Ampco-Pittsburgh Corporation

Q3 2017 Results Conference Call

November 7, 2017, 10:30 AM Eastern

CORPORATE PARTICIPANTS

John Stanik - *Chief Executive Officer*

Michael McAuley - *Chief Financial Officer and Treasurer*

Melanie Sprowson - *Director of Investor Relations*

PRESENTATION

Operator
Good morning everyone and welcome to the Ampco-Pittsburgh Third Quarter 2017 Results Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" and then "1" on your telephone keypad. To withdraw your question, please press "*", then "2." Please note this event is being recorded.

I would now like to turn the conference over to Ms. Melanie Sprowson, Director of Investor Relations. Ma'am, please go ahead.

Melanie Sprowson
Thank you, Jaime, and good morning to everyone joining us on today's third quarter conference call. I'm joined by John Stanik, our Chief Executive Officer and Mike McAuley, Vice President, Chief Financial Officer and Treasurer. Before we begin, I would like to remind everyone that participants on this call may make statements or comments that are forward-looking and may include financial projections or other statements of the corporation's plans, objectives, expectations, or intentions. These matters involve certain risks and uncertainties, many of which are outside of the corporation's control.

The corporation's actual results may differ significantly from those projected or suggested in any forward-looking statement due to a variety of factors, including those discussed on the corporation's most recently filed form 10-K and subsequent filings with the Securities and Exchange Commission. We do not undertake any obligation to update or otherwise release publicly any revisions to our forward-looking statements.

A replay of this call will be posted on our website later today and remain available for two weeks following the conclusion of the call. To access the earnings release or the webcast, please consult the investors' section of our website at AmpcoPGH.com.

Now, let me turn this call over to Mike, who will provide an overview of the company's financial performance for the third quarter.

Michael McAuley
Thank you, Melanie. Good morning everyone and thank you for joining our call. I hope you've all had a chance to read our earnings release issued this morning. I'll take you first through the consolidated P&L for the quarter, and then I'll provide more detail at the segment level, and then review some balance sheet activity.

Ampco's net sales for the third quarter of 2017 were $103.9 million. This compares to net sales for the third quarter of 2016 of $82.9 million. Net sales in the Forged and Cast Engineered Products segment rose 30% compared to prior year, driven by higher sales of forged engineered products for the oil and gas industry and the inclusion of sales for ASW Steel, which was acquired in November 2016.

Net sales for the Air and Liquid Processing segment for the current third quarter of 2017 increased 11% from the prior year. I'll comment more on the business segment results in a moment.

Selling and administrative expenses were $14.2 million or 13.7% of net sales for the third quarter of 2017 compared to $15 million or 18.2% of net sales for the third quarter of 2016.

The prior year quarter included restructuring charges of approximately $1.3 million. The expected benefit from the prior-year restructuring actions was offset by higher R&D expenses, commissions, and higher sales volumes, and some corporate-related expense this year.

Depreciation and amortization expense for the third quarter of 2017 was approximately flat versus prior year. Loss from operations for third quarter of 2017 was $3.2 million. This compares to a loss from operations in the prior year of $4.9 million. I'll expand on that further for you in my segment-level discussion momentarily.

Other expense net for the third quarter of 2017 was $0.5 million, higher than prior year. But there were a few moving pieces there. Interest expense is up slightly on our revolver borrowings and this includes the effect of having effectively replaced the debt of ASW Steel we acquired using the Ampco revolver. But the larger factor in other income expense net year-on-year was a $0.4 million foreign-exchange loss in last year's quarter compared to a small foreign exchange gain this year.

Year-to-date, the story is a bit different. Other expense net is unfavorable by $2.4 million year-to-date versus prior year. Of this, interest expense is $1.2 million higher from the full year effects of debt connected with the Åkers acquisition, early termination of the ASW credit facility debt, and the interest and fees on the Ampco revolver. And even though the dollar weakened for Q3 versus prior year slightly, it is still stronger year-to-date versus prior year, so the majority of the rest of the change reflects foreign-exchange losses recorded year-to-date 2017 versus gains recorded year-to-date last year.

The income tax benefit for the current year periods include a benefit for the release of valuation allowances during the quarter for additional net operating losses able to be carried back to prior years. By comparison, the income tax provision for the three and nine months ended September 30, 2016, includes valuation allowances of $26.9 million and $28.3 million against the majority of the corporation's deferred income tax assets.

An income tax provision has been recognized in each of the periods for subsidiaries not in or not likely to be in a three-year cumulative loss position. Additionally, the income tax provision for the nine months ended September 30, 2017, has been offset by approximately a half million dollars of state income tax refunds, which we reported in Q2. As a result, the corporation incurred a net loss of $2.2 million, or $0.18 per share for the third quarter of 2017 compared to a net loss of $27.4 million or $2.23 per common share for the third quarter of 2016.

Now, here's some color on our operating segment results. Net sales for the Forged and Cast Engineered Products segment for the third quarter 2017 rose 30% compared to prior year. There were two key drivers here. Sales from the November 2016 acquisition of ASW Steel accounted for almost half of the increase. The segment also experienced a significantly higher volume of sales of frack blocks due to the uptick in the oil and gas industry. While the segment recorded modest operating losses for both the three and nine months ended September 30, 2017, operating results improved from the comparable prior year periods, which included unfavorable purchase accounting effects associated with the Åkers acquisition.

While benefiting from a higher volume of sales and the recovery of a portion of a pre-petition accounts receivable associated with a customer bankruptcy, year-to-date operating results are being impacted by lower absorption due to the idling of a cast roll foundry and higher operating and raw material costs. The segment experienced an unusual level of mechanical issues and related plant downtime and maintenance during Q3, which John will comment more about.

Net sales and operating income for the three and nine months ended September 30, 2017, improved against the prior comparable year periods due to a higher volume of sales in Air and Liquid Systems. Custom air handler sales increase for the quarter, primarily as a result of timing, and for the first nine months of 2017, as a result of higher order intake.

Although current-quarter sales of centrifugal pumps fell short of prior years, year-to-date sales exceeded prior year driven primarily by higher shipments to US Navy shipbuilders. A stronger Q3 volume of shipments to OEM and nuclear markets pushed year-to-date heat exchange sales, heat exchange coils, to slightly exceed prior year levels.

The backlog at September 30, 2017, approximated $332 million, a 48.2% increase from the $234 million in backlog at December 31, 2016. The increase is primarily from higher order intake in Forged and Cast Engineered Products, particularly in frack blocks and cast mill roles as well as higher order intake in each of the Air and Liquid Processing businesses.

Now reviewing some movements in working capital and other cash-related items, accounts receivable at September 30, 2017, increased $11.6 million from December 31, 2016, primarily from higher sales. Inventories at September 30, 2017, increased $18.7 million from December 31, 2016. The inventory growth is primarily due to increased production levels in the Forged and Cast Engineered Products segment on higher-order booking levels for frack block and roll demand. John will comment on some production bottlenecks and mechanical issues in the Forged and Cast Engineered Products segments, which impacted shipment timing, thus responsible for a portion of the inventory rise.

Accounts payable at September 30, 2017, increased approximately $10.8 million from the balance as of December 31, 2016, reflecting higher raw material and operating expenditures associated with the higher production activity. Cash and cash equivalents of $25.4 million at September 30, 2017, declined $13.2 million compared to the December 31, 2016, balance of $38.6 million.

Some selected significant uses of cash year-to-date included the inventory growth to support sales and production growth, which I just mentioned, and capital expenditures year-to-date of $9.7 million. Drawings on the Ampco revolver are $20.3 million at September 30, 2017, reflecting the refinancing of higher-interest debt assumed in the ASW Steel acquisition of approximately $8 million and the balance to fund working capital requirements I just described for the higher level of business activity. As of the end of Q3, the Corporation has remaining availability on its revolver of approximately $50 million.

I will now turn the call over to John Stanik. John?

John Stanik

Thank you, Mike. Good morning. The operating loss for the third quarter was a disappointment to all of us at Ampco-Pittsburgh. We had expected an improvement over second quarter results. Unfortunately, we encountered operations difficulties in our metals business segment. To summarize our performance in Q3, the business opportunity we had could've yielded much better results. Revenue opportunities beyond what we shipped had been secured by our sales force, but we fell considerably short of that potential for two reasons.

Internal gaps in our production processes and follow-up communication, and secondly mechanical failures in a portion of our metals manufacturing plants. The fact that we were also in the process of attempting to manage a major step-up in production volume compounded our problems.

Aggregating these complications, the ultimate result was potential operating income being tied up in work-in-progress inventory as manufacturing product was not completed and shipped. At the beginning of the fourth quarter, we find ourselves behind schedule. However, we have evaluated the root causes of these issues and have already instituted what we believe will be corrective actions. These actions will involve redirecting personnel resources, adjusting our manufacturing processes, and reorganizing communications within our scheduling and production forces.

As I inferred previously, and as Mike reported, revenue increased in both segments year-over-year, and by significant percentages. Beneath the segment level, I'm pleased to report that revenue was up in the rolls sub-segment and in our diversified forged engineered products business. Additionally, we saw an increase in the revenue for the Air and Liquids Processing segment.

I've discussed the obstacles. Let me enumerate those challenges. Mechanical and electromechanical problems at our plants were responsible for approximately $1.6 million of operating loss from lower-than-expected sales, lost fixed cost absorption from the downtime, and higher maintenance expenses. We estimate that the buildup of inventory we couldn't deliver as partially manufactured product was well in excess of $1 million.

The good news is that as our inventory buildup stabilizes and reduces as finished shipments catch up, income will be released. Continued raw material cost increases beyond current price surcharge levels had an unfavorable impact approximately $1 million in the quarter.

When we add the ongoing 2017 of approximately $3 million per quarter impact of the partially idled cast roll manufacturing facility in Pennsylvania, and compare all of these problems within our reported results, you can see that the opportunity that was lost in the third quarter was substantial.

The company has moved forward on other fronts during the third quarter. I've been tracking the progress for you of a new and exciting product that has been in development. The product is a new generation of roll that, through the application of its enhanced metallurgical properties, provides a significant improvement in performance, enabling hot strip metals to lower costs while also improving the productivity of the mill by extending roll campaigns.

The commercial release of the product is expected to be formally announced on or around December 15th. In extended-trial customer use, this design has displayed lengthened campaign service by roughly 100% over traditional cast roll designs. The product will be offered at much higher margins than are typical today, considering its value to our customers. And we are already seeing a great deal of interest from them.

During the last week of September, our Board of Directors approved the 2017 strategic plan update. The revised plan looks ahead three years, reviewing business potential through 2020. This year's update included, for the first time, what we believe our near-term potential is for the further diversification into the open-die forged product industry. The outcome, I'm pleased to report, is a very exciting outlook with attractive compound annual growth rates of revenue and profitability at rates higher than the top-line compound annual growth rate.

A negative market development occurred during the quarter, also. Due to the impact of Hurricane Harvey on a domestic electrode manufacturer, in addition to a very large and unexpected decrease in the manufacture of electrodes in China as a result of new environmental restrictions, there is suddenly a severe shortage in supply.

Any producer that has electric arc furnaces to melt scrap needs electrodes. These electrodes are consumable materials and they are made using a raw material named needle coke. Consequently, short-term to intermediate-term costs for these electrodes have already increased two- to threefold and sometimes more. Last week, Ampco-Pittsburgh issued a press release announcing that effective January 1, 2018, it will begin to assess a price surcharge on its manufactured products to recover the increased cost of electrodes. Many other consumers of electrodes, including some of our largest customers, are also implementing like surcharges, so we expect little opposition.

Before looking ahead to the fourth quarter, I should say a few words about the recent announcement of my retirement as CEO. I'll begin by saying that I came to Ampco-Pittsburgh for a very specific reason, and that was to provide an enhanced future for the company. During the three years that I've been here, I believe the company has seized many opportunities, which should provide that enhanced outlook. We've made acquisitions and integrated them. Numerous cost reductions, efficiency improvements, and strategies have been compiled and implemented.

Remember our first major acquisition occurred only 18 months ago, and the second, one year ago, and the depressed market in 2016 certainly didn't cooperate and help. Resolving issues like weak margins and equipment failures, such as those we've encountered in the third quarter, are not unusual under such time frames. This was a time of important transition for Ampco-Pittsburgh, and I am proud of what we achieved.

And now, I feel it's a good time for a change. I'm not saying to you that the work is completed. What I am saying is the strategies are in place. The action plans are in place and a bright future is possible. But as always, plans need to be executed, unforeseen negative developments overcome, and strategies modified to fit future eventualities. I care very much about Ampco-Pittsburgh Corporation, its shareholders, and its employees. Therefore, I have offered my services on a part-time basis in any way that the board would choose to use them. I look forward to the new leadership continuing to build a great future for the company with increasing shareholder value.

Now, let's look ahead to the fourth quarter. Based on my comments from earlier on this call, we have an opportunity to have a strong fourth quarter. Being successful in improving our operations processes could allow us to recover some profit that was missed in Q3 in addition to what is scheduled in Q4 already. The revenue opportunity is in-house. Our corrective actions are relatively new and untested, so I do not promise that we will entirely be successful. However, I will say that I personally involved in these changes and will continue to review their progress often. So far this year, the second quarter has been our highest revenue quarter. We could approach that number again in Q4. And catching up on our manufacturing delays could result in improved operating income. So I'm very much looking forward to what we achieved by year-end.

We'll now take your questions.

QUESTION AND ANSWER

Operator
Ladies and gentlemen, we will now begin the question-and-answer session. To ask a question, you may press "*" and then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys to ensure the best sound quality. To withdraw your question you may press "*" and "2." We do ask that you please limit yourself to one question and a single follow-up. Please note that you may reenter the question queue if you have additional questions. We will pause momentarily to assemble the roster.

Our first question today comes from Justin Bergner from Gabelli & Company. Please go ahead with your question.

Justin Bergner
Hi, good morning, John.

John Stanik
Good morning, Justin.

Justin Bergner
I had a couple questions about some of the comments you made. I guess just to understand the various impacts of the raw materials, the mechanical and electrical issues and the idling of the cast roll facility. It was $1.6 million impact in the third quarter from the mechanical and electrical costs, continued raw material increases were negative $1 million and there was a $3 million impact from the idle cast roll facility in the quarter or year to date? And was that sort of anticipated or unanticipated?

John Stanik
That was for the quarter, and it's been very close to that since we idled the plant in April, so it's running at somewhere between a $900,000 and $1 million per month hit, and that's the way it will be, most likely, for the remainder of this year. And then, once we reset the business in January, hopefully we'll see an improvement.

Justin Bergner
Okay, so in terms of the unanticipated hits, is that mainly the $1.6 million mechanical and electrical headwinds and then the raw material headwinds, of I guess an incremental $1 million beyond what you were expecting?

John Stanik
Yes, in the delays of another million.

Justin Bergner
Okay. The second subject of questioning was this sort of next gen roll product, with better metallurgical properties that allows you to sort of extend life by, I think you said as much as 100%. If I was, hypothetically, a steel mill and I would was buying that, I would need to buy half as many rolls over the course of a year. Is it your intention that you can price that to recover the full incremental usage benefit to the customer, or is it that you can recover a lot of that and gain market share with this product? What's sort of the economic thought process behind that?

John Stanik
Yes, I think that we see this in a number of different ways. The first way to see it is this technology can lengthen campaigns. And this technology applies to hot strip mills, okay? So it applies for a fraction of the market for cast rolls, in other words, and we see it as a major improvement for them.

It does not eliminate the need to resurface or refinish rolls. It also will not eliminate the need to purchase rolls, but it will have rolls last considerably longer. So with those benefits, we believe that we should and will be able to incur much higher margins. The other part of this story is: we're not making these claims without evidence. So when we release the product in December, we will have had several successful campaigns with customers who have taken these rolls and utilized them and proven these statistics.

So now to get onto the economics of your question. So, yes, there are a lot of cast rolls out there. We believe that this will give us a significant cost share improvement opportunity. Some will buy; some may not. But we're banking on introducing this, and in addition to this, other new products. I mentioned there's two others coming in 2018. And we're calling these rolls a different category of roll. So I guess the bottom line is we're expecting to increase share; we're expecting to increase margin. I don't want to talk about exactly what the percentage of increase in margin is, but we believe that it will enhance our performance overall, bottom line.

Justin Bergner
Okay, that's helpful. Then just on the electrode surcharge. You operate one mini-mill, is that right?

John Stanik
No. Well, we operate one in Pennsylvania for our roll business and one in Canada for our forged products, forged engineered products.

Justin Bergner
Okay, so you're just passing on a surcharge, you're not doing anything more to further recover or further benefit from the tightness in the electrode market, like the electrode manufacturers might be doing?

John Stanik
That's correct.

Justin Bergner
Okay, that's helpful. Thanks for taking my questions and hope to see you in a few more calls before you retire, John.

John Stanik
Yes, me too Justin. Thank you.

Operator
Once again, if you would like to ask a question, please press "*" and then "1."

Our next question comes from John Walthausen from Walthausen & Co. Please go ahead with your question.

John Walthausen
Yes, good morning. A couple of questions. You mentioned that you were seeing some potential in your forging business for movements beyond the steel industry and the frack blocks. Can you talk a little bit about where those might be and what the potential timing, if they're successful, might be?

John Stanik
Yes. To help with this, if you check our website, you'll see some of our recent presentations and there are slides showing pictures of the different types of products. There's charts showing the size of the market of some of the different verticals that the forged engineered products, open-die products, specifically, that we hope to enter. But to give you an answer now, I think there's a very broad number of potential industries.

We're looking into the nuclear industry, we're looking into aerospace. Obviously energy, including the oil industry with our biggest penetration thus far being frack blocks. But beyond that, there are other things in other transportation industries, such as shafts, other products in energy other than frack blocks, so there's just a large number. Rings is another one.

So there are both large and small products. There are limited competitors in these markets and with ASW's ability to manufacture alloyed metals, including stainless steel, we believe that it's very possible that we we'll grow into all of these markets. The strategy we're using now and the strategy that must be used to penetrate markets like this is to conduct trials of our material with potential customers and prove that our material is as acceptable, at least, as competitive materials before customers will commit to long times.

An advantage we have is that ASW has been in this market supplying intermediate materials for a long period of time to some of these exact same industry markets. So that means that the base material has already been proven in many of these situations. What will need to be tested is our machining capability, heat treating capability, and some of the other things that need to take place with the products before they are completed.

So our confidence is very high but it will take time to go through these trials and these proving tests before we have very large increases outside of the things that we're doing today. The frack block industry--have we mentioned what the total is in revenue this year so far?

Michael McAuley
We do not disclose product line detail, but it's significantly higher than last year.

John Stanik
Yes, well significantly even higher than the 2015 number, which was at something like $24 million before the market collapsed. So we're doing much better than that this year. So anyway, I hope to answer the question. That was little bit of a rambling response.

John Walthausen
No, that was a helpful response. I guess one of the things that I would take away from it, I think it's obvious when you start getting into things like nuclear, that is a pretty extensive process to prove yourself out. So should we assume that this will probably be more of a cost at least through 2018 than a bottom-line benefit?

John Stanik

No, I don't think so. I mean, we don't give these products to customers to trial them. We sell them, admittedly not at the margin that we expect to eventually get, but we don't expect large quantities of failures. In other words for warranty claims, although there certainly may be some. I think that taking it slowly and going through the trials, making sure that we're satisfied with what we expect the product to do, I do not expect large or any type of ongoing losses from this diversification.

I guess as evidence of that, we really haven't encountered any problems with the frack blocks since we've began to manufacture them, other than we can't handle the total number that we seem to be getting orders for.

John Walthausen
Yes, that's very encouraging, what's happening with the frack blocks. Is it just that they're using so much more sand, particularly in places like the Permian, or are you also gaining share in that market?

John Stanik
Well, I think the biggest issue this year is the fact that the market has come alive. And I think that in addition to that, other markets have also come alive. So while there are maybe three main competitors, the growth of the market has allowed the growth in business that we're receiving.

In addition to that, we're receiving the difference--there's a difference this year over 2015, and that is, it appears that stainless steel blocks are winning out over mild carbon alloy blocks, which used to be the majority that were purchased in '13, '14, and '15. And with that change, which I presume is because of superior economic performance by the metal stainless steel and being because we own ASW, which is an excellent source for stainless steel, I think that is supporting our success.

I don't know if, John, if we can say authoritatively that we've increased share, but we certainly have doubled our level, and maybe even double what we had in 2015 sometime in the near future in terms of revenue.

John Walthausen
That's very helpful, and it sounds like, as expected, ASW is proving so far to be helpful. Is it getting up to the point where it's actually a bottom-line contributor at this point?

Michael McAuley
Yes, it is, John. One of the things John discussed earlier on this call was the fact that were doing a lot of intercompany activity with ASW and there's a fair bit of transfers going on that we have to get the flow-through on the ultimate sale to the customer to recognize the income on the frack blocks in total. So, while we're disappointed with the quarter, we know that the demand is high for the frack blocks. And when we do finally get the production process lined out and straightened out and get the flow-through, we're going to see that income flowing through on the intercompany level of activity.

And then, of course ASW has its own trade sales activity, as well, which are net positive, but they tend to be lower-margin because its, as John indicated, more of an intermediate-level product of basic steel in cast billet and ingot form. But there is a certainly a high value on the stainless products. And they're not only selling stainless intercompany to us, they're selling stainless to other consumers as well. So we're happy with ASW. In the year that we've owned ASW, its opened the door to value creation for the company.

John Stanik
If I could just make one more comment, John, about that to add to Mike's good answer is that when you refer to the markets that ASW service directly, our strategy includes a shift from some of the products they have historically made to higher-value, more difficult to produce alloy products that they plan to sell in the coming years. So we're hopeful that ASW will be contributing even more profitability as a standalone enterprise for us as opposed to not only bringing us value from an intercompany standpoint.

John Walthausen
Good. If I understood correctly, when you acquired it a year ago, they were underperforming in terms of productivity at the mill, among other problems. Now, you're kind of challenging them. How are they doing on actual productivity and efficiency in the mill?

John Stanik
Well, they are making strides in reducing melt time and improving their productivity. I'm sorry, John, I don't remember the references that you're making about problems. They've always been pretty efficient. The problems that ASW was having when we purchased them was a lack of working capital and a lack of just cash to maintain their plant and to invest money into product.

As Mike pointed out in his prepared comments, we've taken care of that. We've obviously supplied them with working capital, but they're a very efficient operation. In fact, so much so that several of our competitors actually purchase their material from ASW.

John Walthausen
Okay, thank you very much.

John Stanik
You're welcome.

Operator
Once again, if you would like to ask a question, please press "*", and "1."

And ladies and gentlemen, at this time, I am showing no additional questions. I'd like to turn the call back over to management for any closing remarks.

CONCLUSION

John Stanik
Thank you. In roughly four weeks, we will finalize our 2018 business plan. As I've previously mentioned, we recently had our strategic plan update approved by the board. Naturally, this strategic update provides an indication of what to expect is possible for the upcoming years, including 2018. I expect to see topline growth again for the third consecutive year, but that's not our top goal. Major bottom-line improvement is.

Right now, it appears that our markets may be strong again in 2018. Already, our bookings for the first half of next year are higher than they were at this time last year. I expect 2018 to be a good year for Ampco-Pittsburgh Corporation. Thank you for your time and have a great remainder of your day.

Operator
Ladies and gentlemen, that does conclude today's conference call. We do thank you for attending. You may now disconnect your telephone lines.