Operator: Greetings, and welcome to the Graham Corporation Second Quarter Fiscal Year 2021 Financial Results Conference Call. [Operator Instructions]

As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Chris Gordon, Investor Relations for Graham Corporation. Thank you, sir. You may begin.

Chris Gordon: Thank you, Christine, and good morning, everyone. We appreciate you joining us today to discuss Graham's Fiscal 2021 Second Quarter Results. You should have a copy of the news release that was distributed across the wire this morning. We also have slides associated with the commentary that we are 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 today with me today are Jim Lines, our President Chief Executive Officer; Jeff Glajch, our Chief Financial Officer; and Alan Smith, Vice President and General Manager of our Batavia, New York facility. Jeff will start with the financial overview of the period, Alan will then provide an overview of our operations, Jim will wrap up the prepared remarks with a strategic overview of our business and provide our outlook for the rest of fiscal year 2021. 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 the risks and uncertainties as well as other factors which could cause actual results to differ materially from what stated in the call. These risks and uncertainties and other factors are provided in the earnings release and in the slide deck as well as 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 the results prepared in accordance with GAAP. We have provided reconciliations of our comparable GAAP to non-GAAP measures in the tables accompanying today's earnings release.

If you will turn to **Slide 4**, I will hand the call over to Jeff Glajch.

Jeff Glajch: Thank you, Chris. As Chris mentioned, we are starting on **Slide 4**. It was very nice to operate in Q2 a normal capacity after running at approximately 50% capacity in Q1 due to COVID-19. Q2 sales were $28 million, up from $21.6 million in Q2 of last year. Sales in the defense, the Navy market were $9.4 million in the quarter.

In the quarter, we had a quick turn material order, which made up approximately a little over half of the revenue in the Navy. We expected this to occur in the quarter. While it is not a repeatable type sale, it was not a surprise.

Year-to-date, defense sales were $12.9 million or 29% of sales. This is slightly higher than we expect for the full year. We would expect around 25% of our sales to be for the Navy for the full fiscal year.

The quarter also benefited from an acceleration of some work at one of our Asian subcontractors. They had available capacity and pulled some work from Q3 into Q2. Q2 net income was $2.7 million or $0.27 per share, up from $1.2 million or $0.12 per share last year. Stronger revenue and margins drove the improvement.

Cash is still good at nearly $68 million. Finally, orders in the quarter were $35 million, driven by strong international refining awards in Asia and defense in the United States. Our backlog improved to $114.9 million. The conversion of a portion of our backlog provides the foundation for our improved guidance for the fiscal year.

Moving on to **Slide 5**. I discussed the sale detail on the last slide with the quarter at $28 million. Sales in the second quarter was 62% domestic, 38% in international. Last year's second quarter was 73% domestic, 27% international.

Gross profit in the quarter increased to $7.7 million, up from $4.9 million last year, primarily due to volume. Gross margins were 27.5%, up from 22.9%. EBITDA margins were 14.2%, up from 7.8% in last year's second quarter. And finally, net income was $2.7 million, up from $1.2 million last year.

On to **Slide 6**. For the first half of fiscal 2021, sales were $44.7 million compared with $42.2 million in the first half of last year. This increase was despite the challenging Q1 when our production capacity was at 50% due to COVID-19. Year-to-date sales are 60% domestic, 40% international compared with 71% domestic and 29% international last year.

Gross profit was $9.3 million, slightly off the $9.7 million last year, and gross margins were down 20.7% versus 22.9% last year, again, impacted by COVID-19 in the first quarter.

Year-to-date EBITDA margins were 4.9% versus 4.5% in the first half of last year, and net income was $900,000 or $0.09 per share, down from $1.3 million or $0.13 per share last year. Again, the first quarter loss due to COVID-19 was substantial, but we have more than recovered that in the second quarter.

Finally, moving on to **Slide 7**. Cash is at $67.9 million, down from $73 million at the end of fiscal 2020, but this is simply timing of working capital namely accounts receivable and accounts payable. We are expecting this to come back in the third quarter.

Our quarterly dividend remains firm at $0.11 a share. Capital spending has been light in the first half of the year at $800,000 compared to $700,000 last year. As we have seen in the last few years, our capital spending will increase in the second half of the year, and we still expect the total spend for the year to be between $2 million and $2.5 million.

Finally, as we continue to work on our acquisition pipeline and activities, COVID has not had an adverse effect on our efforts as we have built some very good relationships over time, and these conversations continue. However, many of them are remote as opposed to in-person. But they are still occurring and still very active.

Alan will provide a presentation by providing more depth on our operations in Q2, and then Jim will provide a market update as well as our updated guidance for the rest of fiscal 2021. Alan?

Alan Smith: Thank you, Jeff. Good morning, everyone. I'd ask that you refer to **Slide 9**. Sales for the second quarter were $28 million. As Jeff had mentioned in his remarks, the company completed a large material-only order for a defense customer, which required very little conversion resources. Sales to defense industry were up $6.8 million year-on-year due to the prior mentioned materials order and greater defense conversion as we continue to grow our naval workforce.

Lastly, and importantly, due to the strength of our backlog, annual guidance has been increased from $90 million to $95 million to $93 million to $97 million.

Please move on to **Slide 10**. While COVID-19 has impacted demand for our product, there are several actions that are being implemented to ensure that we maximize the margin of the work that is expected to convert during this financial year.

During the first quarter conference call, I outlined several initiatives that the company was pursuing in order to maximize the realized margins. In particular, we are focused on reducing our material costs, hiring and quickly onboarding welders, differentiating our company from our competitors in the defense industry through superior execution and leveraging IT tools to increase the productivity of our team.

On the material procurement front, the team has had success in reducing our costs. Graham is a relatively small buyer of carbon steel and stainless steel plate. Therefore, we typically procure our plates from distributors. However, we are finding in this time of low demand, the mills are willing to sell directly to us, thus reducing our cost.

We are also focused on growing our workforce in order to increase the production volume. To this end, we have recently completed an expansion of our weld school. We now have the capacity to train up to 10 welders; up from the five we had originally planned.

The work for the Navy has higher welder content than does for other work. Welding is a critical skill set for the company, and we must expand our capacity. The welds on our campus is a terrific addition for workforce development.

Currently, we are prioritizing improving our productivity in the Navy production areas now that the company has completed many of the first-time operations. Productivity enhancements will stem from improved bill flows, employee training, creation of jigs and fixtures, and lastly, applying lessons learned.

Our IT department continues to develop tools, which will improve our ability to manage our global fabrication partners. We are developing a management dashboard is to track all aspects of our outsourced projects. The dashboard will aggregate information that is stored on several IT platforms and will improve the productivity of our project managers

With that, I'll turn the presentation over to Jim.

Jim Lines: Thank you, Alan, and good morning, everyone. I'll begin my remarks starting with **Slide 12**. Order level in the quarter was strong, especially given the state of crude oil refining and petrochemical markets.

The strong order level in the quarter is the result of effectively implementing our diversification strategy. We discussed over the past couple of years the actions we have taken to be successful in the more price-conscious segment of refining and chemical markets. During this time, both participation and market share were low, which afforded us an opportunity to address this segment differently. Our opportunity generation and bid management structure were modified and we also changed our execution strategy.

Replicating the success we have had in China, we established a subsidiary structure in India. It is necessary in markets like India, as an example, to localize selling, certain technical resources, and quality control personnel. We have the best chance to secure large project orders when they are supported and followed for a long time. A local presence allows that. This then enables us to pull a customer toward Graham, rather than Graham having to move towards its competition.

Also, fabricating certain components locally, in India, is important. As a result of executing this strategy, $10 million of new orders for India were secured in the quarter. These orders were for both customers and end users that had not bought from Graham before.

I am pleased with our success in India. We plan to pursue principally large project work there,.and as of today, the company has secured 2 of the 3 most recent large projects. I commend the team that initiated and drove the strategy and those now executing the orders.

Another highlight was securing additional work for the U.S. Navy. This strategy is about 10 years old, and a large order in the quarter confirms the shipyards and the U.S. Navy are finding value in our engineering and fabrication capabilities, program management strengths, willingness to listen to feedback and implement improvements, our quality program and also that we will invest in facilities, modern machine tools, personnel and employee development.

General conditions in our crude oil refining and petrochemical markets are weak, while the pipeline for the U.S. Navy is strong. This is illustrated by orders for our crude oil refining and petrochemicals being down compared with last year.

Let's move on to **Slide 13**. I want to briefly discuss market outlook and what we are seeing in our key markets. I plan to go clockwise, beginning in the upper left quadrant.

The sales team did well to secure a significant amount of work for Asia. The work in India mentioned a moment ago, plus approximately $10 million in additional fiscal year-to-date orders from Asia. The pipeline must rebuild now, and move from early-stage activity to procurement stage. We expect the next few quarters to be about building the pipeline.

We are seeing COVID having an impact in Asia as one large project in the bid pipeline that was teed up to be place the order, had to be postponed due to workforce impact from the disease. We believe the project will be reactivated, once the country has the spread of the disease back under control. Our team in India, our team in China and those overseeing Southeast Asia indicate that COVID-19 is on the rise again, resulting in slower activity, and heightened uncertainty.

In the Americas, it was quite slow for both revamp retrofit and also routine spare parts. Refiners are focused on preserving cash right now and are postponing MRO or capital projects. We do not see this picking up until demand recovers following the control of COVID-19l. We are carefully following those projects that continue to proceed.

On a positive note, an engineering-only order for a large crude oil refinery revamp was secured, that we are hopeful it will proceed within the next 12 months. For that case, the refiner could fund only upfront engineering at this stage so that detailed layout is done, enabling the project to proceed quickly once it is ultimately released for fabrication. If, and when, it proceeds into fabrication, we anticipate that a change order will exceed $5 million. Crude oil below $40 a barrel and pandemic-driven global disruption have resulted in activity being pulled in by most national integrated and independent oil refiners.

Moving over to U.S. Navy, in particular, and defense overall remains active. We have a solid pipeline of activity. Some of it is for new components that we have not done before, while others are repeat components for upcoming vessels. Submarine programs are vital for national defense and other strategic missions for our country. There is terrific visibility into multi-year new vessel requirements that underpin this segment continuing to be strong. We have identified, and are pursuing, $40 million to $60 million of opportunities for the Navy, and they should be placed with a selected vendor over the next 9 months.

We have M&A target identification and development concentrated in the defense segment due to its strong long-term fundamentals. As Jeff noted, relationships in certain cases were established prior to COVID-19, and we continue to nurture them with a combination of remote interactions along with selective visits.

Our short cycle work is off 20% to 30%. Crude oil refining and petrochemical markets are where the majority of spare parts revenue was derived. These markets, as I mentioned, are in cash preservation mode until the global economy is back on its feet and demand subsequently recovers. On an upbeat note, there is step-up in short-cycle inquiries. However, that has not translated into an improved order level just yet.

Chemicals and petrochemicals are also down. Projects have been shelved or delayed. The pandemic sent a demand shock that is not yet fully abated. Getting past COVID-19 in most regions throughout the world is the catalyst for demand returning.

Let's now move on to **Slide 14**. Backlog is a healthy $115 million, split evenly between commercial and defense. The staging of backlog, or work in process, already provides an ability to state guidance at this extraordinary time when many companies cannot. 60% to 65% of backlog is planned to convert during the next 4 quarters, with close to 40% of backlog planned to convert during the next 2 fiscal quarters.

Please go to **Slide 15**. As Jeff and Alan mentioned, we are updating our guidance. We have increased the revenue range to between $93 million and $97 million, implying the second half should be between $48 million and $52 million for revenue. Gross margin is expected to be between 21% and 23%. SG&A spend between $17 million and $17.5 million. And we are projecting the effective tax rate is approximately 22%.

With that, Christine, I would ask that you open the line for questions.

Operator: [Operator Instructions] Our first question comes from the line of Joe Mondillo with Sidoti.

Joe Mondillo: So I was wondering if you could let us know what the gross margins for the quarter would have looked like if you exclude that defense material order.

Jim Lines: It would have been comparable with to what was reported because that was a materials-only order. So it wasn't appreciably different.

Joe Mondillo: Comparable to?

Jim Lines: The quarter overall, as reported.

Joe Mondillo: Okay. So the 27.5%. Excluding that order, it would have been 27.5% or around there?

Jim Lines: It is not materially different from that. Correct.

Joe Mondillo: And then just as far as sort of what you can see in terms of work and sort of the bookings pipeline over the next, I guess, for maybe the rest of the fiscal year, it sounds like things are relatively slow. In the past, or in this past quarter, you saw some strength in the orders and some of that was Asia related, but you sort of mentioned that Asia is maybe you are expecting a rebuild of the pipeline.

And so does that indicate that, that Asia strength that you saw in the quarter will be lighter than what we saw in the second quarter? And it sounds like Americas is pretty weak. So just overall, it seems like from my vantage point that bookings may be comparable to the 4 quarter trailing average? Or could you just talk about sort of what you are seeing in the pipeline?

James R. Lines: At a qualitative level, I think your assessment, as you take the information that we have shared with you today into account, is generally correct. There is an overall slowness, notwithstanding the Asia region, in refining and petrochemicals. We did secure some large project work in the quarter, but those aren't always repeatable and then they can make our order patterns lumpy, or variable, when those orders are $5 million or $6 million and a quarterly order level might be $20 million to $25 million as an example e. So, those can have a material impact.

As we look at the quarter, or the upcoming quarters, from an order level, we see some softness indeed for large project work. We do not necessarily feel that it takes us back to how Q4 and Q1 were. Also on a more positive note, when we aggregate all of our end markets, we are anticipating a book-to-bill to be above 1.

Joseph Mondillo: And that would be for the year?

James R. Lines: Yes, for the year.

Joseph Mondillo: Okay. And then just related to gross margins and looking at that backlog, your gross margins have been sort of all over the place the last 3 or 4 quarters. Could you help us maybe understand what that gross margin profile looks like in the backlog? It looks like you are expecting some pretty decent gross margin actually in the back half of the year, just relative to your guidance. I guess maybe you can comment on that and then sort of beyond that, beyond fiscal '21.

James R. Lines: I am going to dissect it a little bit. The margin quality for the naval work as we project forward, we believe begins to average up. And there is reasons that we had cited previously for that. As Alan and his team have executed extraordinarily well on that strategy over the last decade, we have been able to move from what was principally 100% of the backlog at a point in time, 5 years or so ago was all competitively bid, to today, maybe 80% is competitively bid, 20% is under sole source contracting.

Projecting forward how we are seeing the evolution of our relationship with the shipyards, we think in a few more years, our backlog should be closer to 50% for the Navy under sole source versus competitively bidding. And that has a different margin potential than what is been running through backlog right now. So we would expect that backlog quality to continue to improve as we move through the next several quarters, the next several years. And then, of course, that translates into an improvement, we believe, in our overall financial performance as a result.

As we look at our Americas or Western hemisphere work, we have not really seen appreciable margin variation with what is going on in those end markets today. We have been able to win what was available at satisfactory margins, probably equal to or averaging up.

As we move into the previously underserved or under participated markets, you may have caught that we referred to the expression of price sensitive or price-conscious segment of the market. Work there can have, and frequently does, have a lower gross margin than most of our other work. However, the drop down to op profit is satisfactory. So, we are not necessarily fixated on where gross margin is going to go. We are fixated on where that profit goes.

Joe Mondillo: Okay. And it looks like the guidance is implying gross margins in the back half of the year of 23%, 24% roughly. What is driving that? Because you've seen other than the second quarter and, I guess you can't really count the first quarter, because you were operating at low operating rates but looking at the back half of last year, you are implying some good, very good improvement. What would be driving that in the back half?

Jeff Glajch: Joe, this is Jeff. We have been communicating for probably the last 3 or 4 quarters that the margin in our backlog was improving. Obviously, Q1 was impacted by the fact that we were at half capacity. But I think if we went back to the middle of last year and forward, we talked about how our backlog was improving, and we were seeing some improvement in the margins there. So that is really what is driving it.

Joe Mondillo: Okay. And then just last question, and I'll hop in queue. Relative to COVID-19, could you just address sort of what you are seeing in your Buffalo market and anything that you have to say regarding the ramp-up that we are seeing in cases in the country and just anything that you are anticipating potentially as we get into the winter months?

Jeff Glajch: Sure. I think in the local markets, we have seen a little bit of an uptick, but not a dramatic uptick. We have put in some very good processes here at Graham to minimize the risk to our employees. We are not allowing visitors on-site with very minimal exceptions.

We have got cleanliness procedures across the company that we have put in place during the time period that we primarily shut down in late March, early April, and those have been very effective for us. So we are pleased with the fact that we have not -- our employee base has not been impacted by COVID, but obviously, we continue to be very wary of what is going on in the community, what is going on outside of our community because some of the COVID issues can be local and some of them can travel their way in.

But we are not seeing a huge uptick locally though, as I think there are a lot of places with a bit of an uptick occurring. But we are going to stay vigilant. Our employees are doing a great job and our leadership team around COVID has stayed focused on making sure that we do not take our eye off the ball.

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

Theodore O'Neill: Congratulations on a great quarter.

Jeff Glajch: Thanks, Theo.

Jim Lines: Thank you, Theo.

Theodore O'Neill: Yes. So my first question is for Alan. Last quarter, Alan, you talked about expanding the welding school up to 8 welders. And now you are saying it is going up to 10. What is driving that? And how is it going?

Alan Smith: The driver behind that is as we completed the project, it appeared that we had more room than we thought. So we were able to locate 2 more weld booths. The project is going very well. We have completed the area where the teaching and training takes place. We are now finishing up a canteen and restrooms, which should be completed by the end of November. Then we will be ready to accept all 10 new students.

Theodore O'Neill: Great, and Jim, on **Slide 13**, I am not sure I understand this bullet point here. Under the U.S. Navy, certain bids are new components. What are those components that you are talking about there?

Jim Lines: Theo, that terminology means it is a new fabrication for us, one that we have not done before. We wanted to cite that because it confirms our ability to continue to grow within the 3 programs that we are involved in organically by winning new equipment, new components on the programs.

Operator: Our next question comes from the line of Joe Mondillo with Sidoti.

Joe Mondillo: Just a couple of follow-up questions. On that same slide, **Slide 13**, in the bottom-left quadrant, talking about the petrochemical market, you cited about the next wave of ethylene capacity in the Middle East and Asia. Could you give us a sense of sort of more what is going on there and the kind of timing of where some of these projects are that you are seeing are at right now? And maybe when they would maybe start to convert into orders for you guys? Is this a multiyear type of thing or next year?

Jim Lines: I would say it is more of a multiyear type of thing, Joe. And the perspective today is different than I would have had 6 to 9 months ago, pre-COVID-19.

The Middle East projects, we would contend, need stability in the global markets and also likely some improvement in the price of oil. These are typically integrated refining projects where they are coupling crude oil and refining with petrochemical production. We think that is a couple of years out. However, there is a clear mission by several countries, Saudi Arabia in particular, about diversifying into petrochemicals and doing that via integrated refineries.

In Asia, China in particular, they will probably be ahead of other regions with the investment in new petrochemical capacity. They are building integrated refineries that couple petrochemical production with crude oil refining. These are massive opportunities for us. We are going through the execution of one of those orders right now for China, wherein as before, we would have thought incremental new capacity in China might be a $3 million to $5 million opportunity for us.

We are working through backlog of $13 million for an integrated refinery. It is work that we had previously secured and is going through the execution phase right now. We anticipate China, in particular, and other regions around the world will be moving towards crude oil-to-chemicals model as they transition from most of a barrel of oil converted to fuels to more of a barrel converting to petrochemicals.

Joe Mondillo: Okay, and as far as your short-cycle business, is that mainly North America, given your installed base is so big? Or is that beyond that?

And based on your answer, I am just wondering, you mentioned inquiries are up. I was just wondering where specifically and what markets or geographies that those inquiries are up.

Jim Lines: We tend to think of our short-cycle work as 80-20. 80% domestic, some of it is international, but the vast majority is domestic.

Joe Mondillo: And so those inquiries are then mainly domestic then?

Jim Lines: That is correct. Yes.

Joe Mondillo: Okay. And then lastly, wondering if you could just sort of give us a typical quarterly update on your balance sheet and M&A and any updates there.

Jeff Glajch: Sure. Joe, this is Jeff again. On the balance sheet, I mentioned our cash is around $68 million, which is fairly consistent to where it was the last quarter. I would expect in this quarter, we should see that improving. We have got quite a bit in receivables right now that should be coming in within the next couple of months. So I would expect our cash position will step up during this quarter.

And the rest of the balance sheet, nothing out of the ordinary. Everything else is in a good place. With regard to M&A, as both Jim and I mentioned, we continue to remain active. We are primarily focused on the defense sector and the Navy sector.

Our process is such that we reach out and start to build relationships over time. Many of those relationships have been in place for a while, so they predate COVID-10. We have been able to continue those primarily remotely, though we have had a couple of in-person visits over the last quarter.

We intend to continue those interactions, and the pipeline on the acquisition side continues to be strong. Even with some of the challenges we are facing, we are able to do this through the virtual environment because we have those relationships. There has not had a slowdown at all. Therefore, we are pretty pleased about where the pipeline is at right now, and hopefully we can continue to move things forward.

Operator: We have no further questions at this time. Mr. Lines, I would now like to turn the floor back over to you for closing comments.

Jim Lines: Thank you, Christine, and thank you Joe and Theo, for your questions this morning. We appreciate everyone listening in to our conference call, and we look forward to updating everyone again in January. Have a great day. Stay safe. Bye.

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