Company: **MTS SYSTEMS**

Conference Title: **MTS Fourth Quarter 2019 Earnings Call**

Moderator: **Laura Fox-Anderson**

Date: **November 26, 2019**

Operator: Ladies and gentlemen, good day and welcome to the MTS Fourth Quarter 2019 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Brian Ross, MTS Executive Vice President and Chief Financial Officer. Please go ahead, sir.

Brian Ross: Thank you, David. Good morning, and welcome to MTS Systems Fiscal 2019 Fourth Quarter investor teleconference. Joining me on the call today is Jeff Graves, our President and Chief Executive Officer.

I want to remind you that we will make forward-looking statements today as defined by the Private Securities Litigation Reform Act of 1995. Future results may differ materially from these statements, depending upon risks, some of which are beyond management's control. A list of such risks can be found in our latest SEC Form 10-K. We disclaim any obligation to revise the forward-looking statements made today based on future events.

This presentation will also include reference to non-GAAP financial measures. These measures are used by management to evaluate the operating performance of the company over time. They should not be considered in isolation or as a substitute for GAAP measures. A reconciliation of our non-GAAP measures to the nearest GAAP measure can be found in our earnings release.

I will now turn the call over to Jeff.

Jeffrey Graves: Thanks, Brian and good morning everyone. We appreciate you joining us on our call this morning. Let me start by saying that it was a year of many successes for MTS, as we delivered record revenue performance led by solid organic growth in both of our businesses, supplemented by two strategic acquisitions during the year, E2M within our Test & Simulation business, and Endevco within our Sensors business, both of which will provide exciting growth and profitability in the years ahead.

The success of our market positioning was reflected in a record year-end backlog, which will help sustain our momentum as we now move into our new fiscal year. More on that in a few moments. As you will have noticed, in addition to announcing our full year results for fiscal 2019 last evening, we were also very pleased to announce the signing of a definitive agreement to acquire the operating entities of the Danish Engineering Firm R&D, adding yet another strategic technology portfolio and expanded market access to MTS.

Our M&A activity does very well in finding high quality Test & Measurement companies that have an outstanding fit within our overall strategy to grow the company profitably, securing and expanding our technology reach, and to open new adjacent markets, having significant barriers to entry. This combination of factors provides for accelerated profitable growth while managing risk of execution, which has in each case proceeded flawlessly.

Core to our acquisition strategy is that each of the companies we acquire have a similar culture to that of MTS, namely that they have a strong engineering focus with a passion for innovation and total customer satisfaction, two of the cornerstone values for MTS over a half-century. Success with this approach is reflected in our history of retaining key leadership talent from the companies that we've acquired, dating back to 2016 with the acquisition of PCB. This approach helps us tremendously in maintaining the strong operating performance and growth momentum of these businesses once they're integrated into our company.

Overall, fiscal 2019 was marked by many achievements, including the highly successful offering of our $350 million senior unsecured notes in the fourth quarter, taking advantage of a very favorable interest rate environment to further optimize our capital structure.

As I reflect on the successes of this past fiscal year, I remain excited for the future as we advance our company into new technologies and markets, which we were excited to showcase this fall at our first ever MTS Analyst Day, which we hosted at our headquarters here in Minneapolis. Before I provide some color on our performance for fiscal 2019, let me give you some additional insight into our latest acquisition that we announced last evening.

In short, the operating entities of R&D employ exceptional engineers that are experts in the design, development and manufacturer of precision, high force testing machines that can simulate in a laboratory even the most extreme operating environments for rotating systems. Being a Danish firm, R&D found a natural market initially in the wind energy business for which Denmark has been a pioneer and a world leader for over a century.

For the manufacturers of wind turbines, R&D's Test Systems can simulate the extreme wind, land and sea forces that are encountered over the 20-year design life of a modern wind turbine in operation. Their systems are so accurate and powerful that they can compress these life tests into months or even weeks in the laboratory, allowing a dramatic reduction in the time it takes for the introduction of new turbine designs.

The result is that new and ever-larger more efficient wind turbines can be confidently introduced to the electric utilities worldwide, accelerating the adoption of these modern, clean, renewable sources of energy. Having had great success with wind turbine test systems, R&D then expanded their focus more recently to aerospace, where they've quickly become a recognized leader in the testing of aero engine systems. This puts them on the critical path to the introduction of new aircraft propulsion systems that are more fuel efficient, reliable and cost effective for airlines around the world.

With MTS' rich history in the testing of high performance materials and static structures in both wind energy and aerospace, the addition of R&D's technologies to the MTS portfolio will enhance the value that we can bring to these markets worldwide. R&D's operating entities bring with them a strong backlog of projects, stretching into 2021, and an exciting pipeline of new wind and aero opportunities that will help ensure exciting growth and profitability for years to come.

With the expected closure of this deal near the end of calendar 2019, which is the end of our first quarter of fiscal 2020, R&D will be integrated into our MTS Test & Simulation business, increasing our focus on the energy and aerospace markets that we describe more broadly as elements of our structures market, which is expected to be roughly now 25% of the business.

From a financial standpoint, the purchase price of R&D is structured as a combination of an initial upfront cash payment of approximately $55 million, which will primarily be funded through our existing revolving credit facility with the additional earn-out payments in total of $25 million being earned over the next 18 months. R&D currently delivers $50 million to $60 million in annualized revenue, as strong operating margins and generates excellent free cash flow.

With an assumed close near the end of the calendar year, we anticipate it to contribute over $40 million in incremental revenue in fiscal 2020, but be neutral to earnings this fiscal year excluding transaction costs, where we expect R&D will be immediately accretive to operating margins.

Moving on then to our fourth quarter and our fiscal 2019 financial performance, our full year performance provided top line growth of 15%, reflected broad secular strength in global research and new product development investments by our university and OEM customers around the world, as well as continued investment in industrial automation for enhanced productivity and reliability of manufacturing systems.

We finished the year with record top-line consolidated revenue of $893 million, in addition to setting records for each of the business segments. Our Test & Simulation business grew 11% in the fourth quarter and finished the year with $559 million in revenue, representing an outstanding growth rate of 20% for the full year. In the fourth quarter, our Sensors business also accelerated, delivering over 16% revenue growth in the quarter giving us full year revenue performance of $335 million or 7% annual growth for the sensor business unit.

Given the timing of the Endevco acquisition very late in the year, the growth in Sensors for fiscal 2019 was predominantly organic driven by the ramp up of our DoD business and continuing strength in the test and industrial sectors. Our sales performance overall for fiscal 2019 reflects the strength of our technology offerings, our broad geographic presence and the expansion of our market verticals in both our Sensors and Test & Simulation business. This top-line performance reflects the increasing success of our growth and diversification strategy, capitalizing on our market leading Sensors and Test & Simulation product technologies, combined with delivering premium service to our customers across the globe.

Consistent with the message I've been delivering all year, we continue to leverage the strong core technologies in both of our businesses and to prioritize the introduction of new products and services in adjacent markets to accelerate our growth and further diversify our market exposure. A confirmation of the success of this strategy was our ability to deliver record year-end backlog, positioning us well to continue our momentum into fiscal 2020. While being very pleased with our top line performance, we also continue to focus intensely on our profitability and are once again pleased with our progress in this area as reflected in our adjusted EBITDA performance.

Looking back on the acquisitions we completed this year, E2M Technologies finished the year with another strong quarter and continues to perform to our expectations as we initially described at the beginning of the year. In addition to opening new and exciting markets in flight simulation and entertainment, we continue to integrate the technology capabilities of E2M into other areas of MTS that we believe will build an even stronger collective brand in the marketplace.

The Endevco acquisition that we completed in August has performed to our expectations for the two months of our ownership and the integration of this business into the existing MTS Sensors business is going very well. I'd like to give a special recognition to the many MTS Sensor employees that have worked tirelessly over the last couple of months delivering flawless performance to both our integration plan as well as to our customer expectations. They've done an outstanding job and I have full confidence that we'll meet all the expected timelines, integrate the business successfully, and build on the future that we strategically initiated with this business well into the future. Customer reception to this combination has been extremely positive.

In short, we're continuing to execute on our strategy of making prudent investments inside and outside of the business to support sustained long-term growth, along with efficiency and productivity improvements. We believe that over time this consistent focus will prove successful in building on our legacy as a technology and customer focus Test & Measurement company, and one that is more resilient to changes in the external environment is better equipped to sustain a higher level of financial performance.

I will now briefly recap the orders, revenue, and backlog for you in the fourth quarter and for the full year. Looking first at orders, we generated orders of $117 million in our Test & Simulation business, a decline on a year-over-year basis of 17%. However, a 12.3% increase in orders from Q3 of fiscal '19. We continue to experience short-term volatility in certain market sectors, specifically related to the automotive headwinds that we've experienced for the last 12 months to 18 months. In addition, we've seen some softness in China due to macroeconomic effects and trade tensions.

Our Sensors business ended the year on a very strong note by adding $90 million in orders during the fourth quarter. We continue to see broad strength across most of our sensor end markets particularly in the Americas region, including both the industrial and test sectors for Sensors. From a geographic standpoint, we've seen higher volatility and periodic weakness in the European and Asian markets compared to the Americas, as we continue to navigate global uncertainty around China and the general weakness in the business conditions in Europe.

For the full fiscal year, we generated orders of $478 million in our Test & Simulation business with orders trailing in the second half of the year ending slightly below the annual orders in the prior year. Our Sensors business generated record orders of $345 million, a 2.5% increase over the prior year providing for a combined total company orders of $822 million, down only slightly from the prior-year level.

Having summarized our sales drivers, let me give you some color on our backlog position. From a consolidated perspective, we ended the year with a total company backlog of $420 million, up slightly from the end of fiscal 2018 and setting a new year end record for the company.

Looking at each business, Test & Simulation ended the year with a backlog of $343 million, while Test ended with $78 million of backlog. As a general comment, we believe our backlog is a significant leading indicator of future performance, our ability to deliver on our growth expectations, and expansion of profitability in fiscal 2020 and beyond. We believe that the fundamental markets we serve, which are supported by secular strength in new product investments and industrial automation around the world, continue to be positive and at the shorter-term macroeconomic volatility experienced in the fourth quarter will correct itself over the long term. This bodes well for both of our businesses.

Moving next to our top-line performance. Revenue from our Test & Simulation business was up 11% in the fourth quarter, and 20% for the full year, compared to the same prior year periods. This performance reflects outstanding production execution from our strong backlog position as we continue to take advantage of opportunities outside of the ground vehicles sector of our Test & Simulation business, particularly in our materials test sector and test services area.

In addition, E2M has expanded the revenue base in our Test & Simulation business and is performing well in both the flight simulation and entertainment markets. We remain very optimistic regarding the continued upside potential associated with the continued integration of our businesses in the months ahead. We continue to reduce our overall exposure to the ground vehicle development markets in our Test & Simulation business through expansion into adjacent market verticals. The award from the Department of Defense in the fourth quarter is a prime example of core technology that we leverage and deliver to our key customers with our market leading ground vehicles Test & Simulation solutions. Through this shift in business mix, we expect to experience more consistent growth, decreased volatility, and improved profit margins in the Test & Simulation business going forward.

Looking at our Sensor business, we continue to expect to grow Sensors revenues on average in the double-digit range annually, with some years being above and some below this mark. At the halfway mark of fiscal 2019, Sensors had delivered revenue growth of 2% for the first six months of the year, paced largely by the need to ramp up production for a record number of new product offerings as well as for our Department of Defense contract.

As we exited our second quarter, we expected growth rates to accelerate and indeed, we delivered 11% growth in the second half of the year, setting new records for sensor revenue on a quarterly and annual basis. Given the general market outlook and our strong backlog of sensors for the Department of Defense, we would expect continued strong double-digit growth through fiscal 2020 and beyond.

With the solid finish to the year, our full fiscal year 2019 revenue growth was just under 7%. This top-line performance allowed us to deliver our targeted Sensors adjusted EBITDA margin performance of 20% with gross margins coming in just under 50%.

With a strong outlook for Sensors demand in the industrial and test markets and the continuing opportunity represented by our Department of Defense sales, we remain extremely bullish about our Sensors business in the coming years. With its strong organic growth potential, margin and free cash performance, we expect our Sensors business to be an increasingly important contributor to our overall company performance in the future. Our addition of the Endevco product line late in August will further accelerate these positive trends maybe for an even more exciting future ahead.

So to summarize, I'd like bring it all together for you and provide a few comments on our outlook for fiscal 2020. For our Test & Simulation business, we're increasingly excited about our structures sector, which comprises infrastructure testing, in addition to the energy and aerospace markets I discussed earlier. With the strength we see in the markets ahead and the acquisitions we've completed in this portion of the business, we expect our structures sector to have an increasingly positive impact on both the top and bottom line of the Test & Simulation business.

However, it will remain potentially lumpy quarter-to-quarter due to the size of individual projects that can sometimes characterize this sector. Of course, we look for another strong year from E2M, with the drivers being strong growth and the demand for pilot training and the entertainment market along with exciting contributions from our acquisition of R&D, which will be integrated into the Test & Simulation business after the deal closes in December.

Test service orders surpassed $100 million again in fiscal 2019 for the second consecutive year. This translated into over $100 million in revenue for the first time in MTS history. We believe our test services business will continue this exciting growth trajectory moving forward, this achievement as a result of a multi-year initiative that we undertook a few years ago to accelerate the growth of our test service business. During this time, we invested the resources needed to create a more robust infrastructure, service and growing installed base of equipment, which now totals approximately $7 billion.

Through these investments, we've expanded our geographic footprint and technical capabilities to provide the high level of service that our customers around the world would expect from MTS and have done so while continuing to experience volatility in the ground vehicles sector, a trend we anticipate continuing in the near term as we move into 2020.

However, on an encouraging note, with respect to this market volatility for our ground vehicles test sector, we were pleased to finally see growth in our 12-month opportunity pipeline, which is an early indicator that at some point this trend we have been experiencing for several quarters will reverse itself. Well with that said, we still model no change to the ground vehicle test market forecast until firm orders are finally booked.

From a Sensors perspective, simply look to keep doing what we've been doing over the last year. This means launching more and market-leading new products, delivering these products with outstanding fulfillment processes, and working with our supply chain to ensure availability, reduce costs, and execute well on sales in each of our markets.

This business has performed extremely well and has the attention of many significant potential customers, which will grow our share in the market and help us further build on our positive momentum. Our contract with the US Department of Defense is a perfect example of this approach.

With our record Sensors backlog at year-end, the strength of our end markets and the execution of our Sensors team, we expect this business to continue growing a strong double-digit rates, producing gross margins of approximately 50% and expanding EBITDA margins, which were slightly above 20% in fiscal '19.

Now, I'd like to turn the call over to Brian to further discuss our financial results and our outlook. Brian?

Brian Ross: Thank you, Jeff. I will start with our fourth quarter results with focus primarily on year-over-year quarterly comparisons. And as Jeff has already provided an overview of our orders and revenue performance, I will begin by discussing gross margin. While we once again experienced another increase in our consolidated gross margin dollars in the quarter, our gross margin rate for the quarter declined by 380 basis points compared to the fourth quarter of fiscal 2018, primarily due to a 630 basis point decrease in Test & Simulation's gross margin percent.

The decrease in Test & Simulation included the unfavorable mix from the completion of projects with slightly lower margins, along with slightly higher project execution costs, which were at a historic low in the fourth quarter of fiscal 2018. This reduction in Test & Simulation gross margin rate related to a combination of factors that were unique to this quarter, and are not expected to continue.

Sensors gross margin rate declined slightly versus the same prior year quarter due to the Endevco inventory acquisition adjustments and unfavorable product mix. Operating expenses of $63.6 million increased by $2.9 million from the prior year quarter, primarily driven by $1.8 million of acquisition related expenses, stemming from the E2M and Endevco acquisitions. The incremental operating expenses from E2M were offset by cost containment programs and increased capitalization of investments in Test & Simulation research and development projects as we continue to invest in our technology to support current and future customer needs.

I would like to emphasize that while operating expense dollars have increased due to the growth of our company, operating expenses have decreased 230 basis points as a percentage of revenue, to 28.4% compared to 30.7% in the prior quarter. Net interest expense increased by $4.6 million compared to the prior year quarter, primarily due to the acceleration of non-cash debt issuance costs related to the prepayment on our Term Loan B facility during the quarter, and the incurrence of additional interest expense on an increased debt position resulting from the issuance of our senior unsecured notes in the fourth quarter of fiscal year 2019.

The effective tax rate of a negative 16.2% for the fourth quarter includes a discrete benefit from the successful completion of our prior-year tax audits, along with routine year-end discrete adjustment. Without the discrete benefit, our tax rate would have been 23.4% for the quarter. Fourth quarter adjusted EBITDA of $29.6 million decreased 9.4% versus the prior year quarter. Excluding the prior year $4.6 million one-time gain on the sale of one of our China manufacturing facilities, adjusted EBITDA would have increased by 5.4%

Recognizing that our business is subject to quarterly fluctuations, which we have discussed in the past, I would now like to discuss our full year results for fiscal year 2019, which provides for a great depiction of how successful the year was for us. With full-year orders and revenue performance discussed by Jeff, I will once again start by discussing our gross margin.

Our full year gross margin rate of 36.9% was lower than the prior year rate by 240 basis points primarily due to the E2M and Endevco inventory acquisition adjustments of $1.6 million, higher expenses associated with the initial manufacturing rollout of several new products by our Sensors business, and the change in revenue mix between our two businesses, as growth in our Test & Simulation business outpaced our Sensors business.

With lower gross margins, this mix shift towards Test & Simulation tempered the consolidated gross margin percentage. Production volumes and yields on our new Sensors products have improved to be more efficient normalized levels with the last quarter that are expected to be sustained going forward, which is expected to help alleviate the margin.

Consolidated operating expenses were 27.9% of revenue, a decrease of 300 basis points. With revenue growth of 14.7% versus the prior year, we successfully managed our cost structure to leverage the significant top line growth resulting in a much smaller operating expense increase of 2.7%. Overall, we continue to invest in our business through research and development efforts. Although we experienced a decrease in research and development expense for the year, the decline is attributable to shifting internal resources to work on larger, capitalizable Test & Simulation projects.

The shift demonstrates our commitment to continuously investing in our technology, which will significantly benefit us in the future as we are better positioned to further service the demands of our customers. Selling and marketing expenses increased over the prior year, primarily due to higher compensation and commission expenses associated with our revenue growth.

Finally, G&A increased primarily due to the addition of E2M and Endevco, along with the acquisition-related and restructuring expenses. Excluding these items, G&A would have declined by approximately 1.7%. Adjusted EBITDA of $132.6 million increased 15.4% in fiscal year 2019 compared to the prior year, primarily due to leverage on higher revenue.

As a percent of revenue, the rate for fiscal 2019 was 14.9% versus the prior year rate of 14.8%. Diversified revenue growth from both our organic and recently acquired businesses along with continued focus on cost containment and operating leverage improvements are anticipated to drive future adjusted EBITDA growth.

Interest expense of $31.6 million increased $5.7 million versus the prior year, primarily due to additional interest expense incurred from our revolving credit facility, which we drew upon during the first quarter of fiscal year 2019 to fund the acquisition of E2M. We paid down the revolving credit facility in conjunction with the issuance of our senior unsecured notes.

Additionally, as I previously mentioned, we incurred significant acceleration on our non-cash debt issuance costs from the prepayment on our Term Loan B and higher interest expense from an increased debt position related to the issuance of our senior unsecured notes in the fourth quarter of fiscal year 2019.

Our M&A activities have increased our debt balance that we will carry into our upcoming fiscal year. As a result, we expect interest expense to be approximately $8.7 million to $9.3 million per quarter in fiscal 2020. For fiscal 2019, our effective tax rate was 11.4%, which includes a discrete $3.5 million favorable benefit primarily from the successful resolution of a prior tax audit and changes effective from the Tax Act. In comparison, the effective tax rate for fiscal 2018, it was a negative rate of 38.7%, which included a $25 million discrete benefit from the Tax Act.

Excluding these discrete tax benefits in both fiscal years, the tax rate for fiscal years 2019 and 2018 would have been 18.7% and 17.9% respectively. The increase was primarily attributable to higher earnings before taxes in the current year. In fiscal 2020, we expect an effective tax rate in the range of 15% to 19% excluding the possible effect of any discrete items. We ended the year with $57.9 million in cash as we funded the Endevco acquisition using cash on hand.

During the fourth quarter, we had capital investments of $13.1 million to meet the growing demand in our Sensors business and to address the long-term needs of our facilities. We generated $73 million of operating cash in fiscal 2019 with $42.9 million of free cash flow or approximately 5% of consolidated revenue. We ended the quarter with total debt of $530 million, a $50 million increase from the year-end, from the end of the third quarter of 2019.

Our outlook for generating cash and managing debt is driven by expectations that each of the recent additions to the MTS portfolio, will generate strong incremental free cash flow to pay down the existing debt balance. We ended fiscal 2019 with a gross debt leverage ratio of 3.97 times and a net debt leverage ratio near 3.5 times.

With the anticipated closure of the R&D acquisition by December 31, 2019, we expect our leverage will increase to slightly above 4 times upon completion of the transaction. However, we have confidence that the financial profile of both our existing and combined businesses will decrease gross leverage to approximately 3.5 times by the end of fiscal 2020. That concludes my comments on fiscal year 2019. I will now provide some additional information regarding our outlook and guidance ranges for 2020.

The range for full year revenue is $955 million to $995 million and the range for GAAP diluted earnings per share is $2.05 to $2.35 for fiscal year 2020. In addition, we are providing an adjusted earnings per share range of $2.20 to $2.55 as we expect to incur acquisition-related expenses from both the Endevco and R&D acquisitions.

Finally, our range for adjusted EBITDA is $138 million to $158 million. These expectations include the incremental revenue from the acquisitions completed over the last 12 months, a strong backlog of $420 million as of the end of fiscal 2019, continued growth in our core sensors market, test services and test simulation materials sector growth, growth in our expanding business from Defense contract and approximately $40 million of revenue from the R&D acquisition that was - that is expected to close near the end of this calendar year.

The EPS guidance takes in to factor additional interest from the debt utilized for our M&A activity during the year and expected for the R&D acquisition. While we are gaining top-line growth, we continue to project neutral earnings from these strategic additions to MTS excluding the impact of acquisition and integration costs.

Gross margins in the Test & Simulation segment ended the fourth quarter on a historical low and we expect these margins to rebound more recent levels seen in the low 30% range. For those that have followed our business, the lower order rate in the Test & Simulation business for the last half of fiscal 2019 will result in slower start to revenue for the first half of fiscal 2020 as we expect the business to pick up in the second half of next year with improved order rates. In addition, the EPS guidance factors increased tax expense in fiscal 2020 when we compare to 2019.

As a closing remark on guidance, after strong top line growth in fiscal 2019 from our Sensors business, we expect to produce high double-digit revenue in fiscal 2020 inclusive of approximately $30 million from the Endevco acquisition all while maintaining approximately 20% adjusted EBITDA margins for the business.

We had many key accomplishments in fiscal 2019, highlighted by strong organic growth in both of our legacy businesses, strategic M&A activities related to E2M and Endevco, substantial new product introductions by our Sensors segment, the recent large contract awards by both business segments as a key supplier for the Department of Defense projects, effective utilization of a favoring interest rate environment to recapitalize our debt structure and deploy cash in a very strategic fashion, and finally hosting our first ever MTS Analyst Day in September.

We made significant progress, enhancing our product portfolio to reduce our reliance on any one market and therefore less than the volatility in our business. Just as important, MTS is increasingly serving markets that have a higher growth potential based on rising demand for services and solutions that required a specialized expertise and knowledge of various technologies that we have been the leaders in developing as well as those technologies that we have acquired. By focusing on these markets and technologies, MTS will continue to grow with our market leading innovation and technology solutions that provide competitive advantages that differentiate MTS and will be key to achieving our long-term goals and objectives.

I will now turn the call back over to Jeff.

Jeffrey Graves: As Brian mentioned, we expect fiscal 2020 to be another good year for us with a strong backlog, exciting growth prospects and expanding margins and free cash flow. We have confidence that we'll be able to accomplish the goals we set forth. Despite a complex business that employs some of the smartest, most insightful engineers in the industry, our story is a simple one to understand at a high level and it remains consistent.

First, we need to keep executing on Sensors. It's a great business with a strong leadership team and we believe will generate significant value for our customers, employees and shareholders alike. Second, we need to take advantage of the strength in our non-vehicle related Test & Simulation equipment and service opportunities to drive growth and margin expansion. This strategy has been consistent and showing positive results.

Third, we need to continue with the same disciplined integration methodology that we've employed in the past with our more recent acquisitions. We have the experience and focus needed to ensure success. Executing well in these three ways will help ensure that we achieve strong financial performance in the year ahead, deliver solid growth with expansion of our margins, and free cash performance.

With that, Brian and I are happy to take questions.

Operator: Thank you. Ladies and gentlemen, if you would like to ask a question, please signal by pressing star 1 on your telephone keypad now. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star 1 to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions.

Our first question will come from Deepa Raghava with Wells Fargo Securities.

Deepa Raghava: Hey. Good morning all. How are you?

Brian Ross: Good morning, Deepa.

Jeffrey Graves: Good morning, Deepa.

Deepa Raghava: First off, Jeff, could you talk about how the test order declines compare with some of the prior down cycles you've seen. It looks like the guide assumes stabilization or even increase by second half - increase in second half. Is that driven by some expectations for automotive growth, but I also thought you mentioned ground vehicle orders should stay flat?

Jeffrey Graves: Yes.

Deepa Raghava: Did I get it right? Yes. So can you please talk to what some of the - what drives that order growth pickup in the second half? Or is it just easy comps?

Jeffrey Graves: No, no. Sure, Deepa. No, I'd be happy to give you some more color on that. And most of everything you said was correct. So if you look back on '19, we had a very strong first half in orders, which flowed through, Q3 was tough. We had orders drop in Test & Simulation and we saw some rebound in Q4, which was encouraging. As we look ahead, our pipeline is very strong with the exception of ground vehicles and that remains, it's strengthening. But we want to temper any excitement there because it's been a long, really a long drought in that market.

So we want to be careful about that. So we're not forecasting growth in orders in the ground vehicle business per se. We are seeing strength in our other market sectors and that would include in the structures area. It includes infrastructure testing, aerospace and energy. All three of those look very good for us, and materials testing looks good.

We expect services to remain strong. So really everything with the exception of the ground vehicle business, we expect orders to be improving throughout the year. There was a tick up in Q4, and we expect continued growth into the future.

Now, remember that business has a lag in revenue. So what you're seeing is that orders drop in Q3 of '19, then flows through in revenue three to nine months later. So the first half of - from a revenue perspective, the first half of '20, we would expect to be softer. The second half to be stronger for the Test & Simulation business. And all of that references organic growth. Okay?

When you superimpose the R&D acquisition that will close at the end of December and obviously there is a step function change there. I would tell you from what we know of that business, backlog is very strong in the business and their outlook, their opportunity pipeline looks terrific. So that will add nothing but upside to the trends that I just explained to you.

Deepa Raghava: Got it. My second question is on Sensors. That's some good momentum there, especially with take rates from DoD business. Can you talk a bit more about what the opportunity there is? It looks like the growth probably was better than you had anticipated. Are you making any new inroads with them versus the original views? If you can update us on what the opportunity set is that would be helpful.

Jeffrey Graves: Yes, sure Deepa. No, it's a pleasure. I am tremendously excited about Sensors. They had a heck of a second half of the year with good solid double-digit growth. Again, growth was dampened in the first half, primarily not because of demand, but because we had a lot of brand new products going into production and we had some yield challenges on those. But we injected a little capital in the infrastructure, a very little amount but it was key.

And in the second half as we overcame that, we were able to fulfill demand and it was terrific, and we had double-digit revenue growth. That business does not work off much of a backlog. So, you know, it's a month to two backlog with the exception of the DoD contract.

So we were very pleased with the demand profile we saw, as we moved all the way through the second half. And we ended just on a terrific upbeat note in Q3 and Q4 with record revenue performance, which immediately flows through -- because of consistent gross margins -- flows right through to EBITDA performance in that business. It was terrific.

So we ended with over 20% EBITDA margins in Q4 and really nice revenue uptick. And Deepa, I would tell you I fully expect that trend to continue and accelerate in 2020. It's - I really believe both organically, we'll see double-digit growth and then we have incremental growth on top of that from the Endevco acquisition that we completed in August late last year, which will provide further upside. So we would be double-digit I expect just organically. And then you add that on top of it will be very strong double-digit growth throughout 2020 in Sensors.

And very simply, we're leveraging - as we said when we acquired PCB, we're leveraging our test customer base and selling sensors into that customer base on an increasing basis. And that was the overlap we talked about back in '16 when we bought PCB with our test market customers and that deep knowledge we have, we're able to increasingly take there really effective delivery operation and their sales team and help them get into test customers worldwide and it is just gangbusters.

So the test market is driving well, the industrial automation market is picking up. So we're selling more into that market. And then on top of that, we have the DoD business. So I fully expect sensors to have by far a record year in 2020. We've really exciting double digit top-line growth, gross margins around that 50% mark and then EBITDA margins of 20% plus in that business and we're finishing off a couple of building expansions but very modest capital absorption. So it's a good business for free cash flow generation as well. So we're very - I'd be very bullish about sensors.

Deepa Raghava: Got it. Brian, one for you. Free cash flow conversion in fiscal 2020, what are you expecting there? At the Investor Day, you mentioned it should improve. And if that's the case, you should - can you talk about some of the drivers there and where I'm coming at it is, you have this new acquisition R&D and that, I don't know if that could drive some of the, that could actually end up dragging some of the free cash flow conversion. If you can talk to that, that will be helpful.

Brian Ross: Yes. So we finished at least as a percent of revenue, our free cash flow is about 5%, which is slightly below our historical rate of about 6% to 8% and that free cash flow conversion was slightly below 50%. So with a growing adjusted EBITDA, the dollars will increase, but we expect it to be roughly about in that same range.

The acquisition wasn't necessarily baked in obviously when we had our analyst day. So that will temper it a little bit. But we really look toward free cash flow generation the latter half of next year and into '21 and '22 for sure, which will help facilitate the debt.

Deepa Raghava: Got it. Final one, just a housekeeping item. So you talked about $40 million R&D revenue as being incremental to fiscal '20, which means the annualized revenues are closer to $55 million, is that correct?

Jeffrey Graves: Correct.

Deepa Raghava: Got it. Thank you so much. And I'll pass it on.

Jeffrey Graves: Thanks, Deepa.

Operator: Thank you. To ask a question, press star 1 now. Our next question comes from John Franzreb with Sidoti & Company.

John Franzreb: Good morning, Jeff, and Brian.

Jeffrey Graves: Good morning, John.

Brian Ross: Good morning, John.

John Franzreb: I guess, I want to start with the R&D acquisition. It's kind of a sizable earn out relative to the purchase price. Is that because there is a contract looming or is there something else we should know about that business that has such a sizable earn out?

Jeffrey Graves: No. It's just one of those points you negotiate, John. Their profitability is sensitive to their volume obviously and they're at a really nice volume right now. We want to see that continue and grow. They've got a lot of opportunities ahead of them. We just wanted to incentivize the owners to continue to perform. So they're booked out very nicely through '20 and into '21 and we just want to see that backlog continue to grow. So we wanted to incentivize them, John.

John Franzreb: Okay, fair enough. And who are their main competitors?

Jeffrey Graves: It's an interesting question, John. We've kind of, I would say, dabbled in that field a little bit ourselves but this rotating machinery is really special and very difficult. And they're primarily their own customers were the ones that were kind of doing it yourself with systems that they would build. And as R&D developed their expertise, they could do it faster and more cheaply than their customers could.

And the overall volume of development work in wind turbines now is skyrocketing. So I think there was increasing demand, customers were struggling and they clearly were - they had a unique position of engineering to go on and win that business. So they did a bang-up job.

John Franzreb: Okay, fair enough. And with six units. I don't remember hearing anything about cost synergies there. Are you going to run them as - still run them as standalones or what are your thoughts on how you are going to operate the business?

John Franzreb: John, it's easier for us to model it with no cost synergies. But I would tell you, as we look at the overall structure of the Test & Simulation business now, I think we have an ability to get some cost out of the business over time and rationalize things. They have a really nice manufacturing base up in Denmark and E2M is over in Amsterdam.

So I think we have some rationalization that we can do from an infrastructure standpoint, but we just modeled it based off no cost synergies. Clearly, we'll have some. And clearly, it will be both in sourcing and manufacturing and certain overhead functions. But they run a very lean operation. So we will realize some over time. We just haven't included it in our return models.

John Franzreb: Okay. And since you mentioned it, let's shift over to the Test side of the business and the gross margin erosion year-over-year. Could you just kind of refresh my memory as to why that happened, and why you think some of it's non-recurring in nature. That would be helpful base it was a sizable number.

Jeffrey Graves: Yes, absolutely. John. So if you go back since kind of late - since '16, just say fiscal '16 through '19, the overall trend was lower gross margins because we had taken - we had booked a lot of business back in '15, '16, '17 in the ground vehicles sector that was predominantly first of a kind, high cost kind of machinery that dragged on margins. So you had a - in the baseline, you had a decline that would have drug us down into the low 30s.

Q4 was very unusual. We had a project that flowed through the operations here, and I would put it more on a strategic category that we - where I had low gross margins associated with it. So it was a one-off kind of big drag on our margins in Q4. They actually were below 30% of the business for Q4. That will recover very quickly, as Brian said, here in Q1. So you will see a bounce back into the 30s in Q1, we would expect. And then hopefully a gradual increase from there as we now go after more diversified business and less one of a kind offerings.

Brian, do you have anything else to add? That was it, John.

John Franzreb: Okay. So embedded in the outlook is how much of an improvement in the Test gross margin in 2020? And how does that step function work? Is it all back ended? As you kind of alluded, Jeff, there's a sizable Q1 step up and do we stabilize from that point? How should we think about it?

Jeffrey Graves: Yes, as far as the actual gross margins, John, we expected to bounce back into the low 30s for the first quarter and then progress after that. And that's how we modeled it even in our three-year from the analyst day, which was slow progression towards roughly 33% and 34% gross margins year after year. So it will be a slow progression next year in the quarter.

John Franzreb: Okay, got it. And I guess one last question, and I'll let somebody chime in. As far as debt repayments, can you talk about the timing of paying down debt? It's the only sizable number at this point given the recent acquisitions. And I guess I might as well add, is it fair to assume that you're not going to be very acquisitive anytime soon?

Jeffrey Graves: Yes, John, let me make a couple of comments and then Brian, if you want to supplement as well. In terms of acquisitions, John, the acquisitions that we will have now completed with R&D, they have pretty much exhausted discussions that we've been having with - these are generally smallish kind of private company - they are all private companies. They're smallish companies that are at a point in their history where they're looking to be acquired by a larger firm and we were a preferred - viewed as a preferred acquirer of those businesses with the technology fit.

So we kind of - I hate to say cherry pick, but we really did cherry pick the ones that were highest priority to us. We went after them. The timing, you know, it depends on the other party a lot as well, and when they wanted to do the transaction. So they came pretty quickly to us, the E2M transactions, Endevco, and now R&D. And that pretty much exhausts our pipeline.

And if you look at the leverage on our balance sheet, we really want to focus on paying that down. And so we'll chip away at here in '20 and I would expect an acceleration in fiscal '21 of the debt pay down. So we're - we have a great base with both businesses now, John. So I think it's fair to say we will not be acquisitive and we'll be focusing on our execution, integration, and our organic growth going forward.

John Franzreb: Okay. Jeff. Thanks. I'll get back into queue.

Operator: Thank you. At this time, we have no further questions. So I will turn it back to Dr. Graves for closing comments.

Jeffrey Graves: Great. Thanks, David. Well, thank you all for participating in our call today and for your interest in the company. We look forward to updating you on our progress again next quarter. We'd like to take a moment to wish you all a very Happy Thanksgiving and a wonderful holiday season. Thank you and have a great day.

Operator: Thank you. Ladies and gentlemen, that concludes the MTS Fourth Quarter 2019 Earnings Call. You may now disconnect and thank you for joining us this morning.