Operator: Greetings, and welcome to the Graham Corporation Third Quarter Fiscal Year 2020 financial results. As a reminder, this conference is being recorded.

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

Karen Howard: Thank you, Doug, and good morning, everyone. We appreciate you joining us today to discuss Graham's fiscal 2020 third quarter and year-to-date 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; Jeff Glajch, our Chief Financial Officer; and Alan Smith, our Vice President and General Manager of our Batavia facility. Jim will start with a strategic overview of our business and provide our outlook for the remainder 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 third quarter earnings call. I will begin with a strategic overview to highlight the focus of management and provide commentary regarding progress during the quarter. Jeff will provide a deeper review of financial results, and Alan Smith, Vice President and General Manager, will provide a review of operational performance.

Please turn to **Slide 4**. An important strategy for us is to reduce volatility of our financial results by strengthening and expanding predictable revenue streams. Energy end markets will remain volatile, and periods between peaks and troughs appear to have shortened. The naval nuclear propulsion program will provide predictable revenue that leverages our key assets of engineering, complex project management, quality processes and large-welded fabrication expertise.

I like the naval work for several reasons: one being it is long-lived backlog, providing vision into a multiyear base loading of our fabrication assets; second, the competition is limited, and international companies are restricted from bidding in most cases; lastly, engineering, program management, quality control and our operating model required for this work result in high-entry barriers. Ultimately, customers in this market value what we do exceptionally well.

The Navy strategy has been successful with current backlog for this sector at approximately $60 million. Our naval strategy leadership has us participating in three different nuclear propelled vessel programs: two different submarine classes and an aircraft carrier program. We want to produce different and more equipment for these programs. Over the next 12 months, we hope to secure the supply of two new components, one is for a carrier program and the other for one of the two submarine programs.

Demonstrable evidence of our success in the naval program, driven by Alan Smith and his team, is the increasing percentage of backlog that is one sole sourced. All of our work for the first decade of this strategy was competitively bid. We now are seeing certain procurement done with sole-source bidding.

Moreover, many of the initial orders were first-time fabrications of very complex weldments and material combinations. Production R&D and developing efficient build-flow methods along with production jigs and fixtures are needed with first-time fabrications. 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 did add another order into backlog during the third quarter that was in excess of $5 million for the Naval Nuclear Propulsion Program.

M&A focus is in the defense and aerospace end markets. We continue to actively engage in discussions with companies serving the Department of Defense. Our current portfolio of components provided to aircraft carriers and submarines, along with new components we plan to break into with this, is our view. Without M&A, we expect to have revenue between $20 million to $30 million on an annual basis in the near future.

We are seeing M&A deals within defense end markets being negotiated in auction processes; valuation multiples vary greatly, where multiples below 10x next twelve months' EBITDA seem to be nonexistent unless the business is broken, and above 15x isn't uncommon. Finding the right fit, where growth in combination with benefits are assured is crucial. We will maintain our discipline for strategic fit, value creation and financial return metrics.

Another more predictable revenue stream is derived from our installed base. From the installed base, revenue takes two forms: one is conventional replacement parts and in-kind replacement equipment; the other is revamp and retrofit. Graham enjoys a sizable global installed base with 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 the equipment we delivered in the 1970s and the '80s, we estimate that our North American installed base approaches $1 billion. Here, too, this sector is not as volatile as large capital projects in the energy markets, with parts and replacement equipment having modest volatility while revamp and retrofit is less variable than capital project investment.

Our customers generally invest to keep their plants operating well. Also, our thesis appears to be correct that in certain regions such as the U.S. and Canada, they will leverage their facilities to get more from them before investing in new capacity.

Regions with dense installation populations are the U.S. Gulf Coast, the 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 our customers. We doubled the size of our performance improvement technical service organization in the past two years. We are currently building out our U.S. Gulf Coast performance improvement engineering team. Two engineers were placed in the territory in 2018, and we expect to add two more in the next six months. These individuals focus on our customers' plans and our installed base, which will be in addition to our historic focus on EPCs and OEMS. Typically, 30% to 40% of revenue is derived in some way from our installed base. Fiscal 2020 to date has greater than 35% of new orders derived from our installed base.

M&A deal generation is centered also on the installed base to add products and/or services. Deal multiples in this vertical aren't as rich as defense multiples. However, we're finding scalability and growth for these types of companies to present some challenges. When taken together, the naval strategy and our predictable base strategy, they are estimated, in combination, to approach $50 million per year in revenue in the coming 2 years. Upon achieving that level of predictable revenue, it will dampen the impact of our highly cyclical, large crude oil refining and chemical project work.

Also, trade policy and tariffs on certain materials have affected competitiveness in international markets and, in certain instances, they have impacted us in our domestic markets. We are also observing customer acceptance of low-cost regions for fabrication of critical components such as our ejector systems and steam surface condensers. In response, and actually 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 in new orders were secured by executing differently to increase market share, where previously we were unsuccessful due to cost. Four projects were for international crude oil refining projects that will add to our installed base, which ultimately drive follow-on revenue in the coming decades from revamps, retrofits and spare parts.

In the past, we approached using the global fabrication supply chain in a limited or targeted manner. Now we are proactively and aggressively attempting to change participation, create broader execution scale and expand market share. Three critical facets of this strategy to expand market share are: controlling quality, achieving predictable results and protecting our IP.

We are building out our supply chain management quality surveillance organization in support of this strategy. Early success, as cited a moment ago, is validating that we have a good formula for success. Bringing on new fabrication partners can potentially lead to missing financial projections for a given order. However, thus far, planned and realized margins have not varied too greatly.

The unique or differentiating elements of Graham's IP will be closely controlled as we execute the strategy. We are not releasing or disclosing our differentiating capabilities; that will remain closely moated. Our exercise of this strategy is now approximately 20x what it was in 2006. And we have safeguarded our critical IP along with realizing satisfactory financial results from those orders.

Since launching this strategy more aggressively, we secured six large orders during the last 18 months. When taken together, expanding predictable revenue streams, repositioning execution strategy to take more market share in underserved segments and M&A to add new revenue, this will result in strengthening shareholder returns, more consistent financial performance and an increase in cash generation to reinvest into the business.

I will now refer to **Slide 5**. I am pleased with our strategy to change execution to shift competitiveness within markets, where our share had been low or where we chose in the past not to participate. Since initiating the strategy, as I said a moment ago, over $35 million has been secured, including an order in the last quarter. In that most recent case, the customer and the end user are both new to Graham.

Fabricator and partner selection is critical. We have a proven process within China. The success of that is being deployed into other Asian countries and certain countries in Europe. Quality control, on-time delivery, and cost efficiency are important performance measures for this strategy. I am pleased with how well we are executing the strategy and achieving realized margins within the market price for this sector of our end markets.

Developing global fabrication partners provides tremendous execution capability with a variable cost. So we aren't adversely changing our fixed costs. This work, due to sharing margin with our partner, can look different at the gross margin line but blends in fine at the operating margin line.

Importantly, we also reach into nontraditional markets for Graham, such as emerging markets with hydrogen fuel delivery systems, natural gas engines or natural gas delivery systems, applications involving supercritical fluids and applications in cryogenic services. In certain applications, Graham products have high differentiating barriers that limit competition. Year-to-date, there were orders within our short-cycle products that were supporting OEMs or end users for natural gas delivery systems, supercritical carbon dioxide extraction, hydrogen fuel delivery systems and so on. These are smaller dollar value orders that fall into our short-cycle sector. However, in the long run, they can become more frequent and more predictable, thereby, further expanding predictable revenue streams.

I will now move on to **Slide 6.** We confirmed full year revenue guidance that will be between $100 million and $105 million. This revenue guidance is predicated on executing a quick turn Navy order in the fourth quarter that is currently in backlog. We feel confident that we will be able to do that. Secondly, Jeff and I were on a conference call this morning with our Managing Director in China. We have some large work being done in the fourth quarter in China that's being recognized on a completed-contract basis, not percentage-of-completion basis. We've been advised this morning that the local government authorities are prohibiting workers to go into the factory for a period of time, due to coronavirus risk. We'll have to monitor the progress of that. This is happening in real time. And it may affect our ability to land within that guidance projection. We just learned that this morning when Jeff and I were on a call.

Gross margin is expected to be between 21% and 22%. This has been adjusted downward from previous guidance. SG&A spending will be between $17 million and $17.5 million. Our effective tax rate is approximately 20%.

I would now like to pass it over to Jeff for him to review the financial results. Jeff?

Jeff Glajch: Thank you, Jim and good morning. If I could have you move to **Slide 8**. Revenue in the third quarter was $25.3 million, up from $17.2 million in Q3 last year. Q3 net income was breakeven compared with $95,000 or $0.01 per share last year. I will speak more to our Q3 results on the next slide.

Orders in the quarter were $20 million, and our backlog now stands at nearly $123 million.

On to **Slide 9**. Q3 sales were up significantly versus last year. However, we had a poor mix of projects converted in the quarter. Sales in the third quarter were 53% domestic and 47% international. In last year's third quarter, the mix was 83% domestic and 17% international. The increase in sales in the quarter was all in the international markets, primarily from outsourced fabrication work. Gross profit in the quarter increased to $4 million from $3.7 million last year. Though the sales level increased significantly, the mix of projects was very unfavorable as well as the amount of short-cycle aftermarket work was lower than normal. Due to this mix change, gross margin was 16%, down from 21.8% last year. We believe the poor mix of projects will shift to a more favorable mix in the fourth quarter and beyond. In addition, we continue to see an improvement in margin with what is going into backlog compared to what is coming out of backlog.

EBITDA margins in the quarter were just above breakeven, down from 4.5% in last year's third quarter. And net income was breakeven, down from $95,000 or $0.01 a share on a reported basis and $500,000 or $0.05 a share on an adjusted basis last year.

On to **Slide 10**, looking at year-to-date results. Sales in the first nine months of fiscal 2020 were $67.5 million compared with $68.2 million in the first nine months of last year. Note that last year had a much stronger first half than second half. And per our guidance, we're expecting the opposite with a strong sales quarter in the fourth quarter.

Year-to-date sales were 65% domestic, 35% international compared with 63% and 37%, respectively, last year. Year-to-date gross profit was $13.7 million, down from $17.1 million last year, and gross margin is down at 20.3%, versus 25.1% in the first three quarters of last year. Unfavorable mix impact of the third quarter is the main driver in the reduction in gross profit margin and dollars. Year-to-date adjusted EBITDA margin is 4.8%, down from 12% last year. Nine month net income is $1.3 million or $0.13 per share on an as-reported basis and $2.2 million or $0.22 per share on an adjusted basis compared with $5.6 million or $0.57 per share on an adjusted basis last year.

Moving to **Slide 11**. Cash is at $70 million, down from $78 million at the beginning of the fiscal year. This reduction is simply the timing of working capital, and we expect it will reverse over the next one to two quarters. Capital spending has picked up in the third quarter and is now $1.4 million through the first nine months, similar to last year. We expect significant capital spending in the fourth quarter, resulting in full year capital spending of $2.5 million to $2.8 million. As Jim discussed, we continue to expand our acquisition pipeline and, despite high prices in that arena, we are pleased with the list of companies we are considering pursuing.

Alan will complete our presentation by providing more depth on our operations in Q3.

Alan Smith: Thank you, Jeff, and good morning, everyone. I'll provide commentary at an operations level. I'd ask that you refer to **Slide 13**, please. $25.3 million in sales for the third quarter reflected the benefit from our increased use of our global fabrication supply chain to improve participation in market share in the portion of the refining market that we previously were not focused on.

The $5.6 million increase in refinery sales in the quarter compared to a year earlier is principally due to this strategy. We are executing a large Middle East new capacity refining project using Asian fabricators to expand our execution capacity and to improve our costs. This happened to be a price-centric decision by the EPC consortium involved, which necessitated a different execution plan. We haven't generally observed this for the Middle East refining applications. We plan to complete this order in the fourth quarter.

The chemical sector sales more than doubled in the quarter when compared to last year due to ongoing investment in North American petrochemical plants tied to the low-cost feedstock advantage stemming from shale-derived oil and gas.

Commercial sales, which include the Navy, increased $1.6 million due to Navy backlog progressing into fabrication. Our geographic sales mix trended closer to 50-50 domestic and international due to the aforementioned Middle East order. I would expect domestic sales to range between 50% and 75% in the long run due to the strength of our naval backlog.

As Jim noted, fiscal 2020 revenue is expected to be between $100 million and $105 million. At risk is a short-cycle Navy order in backlog. It is set up to complete, but our customer can, in fact, order completion in a negative way. My conversations with the customers suggest that we will complete this order within the fourth quarter but the risk exists. Also at risk is a China order, as Jim mentioned, given the coronavirus concerns there.

Moving on to **Slide 14**. The higher level overview of the trend line is that we escaped the cycle bottom for non-Navy orders, having essentially doubled our trailing 12-month order levels when compared to the low watermark in the first half of fiscal '18. We do have rather large orders from time to time, be they from Navy or other end markets, which can create spikes such as the one seen in the second quarter of fiscal '19. We are enjoying a consistent level of orders from our installed base. These orders come in two forms. One is a typical spare parts or in-kind replacement, the other is retrofit or revamp type orders.

Year-to-date, orders derived from the installed base represent approximately 30% of the total orders. More importantly, the installed-base orders typically have the highest margin potential. We did add approximately $8 million of new work into the backlog from our naval end market year-to-date. A portion of the $8 million came in the form of change orders for scope modifications to existing backlog and the larger percentage is for additional components. Most importantly, there is an active pipeline in excess of $50 million of new naval opportunities projected to close within the next 12 to 18 months.

Lastly, there's a large grouping of bids that will require us to utilize our global fabrication supply chain strategy, which totaled $75 million and is planned to close in the next 12 months. We are not expecting to get all of it. However, we are in a good position, I believe, for certain targeted projects. I expect the trend of the line to head upwards across the next several quarters.

Finally, I'll wrap up on **Slide 15**. The backlog is healthy at $123 million, with naval orders representing just over half of the backlog. Refining backlog expanded to 30% of the total. I highlight this as compared to a year ago because refining backlog is up 20%. Importantly, refining backlog provides higher-margin work when compared to the chemical market backlog.

Lastly, backlog conversion is 55% to 60% across the next 12 months, and 25% to 35% will be completed beyond 24 months from now.

Operator, please open the line for questions.

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

Joe Mondillo: So first off, I went back and looked at your 12-month backlog and compared it to your trailing 12 months of revenue. Compared to a year ago, it's actually very similar. But over the last eight years, it's actually one of the highest that you've seen in the last eight years. So I'm wondering, I know you're not giving guidance on fiscal '21 quite yet, but could you talk qualitatively on how you think you're positioned heading into fiscal '21?

Jim Lines: At a qualitative level, Joe, we are projecting and expecting that there will be year-on-year growth in '21 versus '20, that the year is not fully set up, but it's at a very good point at this juncture with where we are entering the year. We have probably six more months of booking large project work that could contribute to revenue in fiscal '21. The pipeline looks ample. The backlog is set up for execution. So it does suggest and direct us towards thinking that '21 will be a strong year for Graham.

Joe Mondillo: Okay. And then a couple of questions on gross margin. So it sounds like, correct me if I'm wrong, it sounds like maybe Middle East or international work that you did and you had to do some outsourcing of the fabrication caused the low gross margins. If that's correct, was this something that you weren't anticipating? And could you just help us understand, it seems like you have a big backlog, and you only had two quarters left in the year, and I would have thought that would have been something that you would anticipate. Could you just help us understand the low margins that we saw in the quarter?

Jim Lines: Sure, Joe, as Jeff had indicated in his prepared remarks, we had some effect, I'm not minimizing the effect, of lower-margin work that was converted. What we have in our book of business, and we've talked about this over many quarters over the last 10 years or so, have varied margin profiles. Some are strong, some can be so-so. As we had set up the third quarter, going into it, we had a particular vision of execution and labor allocation across a certain mix of work.

What actually happened, because of starts and stops or for other reasons, we had to allocate work to lower margin profile backlog. That was not how we had modeled the quarter. And as a consequence, it had lower profit generation potential and drove down margins.

The international refining project and that global fabrication project, we've booked it clear eyed. We understood its margin potential and its projection. That did not surprise us, that's actually mapping toward our margin profile when we booked the order, so there's no surprise there. This came down to – I know you can't see behind the curtain, but from us being able to look behind at the details – it was the way we flowed production hours into the highly varied backlog that we have.

Jeff Glajch: Joe, this is Jeff. One additional comment. We also had, on a relative basis, a lighter quarter of aftermarket and short-cycle sales which, as you know, are at a higher margin for us. So that also contributed to the difference between what one would normally expect compared to what we actually saw from a margin perspective.

Joe Mondillo: Okay. And just to follow, just so I fully understand, this is backlog work that you have different ways to fill the order or deliver? Or was this, you have a backlog of various different orders and, due to timing with the customers, you had to push out the high-margin stuff forward to future quarters, and you had to work solely on the lower backlog work? Which one?

Jim Lines: It's more akin to your latter description, which is we had work-in-process that has a range of gross margin generated per production hour. And what actually happened is, we flowed work into, for a number of reasons, into orders that had the lower gross margin per production hour than we had modeled going into the quarter or how we modeled the second half.

This happens in our large project work, it happens with our naval work, it happens with our energy market work. And it's frustrating because nothing to us is broken in the business. It's a consequence of the wide variability and margin profile of our backlog. What's great is we have an operating model, where we can adjust our production resources and flow work into our work-in-process because we have enough of it in WIP that allows us to deploy those resources effectively into other work. It just is the way that mix and math works when you have such a huge variability in gross margin per production hour. The positive of that is, it portends to a stronger margin in the future.

Joe Mondillo: That's what I was just going to clarify. So the future couple or few quarters, you're pushing out higher margin work. So that should actually benefit you going forward, I guess, in the next couple of quarters?

Jim Lines: Sure. We ultimately need to deliver that higher-margin work, and it will flow through in subsequent quarters.

Alan Smith: Yes. Sorry to interrupt. But an important point in line with what Jim just mentioned is, it's not a situation where we've seen any cost increases or anything like that, that impacted the quarter or will impact us going forward. It's the same project work. It's the margins we booked and our expectations of executing all those projects are in line with the costs that we assumed when we booked them. It's just, unfortunately, as Jim mentioned, some of the poorer projects were executed in this quarter, which portends very nicely for the future.

Joe Mondillo: Okay. Understand. And now one last question on gross margins, a longer-term type of question. I went back to the fiscal '12 through fiscal '16 time period. And over the four to five years, about 30% to 35% of your revenue was derived from your higher-margin refining business. Actually, currently, your refining business is even higher than that as a percent of sales, yet you were realizing 30% gross margins back then and now you're closer to 20%. I'm just wondering, has anything changed compared to that time period back then? Do you think you can get back closer to 30% gross margins?

Jim Lines: I'll answer the second question first. We do feel that the margins that were exhibited year-to-date are not reflective of the margin profile of this business as we get some of the backlog behind us that reflected decisions we made 12, 18 months ago when the order environment was different. And then secondarily, as you might recall, and as Alan said, refining provides our highest-margin potential.

However, within that end market mix is a geographic mix that can affect margin. So North America work is the best. Middle East work under normal circumstances is the second best. In this particular case, I think Alan or I had mentioned that we had a price-centric purchase decision from an EPC that was not typical. Again, we booked it, we understood the margin.

We're realizing our booked margins. So nothing is surprising us there. It just didn't carry the margin profile of a classic Middle Eastern project.

But Asia, depending upon as we shift our mix to where new capacity might be coming from as we deploy the global fabrication strategy, we will be bringing in work from the refining space that has a different margin projection than as you thought about Graham and the refining activity a decade ago, because we're shifting our position where we didn't serve that market fully before. We can add that work into our business. It's going to be additive at the operating margin line, but it can come in as a compression at the gross margin line, that type of work.

Joe Mondillo: Okay. And then just one last follow-up regarding this. It's been a few years, several years where North America has been a little weaker than anticipated, and maybe that's why the margin profile has not been as strong compared to back in that time period. Do you see any catalyst or any growth factors related to a pickup in work in North America? And specifically, also, can you address, everyone's talking about how we are the biggest exporter of oil now, we're self-dependent or independent on oil. However, that's a little bit of a falsity related to the fact that our refineries can't process a large part of this oil that we're actually drilling. Do you see any drivers or work where some of the refineries are thinking about investing in ways to actually utilize some of this oil or any factors at all regarding North America refining?

Jim Lines: Alan hit on it conjunctionally in his remark where he mentioned that our installed-base new orders year-to-date were 30% or 35% of the total. What's important within that is, much of that came from the refining end market. That is implying to us, and Jeff had said, the margin of our work going into backlog is superior to the margin of what was being relieved out of backlog for most recent periods, that's largely due to the fact that we're seeing our mix become more North American and refining based, and that's representing an improvement in our backlog quality with what's being added to backlog. So again, we feel more positive as we look through the windshield than as we look through the rearview mirror.

Operator: Our next question comes from the line of Theodore O'Neill with Litchfield Hills Research.

Theo O'Neill: Jim, in your prepared remarks, did I hear correctly that there were jigs and fixtures you had to build out in Q3, in order to execute on a contract that you'll have in Q4?

Jim Lines: I made a comment in my prepared remarks about first-time fabrications that require jigs and fixtures. And that was not a drag on the third quarter. If I represented it that way, that unto itself wasn't an issue. What I was trying to refer to was the first decade of executing our naval strategy was competitively bid work and some first-time fabrications. So as we look forward, having those fabrications behind us, where we built the collateral fabrication assets that we need for future production, the repeat builds, the margin profile of our naval work will become stronger. However, we're dealing with the backlog, and our strategy was to enter the market over the last decade. Very pleased with what we've done and the execution of that strategy. The future looks stronger than looking backward.

Theo O'Neill: Understood. And on China, I'm hearing anecdotally that no one's going back to work until after February 10. Is that the sort of thing you're hearing?

Jim Lines: The call that Jeff and I were on the location of, where our office is, is February 9. We haven't heard the timestamp for where we're having equipment built. But they are on a Chinese New Year shutdown right now anyways. So nothing was happening with respect to advancing the particular order. However, this is playing out in real time for all of us. We did get notified today through a proactive call Jeff and I had placed to our China team, to understand where that particular order was that we plan to have complete in the quarter. And we shared with you in the prepared remarks what we were advised, which is the government has not permitted workers to return to the factory. The date upon which they can return is not clear to us. We might have better visibility in middle of next week. And we'll watch how that unfolds. There's little we can do.

Theo O'Neill: Got it. And Jeff, just following up on the gross margin question. Does outsourcing necessarily produce lower-margin business for you?

Jeff Glajch: It can in some instances, and other instances, it can be more in line with our margin levels today. I think if we're looking at margin levels that our business will more normally run at during the middle of the cycle, which as Joe Mondillo noted, was up in the 30% range, that might be a little more challenging to achieve on a consistent basis, for outsourced work. On some projects, yes, but I think across the board, it might be a little bit less than that over time.

Jim Lines: I would like to just expand a bit on that. The segment of the market in which we're deploying the strategy is a market that we underserved previously, and it has a different price potential and a different cost basis. We would expect most of those orders to have, as Jeff had outlined, margins comparable to, say, our business as a whole right now. We don't have illusions that, that segment of the market will provide a Western-type margin profile.

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

Tate Sullivan: Okay, thank you. A couple follow-up questions. Alan, in your comments, I think you mentioned a change in an execution plan. Did I hear that, what was that? Can you review those comments, please?

Alan Smith: Sure. To support the expansion into a more price-focused buyer group that Jim had noted in his comments, we're going to a Southeast Asia supply chain. So in doing that, we have to make sure that we have our vendor oversight processes really buttoned down. What's important to us is that the product being produced, even though it's not being made by Graham employees, it meets our quality standards. So we have to have really tight quality surveillance and oversight with the vendors to ensure that we produce the quality products that are worth our nameplate.

Tate Sullivan: Okay. So that was related to Asia, or was that related to the Middle East project for the E&C buyer?

Alan Smith: Yes. That Middle East project was built in Southeast Asia

Tate Sullivan: Okay. And then also, related to your comments too, I heard the number – $75 million potential project pipeline with other work besides Navy, but what was the number that you said is a potential Navy backlog that you can compete for in the next 12 to 18 months?

Alan Smith: Yes. In the next 12 to 18 months, that's in excess of $50 million.

Tate Sullivan: Okay. And following up on that, when you refer to executing, and Jeff and Jim, too, referred to executing a shorter-cycle Navy project in 4Q. What does that mean? Can you clarify what type of equipment that is?

Alan Smith: It's a long lead material order that the Navy or our naval customers give us from time to time. And some of these orders, they like to lock down the time-based risk and material costs. So it's a material order basically for us for a future project.

Jim Lines: Tate, we've had a couple of these in previous fiscal years where there'll be material orders with what I'll call, a nominal amount of fabrication work on them. And they ultimately can become part of a bigger order as they did when we had these in the past couple of years, but they're not necessarily guaranteed to be that. But we've had a couple of these in the past couple of fiscal years, fiscal year '17 and '18.

Tate Sullivan: Okay. And Jeff, also, one of your earlier comments, what usually historically has caused less aftermarket orders in a quarter that you mentioned?

Jeff Glajch: Sure. The aftermarket orders – and we look at the aftermarket as part of our predictable base – over a 12- month period, for example, they are usually pretty predictable. There can be a bump up or a bump down in a particular quarter for aftermarket orders that can move into 15% or 20%, which is really essentially the impact we had in this quarter. It's just timing of orders. There could be a lot of things that could happen, it could be the holidays around December that can impact it, it can be how the plants are ordering, it can be plant budgets, it can be a lot of things. We can see a bump for a quarter in either direction. We don't necessarily overreact. It's when we see it over an extended period of time, and we've not seen that yet, where this was just the amount of orders that came in and/or executed in the quarter were lower than we would normally anticipate.

Tate Sullivan: Okay. And Jim, one last one for me. You mentioned steeper cycles in previous earnings calls, two for refining and chemical work. Why is that? Is it foreign competition or lower budgets? Or what's different today than previous cycles?

Jim Lines: What we're observing today, the difference would be a geographic mix, when we reflect upon the 2006 through 2009 surge or the middle of this decade surge, it was principally North America and Middle East, where we're not yet seeing strong Middle East. And we're seeing more international and not as strong of work coming out of Canada, which was our oil sands work, a good area for us, and we're not seeing as much work coming out of there. So it's a bit of geographic mix. But all in all, as I said in a remark a moment ago, the orders that we've gotten so far this year, about 1/3, round numbers, were from our installed base in the form of some large projects that were revamped retrofit large in-kind replacements that principally are being pulled from the North American refining market, and that's always been a healthy spot for us from a margin perspective. So we're not seeing the same geographic mix today right now as we did in the early years of this decade or in the middle of the 2000 to 2010 decade.

Operator: Our next question is a follow-up question from the line of Joe Mondillo with Sidoti & Company.

Joe Mondillo: Just a couple of follow-up questions. Regarding the slide on Page 5, I just wanted to dive in a little more. It sounds like a new strategy that you're taking, on the first left side of the page, I'm referring to that, are you planning on reducing any fixed labor while you try to transition to more of this outsourcing strategy?

Jim Lines: What actually is quite beneficial is the confluence of this strategy with the strength of naval backlog. So while we're looking at the incremental work from our traditional energy markets perhaps using this shared fabrication strategy, the use of our asset base and our production labor is growing very appreciably from our naval backlog. It's stepping up quite markedly between '19 to current year and between this year and ‘21. So we're actually flowing production resources and production assets into a stronger naval revenue, and so we're not changing, reducing cost as a consequence. It actually is a perfect combination of how we see the markets evolving, complemented by the strength of our naval strategy.

Joe Mondillo: Okay. So you won't have to take on new labor to facilitate orders on the energy side of things. At the same time, your capacity utilization is increasing?

Jim Lines: I don't think that's accurate. We do plan to continue to build out our direct labor force, our production personnel. We see enough market demand that gives us confidence that, that's the right thing to do. I would anticipate, over the next year, we would add another 10% to our direct labor workforce. And if the markets don't change and they play out as we envision, we would probably add another 10% the year after that, primarily fulfilling more energy end market demand because we understand the naval strategy, the naval backlog conversion. And we've structured our business to put our production assets toward that predictable backlog, so that's already understood. The additional direct labor really reflects our vision that the markets are continuing to expand, or if they don't change from this tepid expansion cycle we're in, we'll take more share.

Joe Mondillo: Okay. So you wouldn't have to expand your labor as much as maybe the prior plan where you didn't have the outsourced flexibility then?

Jim Lines: That's fair.

Joe Mondillo: Okay. And then on the right side, just curious. So correct me if I'm wrong, it sounds like you are trying to attack new markets on the short-cycle opportunities. Could you just expand on that? And not sure if you can provide any detail on how big of an opportunity this could be?

Jim Lines: Some of those could be – I don't want to use something too over the top, but if these take off – so the hydrogen economy, if that were to take off, and we're participating in that with a very differentiated product, and that becomes a high-volume produced component for us, that could be quite significant. I don't see that in the next half of a decade or perhaps decade. But the key is we've entered these emerging markets, we're participating, we're helping our customers evolve their technologies and the delivery of these new solutions, and we're on the ground floor. And it's the right thing for us to do.

I don't think they're game changers or needle movers in the next 1, 2 or 3 years, but I like that we're there. I like that we're participating, and I like how we're moving appropriately into other alternative energy sources as a business, so it makes sense. And again, I don't want to convey that they're needle movers or they'll alter Graham's financial performance in the next one or two years. But the long-term play, if, let's say, the hydrogen economy takes off or the compressed natural gas further accelerates, we're in those markets. We participate. There are really nice opportunities for us, nice margin work. And if that were to double, triple, tenfold, it's quite impactful. And those aren't numbers that would be extraordinary as those emerging technologies took hold and have traction.

Joe Mondillo: Okay. And then you mentioned winning a $5 million-plus order in the Navy business in 3Q. Was that related to the material orders for future projects that you were referring to when Tate was asking about that? Or is that something different?

Jim Lines: No. You might recall, on the conference call that we had last quarter when we gave the guidance, we mentioned it was tied to winning a short-cycle naval work order. We've now won it, and now it comes down to delivering it. So it's the same one as we cited last quarter.

Joe Mondillo: And regarding what you have in backlog for Navy or for the defense business, it seems like this year is looking like that business is going to be up maybe $4 million or $5 million. And I remember the big order that you won a few years ago, a big chunk of that was supposed to ship largely in fiscal '21, '22. Not sure where we are in terms of that because I know there are some timing issues and pushing out of certain things. Just curious of what the outlook is for fiscal '21 compared to this year relative to how the customer is doing in production.

Jim Lines: We had commented in our prepared remarks that our naval strategy, really predicated off of our backlog, would imply that we'll have a revenue level between $20 million, $30 million, which should be up from where it had been. We'll be, we think, if this short-cycle order gets completed in this quarter, we'll be above $20 million for the naval strategy. It would be above $20 million that we would have projected in '21, '22, '23 and onward. So we're at the full stride of backlog conversion, those big orders that we had won or the one that you had mentioned. We're well into production now. The only proviso that I would offer is that the first components are first-time fabrications that have a lot of customer engagement and potential for execution not to flow as modeled, not that we did anything wrong, it's just the way those first fabrications go. But we're in production. Those big orders are in revenue cycle now, and we're underway.

Joe Mondillo: Okay. And then just on the order trends, it seems like the $20 million, obviously there's timing issues with your business. I understand that. I'm sure you're hoping for higher than

$20 million on an average quarterly run rate basis. Is that fair to say given the $75 million of potential wins and $50 million plus at the Navy?

Jim Lines: Yes. The $20 million isn't enough. $20 million is the period of time bookings pattern last quarter. The pipeline implies that's not to be expected every quarter going forward. It could happen again, but we have a great book of bids that's out there. Alan mentioned on the naval side or just on the global fabrication strategy side, maybe $50 million, and that's not counting the ordinary Graham energy market, which is very substantial.

Again, it comes down to timing. If there's one thing that we're finding different about this cycle is the ability for us to reliably predict timing of order placement has been impossible. We've been chasing orders that should have closed last year that haven't closed; we haven't lost them, they just haven't closed. And if you would have asked me three quarters ago would we have won this particular project, I would have said yes, and it's still sitting in the bid pipeline. We're sensing a hesitancy, a reticence by our customers to make the final investment decision. We don't know necessarily why. But it's very difficult for the sales forecasters to provide a credible forecast, what's going to book this quarter. We feel more confident over a 12-month period, less confident within a 1-month or 3-month period.

Operator: Unfortunately, we are out of time for questions. I'd like to hand it back to management for closing comments.

Jim Lines: Well, thank you, Joe, Theo and Tate, for your comments this morning. We appreciate the depth with which you probed Alan, Jeff and myself. We look forward to updating everyone on our year-end results as we wrap up the year, and that will be probably not until May, right?

Jeff Glajch: End of May.

Jim Lines: So again, we'll be advising if there's any large new order announcements worthy of press releases, and we look forward to updating everyone as we wrap up the year and have our year-end result conference call. Thanks for your time today. Goodbye.

Operator: Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.