Operator: Greetings. Welcome to the Graham Corporation Second Quarter Fiscal Year 2020 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. Please note, this conference is being recorded.

I will now turn the conference over to our host, Karen Howard, Investor Relations for Graham Corporation. You may begin.

Karen Howard: Thank you, Daryl, and good morning everyone. We appreciate you joining us today to discuss Graham's fiscal 2020 second quarter and first half year results. You should have a copy of the news release that was distributed across the wires this morning. We also have slides associated with the commentary that we're providing here today. If you do not have the release or the slides, you can find them on 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. And I also want to introduce you to Alan Smith, our Vice President and General Manager of our Batavia Facility. Jim will start with the strategic overview of our business and provide our outlook for the reminder of the fiscal year. Jeff will review the financial results for the period, and Alan will provide an operations overview. 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.

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's my pleasure to turn the call over to Jim to begin. Jim?

Jim Lines: Thank you, Karen. Good morning everyone. We appreciate you joining our second quarter earnings call. I will begin with a strategic overview of what we are focused on. My remarks start on slide 4. The key element of our strategy is to strengthen and expand predictable revenue streams. This will reduce financial performance volatility caused by large capital projects, cyclical demand within crude oil refining and chemical end markets.

Refining and chemical end markets have historically had large variation in demand for our products and that is not expected to change in the coming years. To the contrary, we observe these markets to be more volatile today with greater variation between cycle peaks and bottoms. Our strategy to increase participation and market share within the US Navy nuclear propulsion program will provide a predictable level of revenue. Navy work typically has long-lived backlog, providing vision into a multi-year revenue projection, that is predictable and not subject to large variation. The Navy's strategy has been successful, with current backlog for this sector at approximately $60 million.

We are now on each of the three nuclear propulsion vessel programs. Participation is expanding as the types of components provided increases. Over the next 12 months, we hope to secure the supply of two new components, one for carriers and the other for one of the two submarine programs.

We've executed our Naval strategy well. Alan Smith and his team have executed superbly. An ongoing confirmation of our success in differentiating on execution, on-time delivery, and quality is the expanding percentage of our Naval backlog that was won sole source. All our work for the first decade of the strategy was competitively bid. We now are seeing certain procurements done with sole source bidding. Moreover, many of the orders were first-time fabrications for us, very complex weldments and material combinations. This involved considerable production R&D and the development of efficient build flow methods.

Productivity and process improvement will drive fabrication efficiency gains, which will be reflected in better and more predictable margin as we move into repeat fabrications. We expect revenue during the coming few years to continue to expand and also margin quality to improve as we begin repeated fabrications.

This end market is an area of M&A concentration as well. We continue to actively engage in discussions with companies serving the Department of Defense and aerospace end markets. With our current portfolio of components provided to aircraft carriers and submarines, along with new components we plan to break into, this sector, without M&A, is expected to have revenue between $20 million and $30 million annually in the next two years.

Also, we are focusing more on our installed base. Graham has a sizable global installed base and a great installation record in North America. In the last 25 years, Graham supplied equipment valued at more than $650 million that was delivered into North America. Moreover, with equipment delivered in the 1970s and 1980s we estimate that our North American installed base approaches $1 billion. Here too, this sector is not as volatile as large capital projects. Our customers generally invest to keep their plants operating well. Also, our thesis continues to play out that certain regions, such as the US and Canada, will leverage their facilities to get more from them before investing in large new capacity. Regions with dense installation populations are the US Gulf Coast, Mid-Atlantic States and the West Coast plus Alberta.

Customers need our knowledge and expertise to identify performance risk and what may be limiting throughput or impacting product quality. We are localizing performance improvement engineers in key regions to focus on our installed base and to assist customers. This is typically high quality margin work and is not highly cyclical. We are currently building out our US Gulf Coast performance improvement engineering team. Two engineers were placed there in 2018 and we expect to add two more in the next six months. These individuals focus on our customers' plants and our installed base, which will be in addition to the historic focus we have had and we'll continue to have on EPCs and OEMs.

M&A focus is also here, to add products and/or services. Currently 30% to 40% of revenue is derived in some way from our installed base. When taken together, the Navy and the predictable installed base revenue sectors are anticipated to approach $50 million per year in revenue in the coming two years. Upon achieving that level of predictable revenue, it will dampen the impact of our highly cyclical crude oil refining and chemical large project work.

Also, trade policy and tariffs on certain materials have affected competitiveness in international markets and in certain instances it has impacted us in our domestic markets as well. We are observing customer acceptance of low-cost regions for fabrication of critical components, such as our injector systems or steam surface condensers. To reposition our competitiveness and to expand market share, the global fabrication supply chain is being more aggressively used by us.

In the last 18 months more than $35 million of new orders were secured by executing differently to take share, where previously we were unsuccessful due to cost. Four of the projects were for international crude oil refining projects that will add to our installed base, which will ultimately drive follow-on revenue in coming decades from revamps, retrofits and spare parts.

In the past, we approached using the global fabrication supply chain in a limited or a targeted manner. Now, we are proactive and aggressively attempting to change participation, create broader execution scale and expand market share. A key element is quality control and IP protection. We are building out a supply chain management and quality surveillance organization in support of this strategy. Early successes cited just a moment ago are validating that we have a good formula for success. Importantly, the unique or differentiating elements of Graham's IP will be closely controlled as we execute this strategy.

I am now moving on to slide 5. The success of our focus on the installed base is highlighted by this slide. Comparing the eight year periods between 2004 and 2011 to those of 2012 to 2019, the percentage of commercial revenue derived from the installed base expanded from 28% to 41% of commercial revenue. This was coming from a stronger and more consistent level of spare parts revenue and also end users investing in revamps or retrofits to improve operational reliability or gain incremental throughput capacity.

When the original equipment is Graham's, a retrofit or revamp opportunity has a high likelihood of Graham getting an order with strong margin quality. Importantly, and as shown in the second set of charts, gross profit derived from the installed base during these two comparison periods expanded from 44% to 61% of total commercial gross profit, being derived from the installed base.

Crude oil refining, the picture on the top right, installations are absolutely terrific for follow-on revenue after initial sale. This end market invests in revamps and retrofits and also, due to the harsh operating environment in an oil refinery, there is strong spare parts follow-on revenue. Surface condensers, shown in the lower right photo, offer less replacement parts potential, but do drive the complete replacements after 20 to 30 years of operating life in many cases. Again, if the replacement condenser is for Graham original equipment, there is a good likelihood of a high quality margin replacement order for us.

Moving on to slide 6, we confirm full year guidance, excluding the Energy Steel business that we divested last quarter. Revenue is expected to be between $100 million and $105 million. This is predicated on securing a quick turn Navy order in this current quarter that we are anticipating. Gross margin is expected to be between 24% and 26%. SG&A spending will be between $17 million and $18 million. Our effective tax rate is approximately 20%.

I will now pass it over to Jeff for a review of financial results. Jeff?

Jeff Glajch: Thank you, Jim, and good morning, everyone. If you could turn to slide 8, I'll provide some brief highlights on the second quarter. Sales in the quarter were $21.6 million, similar to the $21.4 million in the second quarter of last year. Q2 net income was $1.2 million or $0.12 a share, down from $1.8 million or $0.19 a share last year. Included in last year's numbers were some losses related to the recently divested commercial nuclear business. If we were to exclude those, the comparable net income last year would have been $2.4 million or $0.24 a share.

Orders in the second quarter were strong at $32.6 million, driven by some key refining orders in Asia and the United States. Our backlog has improved to $127.8 million. The backlog level includes a tripling of our commercial backlog over the past 24 months and when we back out the divested nuclear business from prior periods, this is our largest backlog ever.

If you could move on to slide 9. Again Q2 sales were $21.6 million versus $21.4 million last year. Sales in the second quarter were 73% domestic, 27% international, fairly similar to last year, which was 70% domestic, 30% international. Gross profit decreased to $4.9 million from $6.2 million last year due primarily to an unfavorable mix of projects. Gross margin was 22.9% down from 29% in the second quarter last year.

EBITDA margin was 7.8%, down from 14.7% in last year's second quarter. And as I noted earlier, net income was $1.2 million or $0.12 per share, down from the adjusted level of $2.4 million or $0.24 a share.

On to slide 10, looking at the first half of the year, sales of $42.2 million compared with $51 million in the first half of last year. You might note that last year we had a much stronger first half than second half of the year and clearly, per our guidance, we're expecting the opposite to occur this year.

Year-to-date sales were 71% domestic, 29% international, compared with 56% and 44%, respectively, last year. You may recall in the first half of last year, we had a large high value Canadian oil sands project, which helped push the international sales higher.

Gross profit year-to-date is $9.7 million, down from $13.4 million last year. Gross margins were at 22.9% versus 26.2% last year, with the decrease due to unfavorable mix as well as a lower sales volume.

Year-to-date adjusted EBITDA margin was 7.3%, down from 14.4% last year. Both periods reflect the exclusion of our commercial nuclear business, which we sold in June.

Finally, adjusted net income was $2.2 million or $0.22 per share, down from $5.1 million or $0.52 per share last year. Again, as with sales, last year's earnings were frontend loaded with minimal net income in the second half of the year.

On to slide 11. Our cash is at $73.8 million, down $4 million in the first half of the year, but this is simply timing of working capital. We have noted that we increased our dividend in August to $0.11 per share per quarter, or an annual rate of $0.44 per share. Capital spending has once again been light in the first half of the year at $700,000, compared with $400,000 last year. As we have seen in the past few years, our capital spending will increase in the second half of the year and we still expect to spend between $2.5 million and $2.8 million in the full fiscal year.

We continue to expand our acquisition pipeline, particularly in the Navy and aerospace arenas as Jim mentioned earlier, and we are quite pleased with the list of companies that we are considering pursuing, to utilize some of the cash on our balance sheet.

Alan Smith will complete our presentation by providing more depth on our operations in Q2. For those of you who have not met Alan, he is the General Manager of our Batavia business. He's been with Graham approximately 27 years in various engineering and sales roles. Alan?

Alan Smith: Thanks, Jeff. If you could please turn to slide 13. Second quarter revenue was comparable to the same period last year, however, there was some end market variation. Refining industry sales in the quarter were down $3.4 million. This was due to a number of North American revamp or retrofit projects which were under execution last year. This does not signal any change in our end market fundamentals.

On the other hand, chemical industry sales were considerable relative to the same period last year. This is driven by domestic new capacity and investments in retrofits.

Power industry sales are down due to the divestiture of Energy Steel, whose revenue was in 2019 and is no longer part of the ongoing mix.

We continue to have a high concentration of domestic revenue. It is 73% of our overall revenue. Such a high concentration is due to Navy revenue, the strength of the domestic chemical end market and the revamp investments that are routinely occurring in the US-based refineries.

Please turn your attention to slide 14. The highlight here is the strength and improvement in order levels from Graham's commercial end markets, principally crude oil refining and the chemical markets. From the low watermark about two years ago, the level of trailing 12-month orders is up approximately 100%.

We are expecting a book-to-bill ratio greater than 1x for FY 2020, implying that the order pattern is anticipated to be strong in the second half. There is a nice pipeline of bids for the US Navy and our international crude oil refining market. Chemical is expected to be stable, but not as strong as orders from the US Navy or our oil refining end markets.

I'm now referring to slide 15. We have a terrific high-quality backlog and the profitability of our backlog continues to strengthen. The balance on September 30th was $127.8 million, with approximately $60 million for the Navy and roughly $40 million for crude oil refining customers. It is also important to know that, excluding Energy Steel from prior periods, the backlog reported on September 30 represents a record high for our ongoing business.

Our diversification efforts with the US Navy have been effective and provide a strong level of multi-year base load for our operations. 55% to 60% of our backlog is anticipated to convert within the next 12 months and 25% to 35% converts beyond two years.

Daryl, can you please open the lines for questions? Thank you.

Operator: Our first question comes from the line of Theodore O'Neill from Litchfield Hills Research. Please proceed with your question.

Theo O'Neill: Thank you. Congratulations on a good quarter.

Jim Lines: Thanks, Theo.

Jeff Glajch: Thank you, Theo.

Theo O'Neill: I just have a question here about slide 5, where you're showing that the commercial revenue from the installed base has grown in the last seven years relative to the previous seven years. And I understand the profit aspect of it, profit ought to be better, but does this imply that there was some kind of change in construction, in new building of equipment – building of facilities that you would service? Is there a cyclical component to this where there's not as much new equipment any more, they're just retrofitting and buying parts and is this at all cyclical?

Jim Lines: No, it doesn't signal, in our mind, a long-term change. What we had identified, or what our thesis was, coming out of this downturn, that expansion would be driven initially off of investment in the installed base. We thought that would come first and that actually played out as we had expected and we began to shift our customer-facing resources more towards the installed base, because that's where the revenue would come first.

As we look at our bid pipeline, however, and from a global perspective, we are beginning to see our bid pipeline fill with more new capacity work. It's more of timing and it's typically how we come out of a downturn, where installed base gets focused on first before new global capacity starts to be invested in. Now, we have won some orders in the last year or so for new global capacity, but as we look at our bid pipeline, it's beginning to expand and be more filled with global new refining capacity.

Theo O'Neill: Okay. Thanks very much.

Jim Lines: You're welcome.

Operator: Our next question comes from the line of Tate Sullivan of Maxim Group. Please proceed with your question.

Tate Sullivan: Hi, thank you. A couple of follow-ups on your conversation about Navy work and aerospace and defense work in general. First, what do you refer to when you mentioned the quick turn Navy order. Can you give more context to that please?

Jim Lines: Yeah, that's a type of order, if you track back to fiscal 2017 or fiscal 2018 we had acknowledged that there can be some quick turn naval work that comes in and out in one or two quarters that can be rather significant. We are anticipating there might be one of those in fiscal 2020. But I would ask you to step back to the 2017 fiscal year or 2018, where we had the similar type of order happen and affect both those years. We are expecting that to occur again, as more of a material type order, versus a fabrication.

Tate Sullivan: Okay. You mentioned the annual revenue target and you referred to it as aerospace and defense of $20 million to $30 million annually in the next two years. Does that imply moving beyond the equipment work just for the submarine and aircraft programs? Or is that all still sub and aircraft programs?

Jim Lines: No, Tate. That's a great question. That's with our current component mix that we're providing to carriers and the two submarine programs, plus we hope to win additional components for those vessels. But that comment really reflects what our current backlog is and its conversion schedule, plus what we anticipate to win that, as I said, is for carriers and submarines. So, it's not branching into aerospace at all.

Tate Sullivan: Okay. And then have you, I can back into it, but I think on your revenue and how you break it out, there's a line for other commercial, industrial and defense work, I mean relative to that $20 million to $30 million annual target is trailing Navy work about $80 million or can you give that number?

Jim Lines: No. We haven't been definite about that. It's been between 10% and 15% of sales in a given year. That's been the range. And other elements, other end markets to go into the other category could be edible oils, could be pharma, but by far the most meaningful and what we group in other right now is Navy.

Tate Sullivan: Okay. Thank you. You sound optimistic on more future Navy orders. Just based on other companies talking about the submarine and aircraft program, are there orders subject to the procurement cycle, I mean do you have visibility that you have them, but you're waiting for the allocation and the procurement until you put them into backlog or how will that work potentially?

Jim Lines: Well, we have visibility into the bids that we've already made.

Tate Sullivan: Okay.

Jim Lines: We have dialogue with the counterparty of when they would begin to negotiate. It can be difficult to predict when they actually settle on the supplier and release the purchase order. However, we have a view based on the dialogue that we're having and the bids are already very mature and that a good book of opportunities should close in the next six months for the US Navy.

Tate Sullivan: Okay. Thanks. And last one for me, and sorry if I missed it earlier in the prior quarter, SG&A dropping to $3.8 million from $4.6 million in the prior quarter and keeping guidance unchanged. Did I miss – did you talk about some timing in that expense and why that should increase in the second half of the year please?

Jeff Glajch: Sure. A couple of things, Tate. This is Jeff. First off, we did have Energy Steel in the numbers in the first quarter, so that's a piece of the drop off. There was also some timing of some things that did not occur in the second quarter, they will get pushed to the second half of the year. And so there will be a little bit of timing that's part of what's driving the increases. We just had a very light quarter in the second quarter relative to what I would call a normal quarter and that happens on occasion, it tends to happen more in the first quarter, this lightness happened to occur in the second quarter.

Tate Sullivan: Okay. Thank you for all that detail. Well, have a good rest of the day.

Jim Lines: Okay. Thank you, Tate.

Tate Sullivan: Thank you.

Operator: Our next question comes from the line of Brian Lau of Sidoti. Please proceed with your question.

Brian Lau: Hey, good morning, everybody. Brian on for Joe this morning. Congrats on a solid quarter.

Jim Lines: Thanks, Brian.

Jeff Glajch: Thank you, Brian.

Brian Lau: Just real quick, I want to touch on the gross margin a little bit more. When you raised the guidance for the gross margin in the first quarter, did you anticipate the result this quarter? And if not by reaffirming it, are you implying maybe there could be some surprise in the back half? And then also how does that gross margin compare to some of the more recent orders in the backlog, compared to some recent shipments?

Jeff Glajch: So a couple of questions there. The first one is, did we anticipate the margin this quarter relative to the guidance that we gave? And we did that. This quarter was pretty much in line with what our expectations had been, so that was inherent in the guidance we gave for the full year. Secondly, I believe your question was around the margin in backlog. We talked about this quarter having a bit of an unfavorable mix in it. And what's in backlog? What's going on in the backlog is we're continuing to see an improvement in margin, what's going into backlog versus what's coming out. So I think Alan mentioned the high quality or the improving quality of our backlog and part of that comment was clearly a better margin profile than what's recently come out of backlog.

Brian Lau: All right. Great. Thank you. And then just as far as the bidding activity, it sounds like everything is still on track for that $30 million in orders, that kind of cadence going forward, has anything really changed since the last time we spoke, or does that sound about right?

Jim Lines: Nothing has really changed Brian other than we thought we could have booked one or two of the orders that are now pushed out of last quarter. It's just a typical customer delay. We do have some rather large projects. So it might look chunky in terms of how the order flow could be quarter-to-quarter, because of the size of some of these projects in our pipeline between $5 million and $15 million. However our overall view is unchanged from commentary provided last quarter.

Brian Lau: All right. And then last, but not least just on the M&A pipeline, it sounds like you guys are honing in on some targets there. Have multiples come down at all with the general economic environment?

Jeff Glajch: Not really, unfortunately in the space that we're looking at in the defense market as well as in the aftermarket on the commercial side, the multiples are still pretty frothy but we'll manage our way through that. But no, they really have not come down.

Brian Lau: Okay. Well, appreciate it. And again, good job on core.

Jeff Glajch: Thank you.

Jim Lines: Thank you, Brian.

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

Bill Baldwin: Thank you, and good morning.

Jim Lines: Hey, Bill.

Bill Baldwin: I was looking to see what color you can offer regarding the initiatives you've undertaken to secure more of a global fabricating supply chain, using third-party fabricators. Can you offer us some insight there, Jim, as to what that entails? Are you expanding relationships with existing fabricators? Or are you adding new fabricators? And if so, how do you do your due diligence and vet those new fabricators.

Jim Lines: A great question. We do have a group of historic international fabrication partners that we will continue to leverage. And we furthermore intend to expand and add more fabrication partners. We do a very deliberate due diligent process around financial capabilities, quality, customer-centric organization, similar sensibilities to Graham. And once we select a vendor and move them on to our fabrication approved vendor list (AVL), that doesn't mean we detach ourselves. Once we have an order that we'll put into that business, our quality control, our manufacturing specialists are surveilling in those businesses fairly regularly to ensure fit, form and function, quality, contractual adherence, and that it has the Graham badge and we're proud of what's being delivered.

So we're very deliberate and very measured in that. If I thought about the strategy from a historical perspective, we were more opportunistic and we would snipe at this work when it suited us. Now, how we've thought about it over the last 24 to 30 months is we want to aggressively reshape our position in certain sectors of the market, change our market share, and drive down our cost basis for that type of work by using more aggressively the global fabrication supply chain. And really, at the end of the day, it's to take more global share within a different market pricing expectation, while driving an acceptable return for ourselves.

So, we're thinking about it differently. Ultimately, the linchpin is, let's change our position, let's take more share and speed the installed base. And so far, as I've said in the prepared remarks, Bill, we've had half a dozen contracts in the last 18 months, total something north of $30 million

– $35 million. We are executing some of those contracts with old partners and we're executing some of those contracts with new partners.

Bill Baldwin: Are you using the fabricators then primarily for the global refining and petrochemical markets, or is it primarily refining?

Jim Lines: It's actually both. But from a declarative point of view, we want to own and be the dominant player in refining. Our attitude is, we never want to lose the refining project.

Bill Baldwin: Right. Right.

Jim Lines: So we want to make sure, we'll be maintaining that dominant position. And we also want to shift higher our market share in chemicals. So of those six projects that I cited in my prepared remarks, four of those are refining projects and two of those are chemical industry projects.

Bill Baldwin: Okay. Very good. Regarding the extreme tolerances you have to meet in terms of some of your products, do you have some of your own people sometimes go on site there to make sure of the quality of the work– or do these fabricators have the quality people on board to do the kind of work you can do there in your plant in New York?

Jim Lines: Well, no one builds this like Graham, let me start with that. We are an exceptionally capable fabricator. However, we can push our expertise into certain fabricators, not every fabricator is a good fit for us. We're not looking for optimizing price. We're looking for the right balance between outstanding qualities in fabrication capabilities at an acceptable price. So we're not going to the secondary or tertiary fabrication supply chain. They're sort of what you're citing here as a risk. They won't fit us. They won't match our brand and our quality requirements. So we are going into the top tier fabricators, if you will, or the upper tier, where their capabilities are strong. Their ability to fabricate to our tolerance isn't a quality criterion, and the criterion of our customers is acceptable. So we're striking this balance. We're not chasing the lowest costs or only putting quality first. Execution and quality and delivering consistent with our brand is the priority, at an acceptable price. So hopefully that answers the question.

Bill Baldwin: It does. It gives good insight. Are there any IP issues involved here that you have to protect when you're working with fabricators like this, Jim? I mean, are you giving them access to certain of your practices that you consider to be proprietary?

Jim Lines: No, certainly any time you embark on a strategy such as this, that's the first thing that comes to mind, that's the first thing that came to the mind of the management team of how do we execute this and moat the critical IP that is unique and differentiates us. And we have methodologies to do that. What we're imparting into the fabricators is less critical IP and more commercially available technology, that's not the secret differentiator of Graham. We preserve that. We hold that. We moat that and we don't put that into the fabricator's wheelhouse.

Bill Baldwin: Okay.

Jim Lines: A key criterion is, we do this with a clear vision that we will not create a competitor.

Bill Baldwin: Exactly, exactly. Yeah, that's the last thing you want to do there. And lastly, are you finding a sufficient number of these folks to talk to? I mean, are there people out there that meet those criteria you have, pretty much where you want to be located, or where you need them?

Jim Lines: It's a process. We've gone in and done an audit in a pretty large country that has a massive supply chain base of this type of fabricator and we've added five in that particular AVL.

So they've met our audit standards and they passed the mustard and we envision putting work into one, two, three, four or five of those shops.

Bill Baldwin: Yeah.

Jim Lines: We found fabricators that want to associate with our brand, because our brand gives market access. Our brand gives expanded opportunity. So we're finding a really keen receptiveness to work with us because they don't have the global market access that Graham does.

Bill Baldwin: Yes.

Jim Lines: And we don't have the execution scalability that they provide. So it's a great partnership where both sides figure out how to do something together that neither can do independent of each other.

Bill Baldwin: Right. Yeah. I would think they'd be knocking on your door with the installed base you have out there and your reputation. Well, I'd say, as you execute this, this is going to be exciting to see what happens to your market share globally.

Jim Lines: Yeah. We're excited by it.

Bill Baldwin: Very good. Thank you.

Jim Lines: Thank you, Bill.

Operator: Our next question comes from the line of Gerry Heffernan of Walthausen & Company. Please proceed with your question.

Gerry Heffernan: Good morning, everybody and thank you for taking the time to pick my call here.

Jim Lines: Hi, Gerry.

Gerry Heffernan: Hey, Jim. I was very interested in the question set of the last caller and it did trigger a couple of questions on my mind in regards to the statement that you made on M&A. We've been talking for many years here and M&A has always been discussed though it's never been a real big part of the picture. So, my question is, it sounds as though there's perhaps a little bit more interesting news in that area of your efforts than in the past and had me thinking, what is Graham's core competency? When you think of Graham Corp, what is your core competency? And in regards to M&A, are you looking for someone that has that same core competency or are you looking to add a new competency?

Jim Lines: Good question. There are five critical differentiators or core competencies that we believe we possess and that our customers value. First and foremost is our customer-facing platform, in which we serve as a partner in the conceptual design and the facility design for our customers of how our equipment integrates into their process and how they're able to achieve their operating results.

They need us and we've built a customer-facing platform to provide an immense amount of knowledge transfer, information sharing and optimization of their designs. So when they run their plants to meet their operating objectives, we think we differentiate on that front.

Secondly, because of the segment of the market that we've chosen to serve, which is this highly complex critical piece of equipment that integrates into a very complex process, a second differentiator is the engineering organization, the process know-how, after we have an order. When we get an order, and all of you on the call have likely heard this before, designs rarely are frozen for a large project work. We go through a process with the customer to actually finalize the design and it's highly iterative. So we have to have an adaptive and flexible operations model in the office for executing these orders since something always arises, there's design churn, design iteration, we have to have an adeptness and a vision that that's the nature of this work and we don't make every problem a customer's problem, and they need us for that. So that's a second differentiator.

A third differentiator is the custom fabrication of these complex very large weldments to exacting tolerances, a bit like what Bill Baldwin had questioned, as we think about our fabrication partners and the capabilities of doing that. We have incredible artisans and crafts persons on the ground that can fabricate these complex things as big as a house to watch tolerances with massive amounts of metal and welding done to the metal and material movement and that's a unique capability that our company has and had developed over a long period of time.

And here too, even when some things in fabrication design might not be frozen, Alan and his team have to have an operations model where there is ample WIP on the production floor when jobs go on stop. When there's a design change, we can fluidly move and then resource other orders to keep production flowing, while an order goes on stop. That's a particular uniqueness of a low-volume, high-mix operations model that we feel we've perfected, that's what our market demands and that's the key differentiator for us versus a high-volume, low-mix operations model.

A fourth differentiator is the fact that we care about our installed base. We care about operational reliability. We're just not an initial sale partner. We're a life partner. We make sure that the facilities will operate for the life of the facility, when they're using our equipment. Most of our competition, I'm not being disrespectful, they're focused on the initial sale. We're focused on the value over the life of the relationship, not on the initial sale solely. We've built out a post award organization that provides technical services, knowledge transfer, helps our customer with operational reliability, unlock latent capability.

And there's a strong toll on the organization. We gave the organization an identity about 10 years, 12 years ago. We've added to it, it's probably doubled in size since we started the aftermarket team, providing field service. So that's a key differentiator. For most of our competition that's concentrating on the initial sale, that's fourth.

The fifth one is, we will invest in ourselves. We will deploy our capital into our business in an aggressive way. The last 20 years, we've put approaching $30 million of capital into this facility here to expand our capabilities, to drive productivity improvements, to do more with our roof line. And then we've also invested in our workforce, in IT tools, in productivity tools and change agents being brought into the business.

So we think differently about managing the income statement in the near-term versus the long-term value creation of all of those four other differentiators. And I think that's how the customers think about us. That's why they value working with us. And now when we think about a partner, we're looking for someone that has the fabrication shops, the middle part, the two and three differentiators, because that's what we need from them, where they have an ability to execute these orders and then an ability to fabricate these complex weldments to our fit, form and function criterion. And that's no casual chore.

So that's not what we're looking for as we're thinking about M&A. I'll turn it over to Jeff in just a moment with respect to M&A. But I want to be clear as it pertains to M&A on the strategy that we talked about just a moment ago, we're not necessarily thinking of M&A there with an operations type strategy of buying something in the international markets. I very much favor, because of the cyclical nature of these end markets, our flexible cost basis and a way in which we can address the burst demand or burst capacity needs with a global fabrication supply chain. And I'm reluctant, and Jeff is as well, to focus M&A resources on buying bricks and mortar in the international markets, because I don't think that solves anything in the short-term or the long-term and it creates long-term issues.

And I'll turn it over to Jeff for a more broad discussion of our M&A focus and the criteria that we're looking at.

Jeff Glajch: Thanks, Jim. Yeah. Gerry, as we're looking at potential acquisition candidates, one of the things we're focused on is, as Jim just mentioned, we're not trying to buy capacity per se, we're actually looking for a business that fits our type of operating model. So, has the customer and quality focus that we believe we have for our customers and that has a good management team that wants to remain with the organization, that's key to us. We're buying a business, but we're buying the people in the business as well and that's critical for us.

We want someone who has a lot of the same attributes that Jim conveyed about Graham, but we're looking to how do we grow this business in parts of our markets that we believe are perhaps less cyclical than our core energy markets. So we talked earlier about the Navy space and we're looking at aerospace because, many of the companies that we're looking at with a large Navy component, also have an aerospace component maybe not as big, but it certainly exists and that is interesting to us if, product-wise, it ties into what they do with the Navy.

We're also looking at opportunities in the aftermarket, in our commercial markets, because we believe, and our experience has been, while the volatility of our capital investment by our large refining and petrochemical customers can vary 50, 60-plus-percent, the volatility of the aftermarket, or short cycle business, tends to be much less volatile, perhaps more like 15% to 20%. So, in a down cycle, it's a business that's more sustainable.

So, that's really our focus on the acquisition side. But key for us is we want to find the companies that are well-run, that have a lot of the same attributes as Graham and have a management team that wants to remain in that business post-acquisition. I hope that's helpful. If I can clarify further, please let me know.

Gerry Heffernan: That was all very helpful, both Jim and Jeff. Jim, it strikes me when you go through those core competencies and going to the previous question of Mr. Baldwin's there that concern about the custom fabrication competency that you had and are you giving anything away, if you're trying to utilize international players for that aspect of your service? That is just one of five items that you picked out. And the other four are very much people oriented, as opposed to just the artistry of working with the metallurgy?

Jim Lines: That's correct. While there is risk in doing this, we think we've moated the most critical elements of our success factors.

Gerry Heffernan: Great. Thank you very much.

Jim Lines: You're welcome.

Operator: Our final question comes from the line of Tate Sullivan of Maxim Group. Please proceed with your question.

Tate Sullivan: Oh, thank you. Thanks for taking a follow-up. Just on numbers-wise for orders and the most recent quarter of $32.6 million and then earlier in September I think was when you announced most of the refining orders. What are other orders in the quarter? Is it design modifications that you mentioned before or maintenance or aftermarket? What usually are the other orders besides the large equipment orders?

Jim Lines: We had some chemical industry orders that came in and then of course our usual basket of short cycle work, spare parts, small product, new equipment sales that typically come in and out in one, two, three or four months. So that represented the remainder of it. There wasn't so much change orders, but more of the large project work where we had the order announcement of about $20 million of that. And then we did announce a few million dollars of chemical industry end market sales and then our short cycle business makes up the rest.

Jeff Glajch: Tate, just to also clarify a couple of the larger orders that Jim had mentioned. We announced the $19 million or so in early September. We had a couple that came in fairly late in the quarter and our practice is, if they come in that late, if we were to put an announcement out, that might confuse whether it was a second quarter order or a third quarter order if we announced it in early October. So we believe that it just makes sense to hold off on those as any kind of announcement like that and we just talk about them on the quarterly call like this.

Tate Sullivan: Great. Okay. Thank you.

Operator: We have reached the end of our question-and-answer session. I will now turn the call back over to management for any closing remarks.

Jim Lines: Well, thank you, Daryl, and thank you everyone for your time this morning and for your questions of the three of us. We appreciate your engagement and the interest with which you thought about the questions and we look forward to updating you on our progress on executing our strategies and our financial performance in January. Have a great day. Thank you.

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