to assess how they can put more barrels through one refinery and how they convert more of those barrels to gasoline. So there's an ongoing investment, even though North America hasn't built a new refinery since the mid-70s, an immense amount of our refining market revenue comes from North America because they're constantly reinvesting in that asset base to get more from that asset base.

Then also the refining space has a pretty rough operating environment, corrosive, erosive, so there's a very nice repair and replacement cycle. I would say about half of our revenue in general is from the installed base for the refining sector—some way derived from the installed base.

Chemicals and petrochemicals—that's more of a new capacity story, both for North America and internationally, although for North America there also is a restart because for the last decade and for the period from 2003 to 2010, natural gas was so expensive many of the North American pet-chem clients were shut down and idle. Then with low-cost natural gas, because of shale gas, they're restarting these plants, so there has been some investment to restart these plants. And then also there's a nice aftermarket from that segment as well.

US Navy—that's virtually all about new capacity: new submarines, new carriers. The nuclear power market, that's also an installed base demand driver, keeping those utilities up and running. And then our other markets can have new capacity and some aftermarket and spares.

But if we think about business as a whole, somewhere between 30% to 40% of our revenue is pulled from our installed base, either as retrofit, revamp, or spare parts, which is a very nice, stable revenue stream for us.

As we think about where our markets are today, our refining market is coming off the cyclical bottom of two or three years ago. We see nice bidding activity in our big pipeline, projecting that more investments are coming. And then also petrochemical, we think a second wave of North American investment is in the early stages, and there will be ongoing investment in new global petrochemical capacity. And then the naval market is actually creating a very strong, stable base for us. We believe we're into a multi-year expansionary cycle, bouncing off the bottom in fiscal 2018.

As we think about our business in cycle averages, we try to manage our business well across the cycle, with a cycle average EBITDA margin in the range of 17% or higher and an average return on invested capital of 12% or higher across the cycle. Again, we feel strongly, based on our pipeline and where backlog is, we're into a period of year-over-year growth.

This is sort of an easy comparison because we're comparing trough performance, fiscal 2018 was the trough, with about $78 million of revenue. We have nice growth this year, which ends in a few days, fiscal year March 31, 2019. At the end of our fiscal year, we expect to have about 20% growth year-over-year, taking the midpoint of our guidance, and we're projecting successive growth in subsequent years as we go forward, based on our outlook for the market and also where our backlog is.

We believe as we grow and our end markets improve, this generates pricing power for us. We believe that a more favorable quality of backlog leads to mid-cycle gross margin in the low 30s and EBITDA margin mid-cycle should be in the upper teens versus where it has been most recently for fiscal 2018 and fiscal 2019.

We have a fantastic backlog, in my view. Our backlog is at a very high level of $134 million as of December 31st, of which about half of the backlog is from the US Navy, a segment of the marketplace we weren't in about a decade ago, a quarter is from refining, another quarter is from petrochemicals, and about 5% from power generation. What's also nice about our backlog is that it's multi-year. Roughly half of our backlog is planned to convert over the next 12 months, about 10% to 20% between 12 and 24 months and then roughly a third of our backlog will be realized 24 months out. This gives us a very clear view, we feel, of where our business is going—a very stable asset motive for our base of fixed costs. So I'm really pleased with where the backlog is. You can see how it's grown from around $83 million at the bottom to $134 million as of December 31st.

We do have a very strong balance sheet, which I'll get to in a moment. And we have an acquisition strategy around diversifying our revenues, trying to get more of the naval market spend. Also in our traditional refining and pet-chem markets, looking at what we can add that would not be as cyclical as the capital sales, but give us another play in our core markets of refining and pet-chem. That's probably around aftermarket or smaller products.

As we think about the acquisition strategy and the size of a deal, we've been looking at prospects that have revenue ranges ideally between $20 million and $60 million. That's not the transaction value, but that's about the revenue range that we've been looking at. And as we go through the process, and analyze prospects and proceed, trying to bring to closure, in many cases we've had to back off. If you look for an equity-like return, something above an equity cost of capital, that's been a high hurdle for us, but we won't waiver from that discipline. We're also looking for businesses that are well-run, have strong management teams, and think about pricing as a strategic asset.

This gives you a view of how severe the downturn was. I've been with Graham for 35 years. We have some folks that have been with us longer than I have. No one has seen a downturn as severe as this last one for us where we went from $135 million in fiscal 2015 to $78 million in fiscal year 2018. It was the worst since World War II. But we got through it. We did some things to improve our operating performance and market share, so we're coming out of this downturn well-positioned for growth, 20%

growth, if you will, to the midpoint of our FY19 guidance. And as our backlog suggests, this would imply there should be growth in fiscal 2020 versus fiscal 2019.

We have a heck of a lot of cash on our balance sheet—$80 million, so roughly of our $20 share price, $8 is sitting in cash. Therefore, our enterprise value is $120 million. We're a business that generates good operating cash flow. As you can see, through the down period we generated operating cash flow that was very strong.

Our capex needs are very modest. Depreciation and amortization are about $2 million to $2.4 million. We tend to reinvest in CapEx at about that level as well, on average. And as we think about working capital utilization for forward execution, we're extraordinarily low right now, we tend to think about it more normalized between 5% and 10% of sales as operating working capital. Compared to 10, 15 years ago, that was closer to 20% of sales. So our team has done a good job focusing on that and being more efficient in working capital utilization forward execution.

This gives a view of cash generation since this management team has been in place, we have a very strong return of net income to cash flow. For the last 13 years, over 100% of net income was retained as cash. That cash was used to buy back stock, pay a dividend, do an acquisition, and that walks us through where we were from the end of 2005 to where we are as of end of calendar 2018. So very strong operating fundamentals with respect to income to cash flow. Also, looking forward, there isn't a high need for capital investment as we grow.

Our capital allocation priorities for the balance sheet really have one priority, which is to put the $80 million to work for new revenue streams and stronger earnings. We have an active acquisition program. We will opportunistically do stock repurchases. And then from the operating cash flow we will reinvest in the business, capex for productivity, for capacity, and then also pay a regular annual dividend, which right now is $0.40 per share.

We have been focused on the shareholder. We've had a strategy of growing our dividend over time. You can see the ramp up from a relatively low dividend of $0.08 per share to $0.40 per share where it is today. So we have been investor focused with returning some of our cash to our investors. We are very transparent about where the business is. We get out in the field. We spend a lot of time on the road, Jeff more than I do. We've been able to grow our institutional ownership base from what had been around 30% of our shares held by institutions to where we are today with just under 80% held by institutions. That, and our dividend, gives us a relatively stable share price through the cycles that we've had to go through.

Our guidance for fiscal 2019, which ends in a few days, is for revenue to be between $90 million and $95 million. Gross margin, 25% to 27%. SG&A, in an absolute spend, between $18.25 million and $18.75 million. And we expect our tax rate to be nominally 20%.

As an investment consideration, our naval strategy is really at a good point. Our naval backlog is very, very elevated at over $65 million. We have a good pipeline of new opportunities to secure over the next couple of years. And then also complement that with where our oil refining markets are in terms of recovering off of the trough. Global investment in new capacity, global investment in improving the existing asset base and pet-chem is also in a wave of expansionary investment for new capacity.

So we feel the fundamentals are very strong for considering GHM as an investment, as we believe the backlog and the bidding activity is implying multi-year growth and we have great earnings potential.

With that, I'll be pleased to take any questions, as will Jeff.

Q: *[off-mic].*

Jim Lines: The question is, "What gives us the confidence that the market is not permanently impaired?"

That comment, I believe, relates to crude oil refining. We think there is an outlook that's somewhat muted for the crude oil refining market, but then we take the solace that so much of our revenues, so much of our opportunities pull from the installed base, where customers will have to continue to make investments, to keep those assets running or to get more from those assets, and we do quite well. We have a very high share there, very high margin there.

And then as it relates to new capacity, we think that's a story that may be a decade out, not necessarily right in front of us today in terms of the change in new capacity trajectory. But around pet-chem, we don't see any change in the thesis. We think that continues to grow, aligned with global GDP growth rate.

So we don't necessarily see it lower for longer necessarily, except as it might pertain to oil in a decade or so farther out from where we are today.

Q: *[off-mic].*

Jim Lines: The question is, "How might one consider SG&A leverage as the business grows, because it has consumed a fair amount of the gross margin in the recent past?"

That's a phenomenon that relates to where we were in the downturn. We've chosen to maintain and actually invest in SG&A through the downturn so we would be ready to take advantage of opportunities as we grow. We would think, and we view and we model that as we go forward, SG&A as a percent of sales will go down. And our absolute dollar spend in SG&A, there might be a little more incremental investment, but SG&A as a percent of sales will go down.

Q: *[off-mic].*

Jim Lines: Sure. The question is, "Any trend changes that have been observed the last four or five months due to what's happened with oil?"

Around our short-cycle business, which is mainly spares and aftermarket, we've not seen a deviation there; we've not seen a pull-back. We've actually seen that come up year-on-year from about 10% or 15% from where it was compared this year to last year on an annualized basis. It's sort of an easy comp, because we're coming off of the trough, but nonetheless it is showing growth.

If I look at our bid pipeline around the aftermarket, it's implying future growth in the coming next 12 months, should those bids convert to orders. And also on our mid-size project work, we really haven't seen a change in how the end users invest in what we would call equipment for the installed base.

Now, making that comment, I haven't seen a change in the way they have remained hesitant in investing and making final investment decisions over the last 12 to 18 months. So I haven't seen the change there.

Q: *[off-mic].*

Jim Lines: Yes. Sure, the question is, "Graham hasn't been necessarily that acquisitive. Although we have done an acquisition, what resources do we put toward that and have we learned any lessons from acquisitions that we've done?"

We've recently hired—recently being three years ago—a professional to come in to work with Jeff on business development and drive our M&A strategy and get our pipeline of prospects built out. So that compares where we are today to where we were three, four, five years ago, when we had an occasional few we would look at. Now we have a very large pipeline that we're looking at and it's consuming more of our resources, my resources and Jeff's resources. Chris Johnston is leading that effort.

So the opportunity and the prospects have expanded. Our time getting alongside targeted prospects is also higher as we begin to build relationships. If we look at the lessons learned—and my sample size is one, we've done one acquisition –there were some lessons that we learned as we looked at that acquisition in retrospect, which was a great acquisition for four or five years in the nuclear space and a so-so acquisition in the last two or three or four years for the nuclear space.

Thinking about risks, scenario analysis, and cost structure for what might be a headwind on revenue and how flexible or how variable can the costs be, should there be a downturn. That was an instructive lesson that came out of that acquisition.

Q: *This one is about the Navy side of things, are there additional opportunities to work with the Navy?*

Jim Lines: Sure. With the Navy, there can be two types of orders. One is a new design done for the first time. We have some of that work in our backlog. The execution timeline for that type of order can be unpredictable. The push-out that we've had for backlog conversion is around first-time design. The way the engineering cycle goes and achieving a frozen design agreed upon by all the stakeholders, so that has moved to the right.

The other type of order we get is descriptive. It's more of a build to print order. The design is done; the design is frozen. You're into the build mode. Those have a more regular cadence, less susceptible to backlog delay. But what pushed out and affected our revenue in fiscal 2019 and will affect our revenue in fiscal 2020 is that first kind, first-time design that had an unpredictable schedule and a delay caused by a number of stakeholders.

Q: *[off-mic].*

Jim Lines: Yes.

Q: *[off-mic].*

Jim Lines: No. That's still the case. And around the opportunities, there's a massive step-up planned for the Navy to build out their vessels. The supply chain, the shipyards are challenged to be able to meet that demand. The first challenge is that the shipyards, such as Newport News or Electric Boat or others, they need to push more work into the supply chain because they can't keep up, we believe, with the build cadence that's being demanded by the Navy.

So that creates an opportunity for someone like us. And we're advising we want it. We're looking for more work. We have capital to deploy if necessary to expand our capabilities to be able to do this work. We're just not at the point in time when we're ready to make a decision of what supplier might get what work.

But around the more build-to-print, their backlog is roughly $60 million for naval work today. We see a pipeline of opportunities of an equivalent amount to win over the next 12 to 24 months. And if we are successful, we think this strategy's in a great spot to just levelize our asset base. It gives a very high level of predictable loading that dampens the cyclical nature of refining. I'm really, really pleased with that.

Any other questions?

Joe Mondillo: We're actually out of time.

Jim Lines: Oh, well, thank you so much for your questions and for your time. Thank you, Joe.