CIRCOR International, Inc.

Second-Quarter 2015 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to CIRCOR International's second-quarter 2015 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 Mr. David Calusdian from Sharon Merrill for opening remarks and introductions. Please go ahead.

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 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, July 28, 2015. 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 pre-tax 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 David and good morning everyone.

For the second quarter, we delivered revenue above our guidance range at $167 million with adjusted EPS at 55 cents per share. We delivered solid organic growth in our large projects and control valve businesses that partially offset a significant decline in our North American, short-cycle distributed valves business. As expected, Aerospace & Defense was slightly lower than last year due to the exit of our structural landing gear product lines.

From an orders perspective, in our Energy segment we reported solid bookings in the long-cycle international projects business, and we expect this positive trend to continue. This strength was more than offset by the expected decline in our upstream, North American, short-cycle bookings. Aerospace & Defense orders were lower than expected due to the deferral of certain military programs, most notably the Joint Strike Fighter.

The integration of our Schroedahl acquisition is proceeding well, and we're excited about the growth prospects of this business. As a reminder, Schroedahl accelerates our penetration into the high-growth power generation market and significantly improves our presence in Asia. We're in the process of cross training our global sales force, for both Schroedahl and CIRCOR products, in order to leverage our complementary channels to market. We're making good progress with this effort and our salespeople are getting up to speed quickly. Operationally, we're focused on reducing material cost by integrating Schroedahl into our strategic sourcing organization to leverage our common material spend.

We expect our return on invested capital will exceed our cost of capital in the first year. We continue to expect Schroedahl to be accretive on an adjusted EPS basis in year one.

Our simplification and operational excellence priorities remain on track. Today we are announcing another step in our ongoing simplification initiative: we are closing one of our two Corona, California manufacturing facilities. This is an important part of our ongoing effort to improve the efficiency and margins of the Aerospace & Defense business. We are outsourcing the commoditized machining operations performed in this facility in order to focus on higher value-added activities that are core to the business, such as product design, assembly and test. This action will expand our margins while maintaining revenues. This is a significant effort given the number of parts machined in this facility. As a result, we expect to completely exit this facility by the third quarter of 2016. The annualized savings from this project are expected to be approximately $3 million, beginning in the second half of 2016.

All of the other restructuring actions that we announced this year are complete. In total, we now expect to deliver savings of $10 million this year from these actions, higher than our original estimate of $8 million. Annualized savings are now expected to be $15 million. In our Energy businesses, we have reduced our headcount by 26% this year. While the restructuring actions taken so far were primarily in response to the market decline in oil and gas, we are taking advantage of this downturn to reduce our structural costs wherever possible. For example, as part of those efforts, we consolidated several back-office operations in North America and we are in the process of consolidating one of our testing facilities in Europe.

In addition, we are making progress on our operational excellence initiatives. We are seeing significant improvement in our key operating metrics including customer on-time delivery, supplier rationalization, and sourcing savings. For example, our customer on-time delivery has consistently improved from 73% in June of last year to 86% last month -- we are on track to achieve the best in class target of 95% by early next year. In the last 12 months we have reduced the number of suppliers by 25% to 3,800 today -- with a target of 1,200 by 2018. At the same time, we've increased the amount of direct material spend on long-term contracts from 8% to 30% today – with a target of 80% by 2018. Long-term contracts typically provide for better year-over-year productivity, delivery, and quality performance.

Finally, from a capital deployment perspective, I'd like to note that in the second quarter we continued to repurchase shares as part of the $75 million program we initiated in Q1. To date, we've purchased over 1.2 million shares for about $70 million. We expect to complete the full program this year.

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

Rajeev Bhalla:

Thanks Scott. Before I get into the Energy results, you will note that we have excluded last year's divestitures in our year-over-year comparisons for both segments.

Starting with Energy on **Slide 4**.

Energy sales of $127 million decreased 15% over the prior year and 12% organically. This was primarily due to lower sales in our upstream North American, short cycle, business and our upstream instrumentation and sampling businesses. This was offset in part by higher sales in our large international projects business.

Energy's adjusted operating margin decreased 190 basis points to 13.4% primarily as a result of lower volumes. Restructuring savings and cost reduction actions helped mitigate the bottom line impact, keeping the margins above 13%.

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

Aerospace & Defense sales of $39.7 million decreased by 9% over the prior year and 3% organically. As expected, the main driver was the impact of exiting the structural landing gear product lines as well as lower sales in our defense businesses.

Aerospace & Defense adjusted operating margin of 8.8% increased 220 basis points year-over-year driven by ongoing operational improvements and the benefit of exiting the structural landing gear product lines. As Scott mentioned, we announced the closure of one of our two California manufacturing facilities as part of our effort to improve the operations and focus on the core competencies of our Aerospace & Defense business. Our adjusted operating margins improved sequentially by 80 basis points and we are on track to exit the year with double-digit margins.

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

In the quarter, we recorded special charges totaling $7.4 million for restructuring actions, the completion of the exit of the structural landing gear product lines and acquisition-related costs. To better reflect the Company's performance, we are treating the amortization associated with the acquired intangible assets from the Schroedahl acquisition as a special charge. This was about $2.1 million in the quarter.

Our tax rate for the second quarter was higher than we expected. We had a number of discrete tax items that, in the aggregate, negatively impacted Q2 adjusted EPS by 5 cents per share. The primary item related to the previously disclosed tax audit in Italy, which we settled in the quarter. The adjusted tax rate for the quarter was 34.7% compared to our US GAAP tax rate of 36.5%. We expect our third quarter tax rate to be about 28%.

Adjusted earnings per diluted share were 55 cents compared with 88 cents in the prior year on a pro forma basis.

Turning to our cash flow and debt position on **Slide 7**. During the second quarter, we generated $4.5 million in free cash flow, below our expectations. An increase in working capital drove a significant portion of the cash outflow, especially on the inventory side. Two primary factors drove the increase in inventory.

- First, availability of product for smaller, book and bill demand has become the most important factor in taking share in our North American, short cycle business. We are not seeing a pick-up in large stocking orders from distributors. We are adapting to this new reality by strategically holding inventory of parts ready for rapid delivery; and,
- Second, due to strong orders from long-cycle projects in the first half, we increased work in

process inventory for projects that will ship later this year.

We remain focused on improving our working capital position and free cash flow performance.

Regarding our share repurchase program, we spent $53 million in the second quarter. This equates to about 953,000 shares.

That brings us to our third quarter guidance. Please turn to Slide 8.

We expect revenue to be in the range of $155 million to $165 million, reflecting lift from our large projects and control valve businesses and lower volumes from our upstream, short cycle business in North America.

And we expect higher sequential adjusted EPS in the range of 55 to 65 cents per share reflecting the benefit from cost reductions, restructuring actions, productivity, and the lack of the discrete tax items that we had last quarter.

For Q3, we anticipate special charges to be in the range of $2.9 million to $3.2 million, or 12 to 13 cents per share.

For comparison purposes, the divested businesses generated $14.1 million of revenue and 6 cents of EPS in the third quarter of 2014. In addition, our guidance reflects currency headwind of $11 million on revenues and 7 cents per share on adjusted EPS.

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

Scott Buckhout:

Thank you, Rajeev.

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

First, Energy.

As a reminder, about a third of our consolidated revenue last year was in the upstream oil and gas segment. This includes most of our distributed valve and international projects businesses, as well as part of our instrumentation and sampling business.

In our short-cycle distributed valves business, we expect lower volumes year over year due to the lack of activity in North America. While rig counts seem to have found the bottom, activity is down significantly versus last year. Distributor destocking is expected to continue and will have an impact on our bookings in the third quarter. We’re expecting orders and sales to be down approximately 50%, consistent with our discussion during last quarter’s earnings call.

We are not currently seeing significant pricing pressure in the distributed valves business. The market dynamic now is more about lower demand, smaller orders and product availability.

Within our long-cycle project business, we continue to see positive activity and we are achieving good win rates. We continue to see strength in the Middle East, especially for gas projects. Engineered projects in North America for mid-stream LNG and downstream Oil and Gas are running at similar levels to last year. In contrast to the short-cycle business, we are seeing pricing pressure in this market: our competition is more aggressive than we have seen historically.

In power, the combined cycle segment in North America is doing reasonably well, and we're seeing good activity in the emerging markets of SE Asia and China. We're also experiencing good quoting and order activity for our recently launched Aero-flow turbine bypass valve.

We expect Instrumentation and Sampling orders to be down year over year as a result of a difficult compare with Q3 2014, when we reported strong orders. This business is inherently lumpy, and we see fluctuations from time to time.

Sequentially, Q3 orders should be about flat, although we expect demand to improve towards the end of this year as we start receiving orders for the Johan Sverdrup project in the North Sea.

In Brazil, we are seeing substantially lower orders and sales as a result of the ongoing issues at Petrobras and the economy in general. We're not optimistic about the outlook in this market, and we're working to realign our business and cost structure to adapt to the new outlook in Brazil.

In Aerospace & Defense, as Rajeev mentioned earlier, orders for certain programs were deferred from Q2 until later this year and into 2016. We do expect a sequential increase in orders in Q3, largely driven by a number of defense programs globally.

Let me sum up by leaving you with three important points.

First, with the exception of our upstream North America business, our primary businesses are showing positive momentum going into the back half of the year. In the upstream market, our large project business is expected to continue to see good order activity and higher revenue as we deliver projects from orders won earlier in the year. In addition, we're seeing improved activity in mid and downstream businesses, especially in control valves and power generation.

Second, we're starting to see the effect of the restructuring that we completed so far this year, and these savings will improve our results in the second half of the year. In addition, we believe we're turning the corner operationally in Aerospace & Defense. All the work we've done recently to improve our operations is starting to show in the results. We still plan to exit the year with a double-digit operating margin in Aerospace & Defense.

Third, we continue to invest in growth through the cycle. We are increasing the size, capability, and scope of our commercial team and introducing more effective marketing and product management talent and processes. New product development continues to be a priority across the Company. We expect to exit the Energy downturn a much stronger company than when we entered.

In short, we remain focused on creating long-term shareholder value by investing in growth, expanding margins, generating strong free cash flow, and being disciplined with capital deployment.

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

After Q&A

Scott:

Thank you for your joining us this morning.