CIRCOR International, Inc.

Third-Quarter 2015 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to CIRCOR International's third-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, 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, November 9, 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.

During the third quarter, we demonstrated good progress on our margin improvement strategy, as we continue to face macro-economic headwinds. We delivered revenue of $160 million, at the mid-point of our guidance range, and our adjusted earnings per share came in at 64 cents, at the high end of our guidance range.

We delivered strong year-over-year sales growth in our large projects business, especially in the Middle East, and higher sales of control valves including shipments to the US Navy. But that was more than offset by the continued and significant decline in our North American, short-cycle distributed valves business. In addition, the completion of large Instrumentation and Sampling projects in 2014 adversely impacted the comparison to this year.

Aerospace & Defense sales were down year over year primarily due to push outs of large military programs, most notably the F35, as well as the residual impact of exiting the structural landing gear product line last year.

Today, we announced that we will be closing our manufacturing operation in Brazil. While results have been inconsistent, the Brazilian manufacturing facility has realized significant losses since it was acquired in 2011. The Brazil operation's operating loss was approximately $5 million in 2014. We anticipate a similar loss in 2015. We began curtailing business operations in Brazil in the fourth quarter of last year, and the underlying market conditions that led to that curtailment have continued to deteriorate. This closure permanently removes a high cost, negative margin business from the CIRCOR footprint, and puts us another step closer to achieving our long term margin targets. We expect to complete the exit before the end of the first quarter next year.

As a result of this closure, we recorded $16.9 million of special and restructuring charges during the third quarter. Rajeev will provide more color on these charges later in the call.

Going forward, we intend to maintain our small sales office in Rio de Janeiro to continue our relationship with Petrobras and other Brazilian customers. Any orders from Brazil would be shipped from our Milan or Oklahoma City facilities, which are both qualified by Petrobras.

During the quarter, we made substantial progress in the integration of our Schroedahl acquisition, and we are now beginning to capture new business, especially in the North American power generation market. We continue to expect that in year one, our return on invested capital will exceed our cost of capital, and that Schroedahl will be EPS accretive.

Our simplification and operational excellence priorities remain on track. Last quarter we announced the closure of one of our two California manufacturing facilities as an important part of our effort to improve Aerospace & Defense margins. The plan is on track and we continue to expect to 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.

We are still on track to recognize savings of $10 million in 2015 from the restructuring actions we announced earlier this year, with annualized savings of $15 million.

On the operational excellence front, we are methodically improving our key operating metrics across CIRCOR. For example, our customer on-time delivery is now at 90% compared to 86% in the last quarter, and 73% last summer. In addition, our strategic sourcing team has delivered savings of 2%, net of inflation.

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

Rajeev Bhalla:

Thanks Scott. Before I get into the segment numbers for the third quarter, let me start by providing you with some additional detail on Brazil-related special and restructuring charges.

In total, we recorded $16.9 million in charges of which approximately $11 million are non-cash. These charges included the write-down of fixed and intangible assets, an estimate for potential claims, and the revaluation of inventory to its saleable value. We expect to record an additional $2 million of closure-related expenses, primarily severance and shut down costs, between now and the end of the first quarter 2016, when we expect to have exited the facility.

In addressing the deteriorating economic environment in Brazil, we performed additional audit procedures in the third quarter, and concluded that the previously reported operating income for the second quarter this year was overstated by $2.5 million. This was primarily due to an overstatement of certain Brazilian taxes, such as the Value Added Tax, that we assumed would be recovered upon sale of our product. Accordingly, this morning we filed an amended Form 10-Q for the second quarter of 2015.

In performing our audit procedures, we also re-evaluated our internal controls for the Brazil business to better understand the root cause of the misstatement. We found that the local management team was not adhering to our established control policies and procedures and, as a result, determined that we have a material weakness with respect to the Brazil control environment. We are working to remediate this weakness until the facility is closed in the first quarter of next year.

We are pleased to put this behind us and to move forward without the negative effect on earnings from this business.

As a reminder, we have excluded last year's divestitures in our year-over-year comparisons for both segments.

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

Energy sales of $123 million decreased 16% over the prior year. We delivered strong year-over-year sales growth in our large projects and control valve businesses, especially into the power generation market. But that was more than offset by the continued and significant decline in our North American, short-cycle distributed valves business. We saw a 54% decline in short-cycle sales compared to the prior year as bookings were lower by over 60%.

Energy's adjusted operating margin decreased 210 basis points year-over-year to 15.4%, but was up sequentially as our restructuring and cost cutting initiatives helped to minimize the impact on margins from lower volumes. We continue to take strong actions to mitigate the margin erosion from lower distributed valve sales.

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

Aerospace & Defense sales of $36 million decreased by 10% organically, in part due to a difficult comparison to 2014, when we completed certain UK Navy program deliveries. As Scott mentioned, the decline was also due to push outs of certain large military programs, most notably the F35, and the residual impact of exiting our structural landing gear product lines.

Aerospace & Defense adjusted operating margin of 9.1% increased 510 basis points year-over-year, and 30 basis points sequentially, driven by ongoing operational improvements and the benefit of exiting the structural landing gear product lines. We remain 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 and restructuring charges of $19.7 million. Excluding Brazil, special and restructuring charges relate to continued reductions in workforce and acquisition-related amortization expense.

Our tax rate for the third quarter was significantly higher due to the charges taken for the closure of our manufacturing facility in Brazil. As you may know, we do not get a U.S. deduction for the losses from our Brazil business. Excluding all of the results from the Brazil business, the adjusted tax rate for the quarter was 28%. We expect our fourth quarter tax rate to be in the range of 28% to 29%.

Turning to our cash flow and debt position on **Slide 7**. During the third quarter, we generated $2.2 million in free cash flow, below our expectations as a result of an increase in working capital, especially inventory. Two important factors impacted inventory.

First, availability of product for smaller, book and ship demand has become the most important factor in taking share in our North American, short cycle business. We are adapting to this new reality by strategically holding inventory of parts ready for rapid delivery; and,

Second, due to strong orders for long-cycle projects in the first half, we increased work in process inventory for projects that will ship in the fourth quarter and next year.

Therefore, the combination of the current short-cycle market dynamic focused on availability, and the ramp up of engineered projects, led to lower cash flow in the quarter. With that said, we remain focused on improving our working capital position and driving better free cash flow going forward.

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

Given our backlog in the large project and control valve businesses, and considering the market dynamics in our short-cycle book and ship businesses, we expect revenue to be in the range of $155 million to $170 million.

We expect adjusted EPS in the range of 58 to 68 cents per share reflecting the benefit from cost reductions, restructuring actions, and productivity.

For Q4, we anticipate special charges to be in the range of $3.5 million to $4.0 million, or 18 to 20 cents per share.

In addition, our guidance reflects currency headwind of $9 million on sales and 6 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 project businesses, as well as part of our instrumentation and sampling business.

Energy segment orders were lower in the quarter primarily due to the continuing decline in our upstream, North American, short-cycle business as well as lower large project bookings.

In our short-cycle distributed valve business, distributors continue to carry a significant amount of product on their shelves, with a goal of substantially reducing that inventory. We expect that destocking will continue to have a negative effect on our fourth-quarter bookings, and that our order run rate will not improve over the third quarter. As a result, we anticipate North American short-cycle orders in Q4 will be down about 60% from a year ago. This market continues to value inventory availability and rapid delivery, so we are responding accordingly. In addition, we are starting to see pricing pressure in this market that we were not seeing in prior quarters. We anticipate this will increase over time with ongoing market weakness.

Within our long-cycle project and instrumentation and sampling businesses, we're seeing delays to major projects, as the oil majors continue to reduce capital expenditures. As you know, large project orders are lumpy and a number of orders that we had expected to book in the third quarter shifted out of the quarter. Despite this overarching trend, quoting activity for projects in the Middle East continues to be strong. The North American large gas pipeline projects are still progressing as companies execute their firm backlogs. In addition, the approved LNG projects are proceeding. However, in the downstream Oil & Gas sector, we are seeing lower capex spend with the oil majors. We continue to see pricing pressure in this market as we discussed in previous quarters.

In power, we’re seeing good quoting activity in both North America and the emerging markets of SE Asia and China. Control valve orders in Power were a bright spot in the quarter. We expect continued demand in Q4 in the power and process markets, with some moderation in industrial markets.

Aerospace & Defense orders were lower year over year as a result of a number of defense-related programs being pushed out. However, we did see higher orders for our fluid control products sold into the commercial sector.

In Aerospace & Defense, as our operations continue to improve, we are focusing more on growth. We are bidding on a number of large military and helicopter programs. We are seeing improved growth in our MRO business resulting from dramatically improved turnaround times. In addition, we are developing a number of exciting new products for both the commercial and defense markets.

Before concluding our prepared remarks, I want to take a moment to thank Jerry Brady for his more than 12 years of service on our Board of Directors. As you may have seen in a press release we issued this morning, Jerry will be retiring from the Board at the end of the year. While we will miss Jerry and wish him well in his retirement, we are excited to welcome Helmuth Ludwig to the Board at the beginning of next year. Helmuth brings a wealth of global experience and a keen understanding of IT in manufacturing environments. During his career at Siemens, he also has had significant success in integrating and simplifying complex global organizations. We look forward to having him on our board.

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

First, we continue to make excellent progress on our margin expansion initiatives across CIRCOR. In Aerospace &

Defense, adjusted operating margin was up 510 basis points from the prior year; and 30 basis points from the prior quarter, to 9.1%. This solid ongoing expansion reflects the success of our operational improvements and restructuring efforts. We remain on target to achieve our goal of double digit adjusted operating margins by the end of the year. In addition, our Corona, California restructuring project is on track, and we expect to reap the benefits of that effort in the second half of 2016. Our margin improvement initiatives in Energy are yielding positive results offsetting much of the margin erosion from the decline in our short cycle distributed valves business. Our adjusted operating margins in the Energy segment are up sequentially to 15.4% on lower revenue. We continue to align the size of our operations with market demand. We have reduced the workforce in Energy by approximately 25% from the beginning of this year. We will continue to take smaller, incremental actions in response to changes in the market as necessary.

Second, we are increasing our focus on cash flow as we implement a more robust sales, inventory, and operations planning process, to improve the flow of product through our factories.

Third, despite the downturn in the Energy markets, we continue to invest in long-term growth across CIRCOR. We are investing in new products, improving customer service, realigning our global sales team, and selectively increasing our engineering capacity and capability. On the M&A side, we are actively working a strong pipeline of opportunities.

Going forward, we continue to focus on creating long-term value for shareholders 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.