CIRCOR International, Inc.

First-Quarter 2016 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to CIRCOR International's first-quarter 2016 financial results conference call. Today's call will be recorded. At this time, all participants have been placed in a listen-only mode. There will be an opportunity for questions and comments after the prepared remarks. (Operator Instructions). I'll now turn the call over to Ms. Jamie Bernard from Sharon Merrill for opening remarks and introductions. Please go ahead.

Jamie Bernard: *Sharon Merrill*

Thank you and good morning everyone. On the call today is Scott Buckhout, CIRCOR's President and CEO, and Rajeev Bhalla, the Company's Chief Financial Officer. The slides we'll be referring to today are available on CIRCOR's website at www.CIRCOR.com, on the "Webcast and Presentations" section of the "Investors" link.

Please turn to Slide 2.

Today's discussion contains forward-looking statements that identify future expectations. These expectations are subject to known and unknown risks, uncertainties and other factors.

For a full discussion of these factors, the Company advises you to review CIRCOR's Form 10-K, 10-Q and other SEC filings. The Company's filings are available on its website at

CIRCOR.com. Actual results could differ materially from those anticipated or implied by today's remarks. Any forward-looking statements only represent the Company's views as of today, April 29, 2016. While CIRCOR may choose to update these forward-looking statements at a later date, the Company specifically disclaims any duty to do so.

On today's call, management will often refer to adjusted operating income, adjusted operating margins, adjusted net income, adjusted EPS and free cash flow. These non-GAAP metrics exclude any special charges and recoveries.
The reconciliation of CIRCOR's non-GAAP metrics to the comparable GAAP measures are available in the financial tables of the earnings press release on CIRCOR's website.

I will now turn the call over to Mr. Buckhout. Please turn to **Slide 3**.

Scott Buckhout:

Thank you Jamie and good morning everyone.

CIRCOR delivered solid first-quarter financial results with revenue of $151 million and adjusted earnings per share of 52 cents.

Despite significant headwinds in our Energy markets, we maintained strong margin performance and delivered year-over-year sales growth in our engineered valve and control valve businesses. As expected, we continued to see a decline in our North American, short-cycle distributed valves business due to ongoing market deterioration. Aerospace & Defense improved its bottom line results, expanding margins 130 basis points over last year. Aerospace & Defense sales were flat year-over-year as higher sales from our fluid controls business were offset by lower sales from our defense programs.

Our simplification and operational excellence initiatives remain on track. Last year we announced plans to close our manufacturing operation in Brazil, as well as our California machining facility. We stopped production in Brazil in March, which removes a high cost, negative margin business from the CIRCOR footprint. Our California facility closure is progressing well, and we expect to complete the project in July, slightly ahead of our original schedule. Combined these actions will deliver annualized savings of approximately $7 million.

In response to market conditions in our North American upstream oil and gas business, and the excess manufacturing capacity it has created in China and Oklahoma City, we suspended our manufacturing operations in China, and reduced the workforce accordingly. While our Oklahoma City facility has been downsized as well, it can comfortably support our anticipated distributed valve demand. We intend to continue to source from our established Chinese supply base. This action should deliver annualized savings of approximately $2 million.

Working capital and cash flow continue to be a priority for us. We reduced working capital in the quarter, which contributed to free cash flow of $4 million, up $22 million over last year.

After Rajeev discusses our Q1 financial results, I will provide more context to our expectations with a review of our end markets.

Now, I'll turn the call over to Rajeev.

Rajeev Bhalla:

Thanks Scott.

Let's start with Energy on **Slide 4.**

Energy sales of $113 million decreased 12% from the prior year. As Scott mentioned earlier, we delivered strong year-over-year sales growth in our Engineered Valves and Control Valves businesses, but that was more than offset by the year-over-year decline in our North American, short-cycle

Distributed Valves business, as well as a modest decline in the upstream portion of our Instrumentation and Sampling business. Distributed Valves sales decreased more than 50% from the prior year, however, sequentially the decline was less than 10%. Declines in rig count and well completions continue to adversely impact our sales. As you may know, rig count was down 40% in the first quarter from year end.

Energy's adjusted operating margin decreased 120 basis points to 12.6%, primarily as a result of lower volumes, and pricing pressure in our distributed valves business. Productivity actions, restructuring, and sourcing savings have helped mitigate the bottom line impact.

For Aerospace & Defense, please turn to **Slide 5**.

Aerospace & Defense sales of $38 million were flat year-over-year as higher sales in our fluid controls and actuation businesses were offset by lower sales from our defense programs.

Aerospace & Defense adjusted operating margin of 9.3% increased 130 basis points year-over-year due in large part to savings from prior period restructuring, recent pricing actions, and ongoing operational improvements. Sequentially, Aerospace & Defense margins declined slightly due to lower volumes, as well as the mix of our product sold in the quarter. We expect full-year adjusted operating margin to be approximately 11%, up about 200 basis points from 2015.

Turn to **Slide 6** for selected P/L items.

We recorded special and restructuring charges of $5.8 million in total. These charges relate primarily to restructuring and facility exit costs of $4.2 million and the non-cash, acquisition-related amortization expense of $1.9 million.

Our adjusted tax rate for the first quarter was 23%, lower than we expected given the distribution of sales and income between the US and international sites. We expect our second-quarter tax rate to be back in the range of 28% to 29%.

As Scott mentioned, adjusted earnings per diluted share were 52 cents, above the outlook we provided earlier this year.

Turning to our cash flow and debt position on **Slide 7**. During the first quarter, we generated approximately $4 million in free cash flow. I should note that the improved working capital performance in the quarter contributed over $10 million of cash, however, this was offset by the outflow for certain items such as the cash cost of restructuring as well as expenditures that typically fall into the first quarter, such as customer rebates, annual incentive compensation, and insurance premiums.

This brings us to our guidance. Please turn to **Slide 8**.

Overall, we expect the sales trend to be consistent with our experience in the first quarter, with the exception of Aerospace and Defense, as well as distributed valves, which will be slightly lower. We do expect continued pricing pressure in most of our Energy businesses. As a result, we expect revenue in the range of $135 million to $145 million and Adjusted EPS in the range of 38 to 48 cents per share.

For Q2, we anticipate special charges to be in the range of $4.0 million to $4.5 million, or 19 to 22 cents per share.

With that, let me turn it back over to Scott.

Scott Buckhout:

Thank you, Rajeev.

Let's start with an overview of current market trends for Energy and Aerospace & Defense.

First, Energy. Energy segment orders were lower overall in the first quarter versus prior year, primarily due to continued weakness in our upstream, North American, short-cycle business. The large projects business order flow was good but lower than prior year. Keep in mind this business is inherently lumpy, and we recorded a number of large orders in the first quarter last year.

In our short-cycle distributed valves business, we saw a small sequential decline in our order run rate from Q4, 2015 through Q1. Going into Q2, we expect a moderate decline in order intake again, due to lower rig count, and ongoing destocking at our large distributors. We believe that we are at, or very close to the bottom of this market. We are seeing very few upstream project opportunities, and volume is largely coming from replacement valves and MRO. The one bright spot in the market is strong activity in the midstream segment. While we have not historically been a strong player in this part of the market, we are seeing increasing quoting activity for pipelines, and some success winning orders against competitors with operational challenges in the market.

We continue to see strong market headwinds in our long-cycle engineered valves business. Oil majors are reducing capex, resulting in project delays, and aggressive competition with increased pricing pressure. We see very little activity in Europe, Asia, and North America. The only region with strong activity is the Middle East. Recent order intake has been good, and we have a strong pipeline of outstanding quotes and opportunities for projects in the region. You might remember from last quarter's call, the second half of the year was dependent on order intake in Q1 and Q2. The orders we booked in the first quarter, combined with our current backlog and order pipeline, give us confidence in the back half of this year. As a result, we expect the full year to be flat to prior year with slight moderation in back half revenue relative to the first half of the year.

In our Instrumentation and Sampling business, we saw a dip in the order run-rate around the middle of last year, and that rate has held fairly steady through the first quarter of this year. The <u>project</u> business is generally down, however, the book and bill business, especially for replacement product, is holding up well. We expect this business to continue at its current order rate.

In our Control Valves business, the Power market continues to show good growth, especially in Asia and North America, where we see higher quoting activity. You may recall that with the Schroedahl acquisition, a key growth opportunity was to leverage our North American sales channel for Schroedahl product. We are seeing early signs of success with a very strong pipeline of quoted projects. On the other hand, the Industrial control valve markets are essentially flat, with pockets of growth.

Let me comment on pricing in our Energy businesses. We are experiencing price pressure in all markets, especially in engineered and distributed valves. We continue to exercise strict pricing discipline in our bidding process. We’ve seen the competition price projects 10 to 15 percentage points below our best price. For the business we do win, we are able to partially offset the pricing pressure with productivity, cost reduction actions, and the benefit from lower commodity costs.

Aerospace & Defense bookings were down in the quarter, primarily due to the timing of certain defense programs. The commercial market remains strong with high levels of OEM backlogs, although the general aviation market is showing some weakness. While orders in the Aerospace & Defense business can be lumpy, we do expect an increase in bookings this quarter, especially for our major defense platforms. This increase in orders will lead to revenue growth in the back half of this year.

Let me sum up by leaving you with three thoughts.

First, looking at our markets, we believe that we are at, or near, the bottom for both distributed valves and instrumentation and sampling, where we see relatively stable order run rates. We expect revenue growth as we proceed through the year in Control Valves and Aerospace and Defense. With the benefit of bookings from the Middle East, we expect our Engineered Valves business to be essentially flat with the prior year.

Second, we are taking advantage of volumes being down to drive simplification at a much faster pace than we initially anticipated. We are controlling what we can control, and aggressively driving our margin expansion initiatives across the company.

And finally, despite the difficult market environment, we continue to carefully invest for long-term growth, with a focus on new products and geographic expansion. We have an active acquisition pipeline, and we're currently looking at opportunities in both the Energy and the Aerospace & Defense markets.

So in summary, we are focused on what we control. We're investing in growth, exercising discipline with capital deployment, and driving for better margins and free cash flow.

With that, Rajeev and I are available to take your questions.

After Q&A

OPERATOR: This concludes today's call. Thank you for your joining us this morning.