Company: **MTS SYSTEMS**

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Moderator: **Laura Fox-Anderson**

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Operator: The conference is now being recorded. Good day and welcome to the MTS fourth quarter 2018 earnings call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Brian Ross, MTS Senior Vice President and Chief Financial Officer. You may begin, sir.

Brian Ross: Thank you, (Chantal). Good morning and welcome to MTS Systems fiscal 2018 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 Forms 10-Q and 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 measures can be found in our earnings release.

I will now turn the call over to Jeff.

Jeff Graves: Thank you, Brian, and good morning, everyone. We appreciate you joining us for our call this morning. Today marks another notable day in our company's history.

First, we announced last evening a solid fourth quarter and fiscal year 2018 earnings report culminating in a record backlog in our company's 50-year history, which sets us up for an exciting year ahead, as we'll discuss later in our fiscal 2019 outlook.

We also had the pleasure of announcing the acquisition of a wonderful company called E2M Technologies that not only brings us critical electric motion technology for our test business, but also provides a unique position in two adjacent high growth simulation markets. The combination of these events have positioned us extremely well for the year ahead.

Before I provide color on the momentum we're seeing in both of our business units, let me give you some added insight into our acquisition of E2M Technologies.

E2M was founded in 2007 in Amsterdam, Netherlands, by a handful of brilliant entrepreneurial technologists who were experts in electrically driven motion and control systems. They proceeded very systematically over the last decade to gain the highly coveted certifications required for flight simulation along with key customer approvals for human rated motion systems for the entertainment and theme park industry.

While you can describe the individual technologies that comprise E2M systems, which in their own right are incredible in their precision, the true art of their performance lies in their ability to manipulate the human brain into actually feeling the experience of real world motions, such as flight.

This ability to create a highly realistic environment for a human being requires the integration of mechanical, electrical and software technologies in a precisely controlled and exceptionally smooth motion, which is then adapted to the targeted simulation environment.

This capability is extremely important for pilot training for simulation of takeoffs, flight and landing under a wide range of environmental conditions is essential. E2M is one of the very few companies whose technology and hardware are approved for FAA Level D flight simulators, which is the most realistic and demanding level of capability.

With record deliveries of new aircraft planned over the next decade combined with accelerating retirement rates for experienced pilots, demand for pilot training simulators is expected to remain robust for many years to come.

In fact, a recent study by Boeing estimated that the number of new civilian pilots needed over the next 20 years will approach 800,000. This equates to over 100 pilots trained per day, seven days a week, 365 days a year continuously for the next 20 years, a feat that's never been done in history.

This is in addition to any incremental needs the military may have for pilot training over this same period. In short, we believe it's a great time to be certified and able to support the pilot training industry and E2M provides an excellent entry point for us.

This same simulation technology is also expanding into new training applications for ground base vehicles ranging from high speed trains to mass transit vehicles to autonomous cars and even to advanced military systems where realistic battlefield conditions may be simulated.

The common thread through all of these applications is the ability to create realistic training environments flexibly, efficiently and enabling pilots, engineers or drivers to master the newest generation of advanced vehicle technology.

In parallel to their entry into flight simulators E2M also brought their innovative skills to bear in the entertainment industry, where realistic motion simulation is becoming central to modern theme parks.

The ability to simulate flights, adventure and other exotic motion environments for guests of all ages in an extremely safe and yet realistic manner is a key requirement for the competitiveness of E2M's customers in this market segment.

Combining the E2M motion technology and key customer qualifications with the existing MTS global service capability that can help maintain the E2M systems and ensure system availability offers a compelling value proposition that we believe will drive exciting growth in this market vertical over the coming years.

From a technology perspective, the addition of E2M's strong technology leadership position in electric motion systems is an excellent complement to the historic MTS strength in hydraulically driven motion systems.

Looking ahead to future years, we expect electric motion to continue to expand as higher force systems are developed and that hybrid systems using combinations of both technologies will provide an ability to optimize solutions for customers across all market segments.

With this acquisition now complete, E2M will be integrated into our historic test business unit from a reporting perspective.

While E2M clearly accelerates our move into new market verticals for simulation, our historic test markets have also been expanding in this direction for several years with applications ranging from ground vehicle and wind energy environmental simulations to the simulation of earthquakes and tsunamis on civil structure.

Given these trends, which we believe will now accelerate with the acquisition and growth of E2M, we are renaming our test business moving forward. This business unit will now be called Test and Simulation.

From a financial standpoint, the purchase price of E2M was 70 million euro, or approximately $80 million in U.S. dollars. And it was funded primarily via the borrowings on our revolving credit facility.

E2M currently delivers $30 million to $35 million in annualized revenue, has strong operating margins and generates excellent free cash flow. We expect it to be neutral to earnings this year, exclusive of transaction costs, but expect it will be immediately accretive to gross margins, EBIT, and EBITDA margins in fiscal 2019.

Moving on to our fourth quarter in fiscal 2018 financial performance, we finished the year on a strong note across both business units and are positioned to continue this momentum in fiscal 2019.

Our business remains healthy as evidenced by how we closed out the year in orders, backlog and revenue, which I'll now recap for you.

In the fourth quarter, we generated orders of nearly $141 million in our test business and $96 million in sensors. This continued the momentum we had established in our third quarter and translated to a record orders performance of $456 million for the second half of the fiscal year.

This was an increase of over 20% from the first half of fiscal '18 and provided us with a record backlog of $415 million as we ended the year.

Test orders in the fourth quarter were supported by strength in the structures and materials test markets along with continued growth in test services. Our performance in test orders was especially pleasing as we were lapping a record fourth quarter from last year. And we continue to navigate volatility in our ground vehicles sector.

Ground vehicle orders continue to be weaker than historical norms as our customers continue to invest disproportionately in safety related testing of new vehicles. Our efforts to drive an improved balance of orders across the test markets that we serve continues. And we're now seeing the benefits of it in terms of positive overall orders growth and an improving mix of business.

I'd like to recognize the hard work of our test employees to solidify project commitments from our customers in the second half of the year that will benefit us in the new fiscal year to come.

From a sensors perspective, we again were delighted with our momentum in the fourth quarter which rounded out a fourth record year for our sensors business unit.

From an orders perspective, broad market strength across all end markets. including both the industrial and test markets, combined with strong execution and fulfillment led to an outstanding orders performance giving us a book-to-bill ratio of 1.24 in the fourth quarter.

This tremendous orders performance allowed us to finish the year with a record backlog for sensors going into fiscal 2019 supporting our continued projections for double-digit top line growth moving forward.

This included our first purchase order associated with our new US Department of Defense contract, which we announced earlier in the fourth quarter. This first purchase order totaled roughly $20 million and is included in our reported backlog number. This is the first increment in our new DoD contract whose total value is approximately $187 million, inclusive of all options over the next five years to seven years.

So in short from an overall Company perspective, with the order strength we've seen across both business units, we're very happy with our backlog position as we enter our new fiscal year and believe that the market dynamics we experienced in the second half of fiscal '18 are continuing as we move into the first quarter of our fiscal 2019.

Let me now move to some comments on our revenue performance in fiscal '18. An important thing to remember about our Company is that the two business units are quite different in terms of the rate of conversion of orders into revenue.

For test, this cycle can frequently span 12 months or longer. Therefore, the backlog that is seen in a quarter does not convert into revenue in some cases for up to six months.

For our sensor business, the order to revenue cycle is much shorter often measured in weeks, not months. With this in mind, the softness that we had in orders in the first half of fiscal '18 for test, driven exclusively by the test ground vehicle sector negatively impacted our overall revenue performance for the year in spite of an excellent sensors performance.

This translated into consolidated revenue in the fourth quarter declining 1.8% versus fiscal 2017. Test revenue was down 3.5% in the fourth quarter and 7.8% for the full year. However, excluding the ground vehicles sector, our test business generated revenue growth of 4% for the year in fiscal 2018.

We believe this is repeatable as we continue to take advantage of opportunities in other parts of our test business, namely test materials and structures as well as test services which have all performed well during the year.

We're also working hard to diversify our business so that we are less exposed to ground vehicles over the longer term. Test equipment sales to our ground vehicle customers represented approximately 25% of our total revenue in '18. This is down from approximately 30% in '17 and 35% in '16.

Based on the trajectory of our sensor business, the growth plan we have in place for other parts of test and the addition of the E2M acquisition, our long-term target is to get ground vehicles test to roughly 15% of our revenue base.

Importantly, this does not mean reducing our commitment to our test ground vehicles customers, rather it's a result of preferentially pursuing strong growth opportunities that are now in front of us across our other markets.

Demand for our sensor products was robust and steady throughout the year as industrial markets across key geographies were supported by economic growth and market trends that were favorable. Our sensors team capitalized on this demand with a strong focus on customer service and a diversified product portfolio.

Sensors revenue growth was 11% for the full year and 1.4% in the fourth quarter. The fourth quarter performance was strictly attributable to shipment timing and new product production ramps versus the prior year.

With the outstanding orders performance in Q4 and continuing market strength broadly, we expect fiscal 2019 to be another year of double-digit top line growth for our sensor business. As a note, the 11% growth in fiscal '18 for sensors was the second consecutive year of 10% plus growth, a trend we expect to continue. So to summarize, I'd like to bring it all together for you and provide our outlook for fiscal '19 from a strategy perspective.

For our test business, we continue to plan for volatility in the test ground vehicles sector as we move into fiscal 2019 with our strong 12-month pipeline indicating that at some point this trend will reverse itself.

We expect test structures to be stable with a slight positive trend, but lumpy quarter-to-quarter due to the size of individual projects that characterize this sector.

We expect to continue to benefit from the positive test materials trends that we've been experiencing driven by the growth in carbon fiber composites and the rapidly expanding application of additive manufacturing. This growth brings with it more standard equipment sales and higher operating margins to our test business.

In fiscal 2018 test services orders surpassed $100 million for the first time ever at MTS and will continue on an exciting growth trajectory moving forward. This achievement is a result of a multi-year initiative we undertook a few years ago to accelerate the growth of our service business.

During this time, we invested resources needed to create a more robust infrastructure to service a growing installed base of equipment, which now totals approximately $5 billion. Through these investments, we've expanded our geographic footprint and technical capability to provide the high level of service that our customers around the world would expect from MTS.

And of course, we look for an exciting contribution from the newly acquired E2M business, which will be integrated into our renamed Test and Simulation business moving forward.

From a sensors perspective, we quite simply look to keep doing what we've been doing over the last two years. This means launching market-leading new products, delivering those products with outstanding fulfillment processes, working with our supply chain to ensure availability and to reduce costs and executing 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 continue to grow our share of the market and help us build on our positive momentum even further. Our contract associated with the US Department of Defense is a perfect example of this approach.

With our record backlog at the end of the year, the strength of our end markets and the execution of our sensors team, we expect this business to continue growing at double-digit rates, producing gross margins of approximately 50% and expanding EBITDA margins, which were roughly 21% in 2018.

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

Brian Ross: Thank you, Jeff. As I hope you can tell we are very excited to add E2M to our Company to help bolster our electric actuation and simulation businesses. Similar to our PCB acquisition, we welcome the entire E2M management and employee base to MTS as they continue to execute on their impressive growth and technology strategy.

Our near-term integration strategy is simple, enable E2M to execute on their 2019 financial strategy. This includes helping E2M where they need assistance in sharing MTS resources to drive continued growth in the E2M business.

Longer-term, we expect to capitalize on synergies with our similar technologies and adjacent markets that will enhance the combination of our two businesses.

In terms of financial details, as Jeff indicated, we acquired E2M last Wednesday, November 21, in an all-cash deal valued at approximately 80 million U.S. dollars. Total acquisition costs are expected to be approximately $1.5 million to $2.5 million. And we financed the acquisition through an expansion of the company's revolving credit facility.

Going forward, we expect strong free cash flow generation from both MTS and combined E2M and available cash balances to help us pay down our debt. As a reminder, before this deal, we had continued to de-lever our balance sheet and reduced our debt for eight consecutive quarters.

Our starting leverage ratio upon announcement of the acquisition is approximately four times. And we currently forecast our leverage ratio to decline to approximately 3.5 times or below by the end of fiscal 2019.

We project the E2M business to deliver top line of approximately $30 million for fiscal year 2019 with double-digit growth in the future along with strong operating margins that are accretive to MTS test margins.

With the purchase on November 21, the acquisition will be included only for a little over 10 months of our fiscal year. We do not expect a material amount of near-term cost synergies, although potential technology synergies are very strong.

In short, we found a company with solid financials and great growth expectations coupled with an employee base and technology focus that will bring many benefits to both MTS and E2M.

I will now move to our fiscal 2018 highlights. As Jeff mentioned, it was a good year that positioned us well for 2019. I will start with our fourth quarter fiscal 2018 results with focus primarily on year-over-year quarterly comparisons.

Jeff already touched upon orders and revenue performance so I'll start with gross margin. Our gross margin rate for the quarter improved 180 basis points compared to the fourth quarter of fiscal 2017 with the test gross margin percent increasing by 410 basis points due to improved project cost management and other cost reduction efforts.

The gross margin rate for our sensors segment declined versus the same quarter results in fiscal 2017 because of unfavorable mix from lower revenue in the energy sector and production inefficiencies incurred from the introduction of new products, both of which we consider to be temporary in nature and are expected to return to prior quarter performance levels.

Both segments have ongoing programs that have begun to lower their cost structure and drive productivity improvements.

Before leaving gross margin, I'd like to address the proposed tariff increases on goods imported from China. Specifically with regard to our production in China, we have not historically imported these products into the US and would expect minimal impact from US import tariffs.

With regard to our production in the US, we do import some materials used in the US manufacture of our test equipment. However, we believe any exposure to us is small and is mostly related to steel and aluminum used in the US manufacturing of our test equipment.

We believe we have several viable options on how to mitigate increased tariffs if they ultimately are enacted and we continue to manage this closely.

Operating expenses of $60.7 million were relatively unchanged from the prior year quarter as we are managing costs closely to keep our expense leverage aligned with the needs of our business and to be prudent in the investments we undertake to drive profitability.

Net interest expense declined by $2.3 million compared to the prior year quarter primarily due to a significant decline in our outstanding debt balance over the last 12 months. In addition, the fourth quarter of fiscal 2017 included $1.8 million of non-reoccurring expense related to the repricing of our Term Loan B debt.

The effective tax rate of 26% for the fourth quarter includes the true-up of the discrete benefit from the Tax Act that was reported in a previous quarter along with routine year-end discrete adjustments. Without the discrete benefit from the Tax Act, our tax rate would have been 23.4%.

Fourth quarter adjusted EBITDA of $32.7 million increased 15.6% versus the prior year quarter and 17.6% sequentially versus the third quarter of fiscal year 2018 primarily because of the $4.6 million gain on the sale of one of our China manufacturing facilities.

We ended the year with $71.8 million in cash, which is down from the beginning of the year due primarily to our debt payments made in excess of our mandatory repayment requirements throughout the year.

We made $59.3 million of these additional principal payments in fiscal 2018 using a combination of free cash flow and cash on hand. Moving forward, we expect to apply the same level of judiciousness on our capital allocation.

I will now provide an overview of our full year results for fiscal year 2018. Total revenue was $778 million, a decrease of 1.3% compared to fiscal year 2017. Overall test revenue declined

7.8% driven by the volatile demand in the ground vehicle sectors that we have discussed over the last few quarters.

Excluding ground vehicles revenue, the remainder of the test segment reported a revenue increase of 4.1% compared to the prior year due to growth in our service business and new sources of demand in the materials sector for our testing equipment.

In fiscal 2018 sensors revenue grew from $284 million to $314 million, or 10.7%, driven by robust demand in our industrial markets and rapid growth from our mobile hydraulics products.

Shipments from an initial contract associated with the US Department of Defense awarded in fiscal 2017 and other markets within the aerospace and defense industries also contributed to the growth in sensors revenue for the full year.

The next item is gross margin. The gross margin rate of 39.3% is higher than the prior year rate by 90 basis points primarily because the prior year rate was negatively affected by the acquisition-related expenses from the PCB acquisition and restructuring expenses.

Gross margin continues to benefit from the robust growth in sensors revenue as a greater proportion of our revenue is coming from this highly profitable business segment.

Consolidated operating expenses were 30.9% of revenue, including restructuring expenses which impacted this rate by 10 basis points. In comparison fiscal year 2017 operating expenses were 31.4% of revenue, including non-reoccurring China investigation costs, acquisition-related and restructuring expenses which impacted this rate by 170 basis points.

Higher selling expenses and spending for R&D to drive sensors revenue growth and an increase in professional and compensation expenses accounted for the increase.

Adjusted EBITDA as a percent of revenue declined from 15.2% in fiscal 2017 to 14.8% in fiscal 2018 as this decrease in test ground vehicles revenue offset the strong profit contribution from 10.7% revenue growth in sensors.

Going forward, we expect to improve on this important measure of our business performance through increased leverage on our cost structure from higher volumes in both business units and selective cost management as well as the positive contributions from E2M.

Interest expense of $25.9 million decreased by $4.9 million compared to the prior year expense of $30.8 million. The primary reasons for the decrease are, one, we have benefited from a lower interest rate realized on the repricing of our Term Loan B debt in the fourth quarter of fiscal year 2017.

Two, fiscal 2017 included $1.8 million of one-time expense related to the debt repricing. Three, gains on interest rate swaps have provided us with a benefit as rates have increased. And, four, our outstanding debt has declined significantly from debt payments made throughout fiscal 2018.

For fiscal 2019, we expect our interest expense to be approximately $6.5 to $7.5 million per quarter, which reflects the increase in debt incurred as part of the acquisition of E2M.

Our effective rate for fiscal 2018 was a negative rate of 38.7%, which includes a $25 million discrete benefit from the Tax Act. In comparison, the effective tax for fiscal 2017 was a negative rate of 9%, which included discrete tax credits for domestic manufacturing, deductible PCB acquisition-related expenses and the US R&D tax credit.

Excluding these tax benefits, the rate for fiscal year 2018 and 2017 would have been 17.9% and 3.2%, respectively. This increase was primarily due to higher earnings before taxes. In fiscal 2019, we expect an effective tax rate in the range of 15% to 19%.

With fiscal 2018 completed, I will now move to some more details on our outlook including guidance ranges for fiscal year 2019.

The range for full year revenue is $830 million to $870 million and the range for GAAP diluted earnings per share is $2.30 to $2.60 for fiscal year 2019. In addition, our range for adjusted EBITDA is $122 million to $142 million.

These expectations are supported by our record ending backlog, a return to growth in our test business, continuing strong momentum in our sensors business, improving business mix, the E2M acquisition and slightly positive contributions from the revenue recognition standard adoption.

In summary our financial performance for fiscal year 2018 was defined by the underlying fundamentals of the diverse markets that we serve across our different sectors. Our orders and revenue growth was strongest in those markets, which had the highest demand while test ground vehicles was limited by lower automotive investments in durability testing equipment.

We were well served by our strategy that includes expanding our portfolio of products in the rapidly growing sensors market and staying focused on meeting the demands for new test solutions due to evolving technologies and favorable demographics.

As a part of that strategy, we are very pleased to add a high-quality business enterprise like E2M at a time when its business model is gaining momentum and size. The addition of E2M along with the strongest backlog in our history, a strong outlook for sensors and a return to growth and margin expansion in our organic test business are the primary reasons that we are confident in our expectations for fiscal year 2019. I will now turn the call back over to Jeff.

Jeff Graves: Thanks, Brian. As Brian just mentioned, we expect fiscal 2019 to be a good year for us with a very 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 game plan is still a very simple one to understand at a high level.

First, we need to keep executing on sensors. It's a great business with a strong leadership team that has terrific momentum.

Second, we need to take advantage of the strength in our non-vehicle related test equipment and service opportunities to drive growth and margin expansion. Our orders profile in the second half of fiscal 2018 is a clear confirmation of this opportunity.

Third, in integrating E2M technologies into our Test and Simulation business, we need to match the success that we had in integrating PCB, which we acquired in late 2016 and has since lived into the full potential that we had envisioned. We have the experience and the focus to do this well.

If we continue the positive momentum of the second half of 2018 executing well in these three ways, we'll have strong financial performance in the year ahead, delivering solid growth with expansion of our margins and free cash performance.

We closed fiscal 2018 knowing that there were tremendous opportunities ahead for MTS to be a leader in developing the test, measurement and simulation markets worldwide with strong brands that are known for market-leading technology and outstanding customer satisfaction.

The MTS brand is synonymous with the highest level of accuracy, reliability and professionalism in the world. Our management team is committed to maintaining this reputation as we deliver on our value proposition to our loyal customers and to reward our shareholders for their investment in MTS.

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

Operator: Thank you very much. Ladies and gentlemen, at this time we would like to open the floor for questions. If you would like to ask a question, you may press star 1 on your telephone keypad now. Again, that is star 1 to ask a question.

Our first question will come from John Franzreb, Sidoti & Company.

John Franzreb: Good morning, guys. How are you doing?

Jeff Graves: Good morning, John.

Brian Ross: Hi, John.

John Franzreb: I got a host of questions but I'll start simple. Regarding the guidance, the EPS guidance is a GAAP guidance I assume. I'm wondering what's embedded in that in regards to restructuring or other one-time items that also includes any one-time asset sales. Should we be aware of anything of that that's in the guidance?

Brian Ross: Yes, so the guidance, John, is a GAAP number that includes all amounts in there. There's only a limited amount of restructuring that's left to be recorded from the China announcement that we had at the end of fiscal 2017. Otherwise, we're now restructuring actions for the '19 guidance.

John Franzreb: And one-time gains?

Brian Ross: We have no one-time gains built into there.

John Franzreb: Okay, perfect. All right, secondly, Jeff, in your prepared remarks you talked about the order trends and you gave us historical references on the booking turns, recognizing revenue, the difference between the sensors and the test business.

Given that incoming orders was $96 million in sensors, and I'm assuming that $20 million or so of it was the DoD job, how should we think about when you're booking that number because it seems like you are putting more emphasis now on the sensor backlog and order incoming take and is it all deliverable within one quarter like it's historically been? Do you understand what I'm saying?

Jeff Graves: Yes, you know, I got you, John. And yes, it's interesting now that sensors has gotten so large for us. We tend to talk about it and we describe orders because we do that for test. Really you can look at the book-to-bill ratio, John, and put a trend together that way.

And you are correct. Virtually all of the backlog traditionally in sensors gets shipped in the next quarter. Now, the DoD contract purchase order, and you're right at the value, its 20 million bucks. It's in backlog. The exact timing on that is dependent on the customer that's taking it as well.

But, yes, it all roughly turns in a quarter because the build and ship time is measured in weeks in that business.

John Franzreb: Got it. Okay. I just wanted to make sure. All right and lastly, E2M, it would be great if they could teach the New York Jets quarterback how to recognize a blitz, but just a little bit on that business.

Jeff Graves: I thought about that, John.

John Franzreb: Could you tell I'm a long suffering Jets fan? Could you talk a little bit about the double-digit growth rate? How long has that been going on? A little bit about who the historical competitors are and what's the composition of their end market revenue mix?

Jeff Graves: Yes. So in terms of mix, John, it's been predominantly this flight simulation business. Okay, it's been growing nicely. They've developed customers there for some time.

As I mentioned, they were founded in 2007. So, it took them, you know, the better part of the decade to get the certifications required for the highest level of participation there. Their order rates have been tremendous though. It's been great.

We will stick to a line of double-digit growth because I would tell you and, you know, coming off a small base it's been much higher than that historically. But, you know, I think a good plan for that business is good, solid double-digit top line organic growth.

I would guess that flight simulation will remain a very key part of that end market for them. But the entertainment industry is interesting. They've only recently begun penetrating that market and gained the customer qualifications.

There's not as much regulatory qualification, but there are very strict customer qualifications as you might imagine because of the human rated theme park industry. So, it took them a long time to earn those.

But a big attraction to us was both of those markets are really hard to get into and they've spent their time since '07 developing the technology at the right price point to be attractive and then to gain the qualifications to get in. So it's terrific.

I would guess that just given the -- and just the public statistics, John, on pilot training, I'm guessing flight simulation will remain a very key part of that segment. But nicely for us, we can take that electric actuation technology and start putting it increasingly into our test systems, which we're already doing part of but this really accelerates that.

So from a technology perspective and synergies there we are really excited to have these guys a part of our test business. They will bring electric motion to the test industry much like they did to their simulation industry historically. So it's terrific.

And the management team, John, is absolutely outstanding. As I'm sure you are aware, we weren't really in the market, you know, for acquisitions, but we continue to have dialog with small private companies. And the timing on those coming to market is always uncertain.

These guys ran a process. And when Brian and I were over with our test leadership team to meet their management team, they are just outstanding individuals, great engineers, world-class engineers that know that industry really well and they are extremely entrepreneurial.

So they've just developed - and I could go on and on about them. But from design tools to technology to customer certifications, just a terrific fit with MTS. So while the timing was a little earlier than we would have otherwise planned, it was a lovely bolt-on acquisition that will make a real difference for the test business.

John Franzreb: Okay and the competitive landscape?

Jeff Graves: You know, John, it's a very small competitive base and a relatively small customer base. So we're just taking a line that we're not going to comment on that nor their margins.

Obviously, they'll be fully incorporated in our test business. We may give some color on the demand in those markets. But you can probably with a little homework understand, you know, who is in the flight simulation business and who else participates.

There are, just like our test business and do-it-yourself, guys out there that build their own simulators. But more and more, they source this to people like E2M and a few others. But again the certifications by the FAA are absolutely critical to supply that industry. So we expect it to remain a very limited competitive base to supply that product.

John Franzreb: Okay. You know what? At this point, I'll get back into queue and let someone else ask some questions. Thanks, guys.

Jeff Graves: Thanks, John.

Operator: Thank you. Again, that is star 1 to ask a question. Our next question will come from Neil Van Horn, Guyasuta Investments.

Neil Yost Van Horn: Yes, we're long-term shareholders. And I was curious. The first question, on the earnings for next year and so forth that shows up on Page 4 of the press release of the range of

$2.30 to $2.60 for your estimate for fiscal '19, but how does that match up with what I read in terms of what you reported for fiscal '18, i.e. $3.18?

Jeff Graves: Yes, I'll let Brian do the reconciliation for you, Neil, but let me just thank you for being a long-term shareholder in the Company. We really appreciate that. So, Brian, I took the hard part. You can take the reconciliation.

Brian Ross: Yes, Neil. So in fiscal 2018 with the tax reform changes we did recognize a one-time benefit of roughly $1.30 of EPS. So our performance EPS puts us at just a little bit below $2 per share. So the increase to $2.30 and $2.60 equates that amount to over 20% growth in our EPS for fiscal 2019.

Neil Yost Van Horn: Thank you.

Brian Ross: You're welcome.

Jeff Graves: Thanks, Neil.

Operator: Thank you. Our next question will come from John Franzreb, Sidoti & Company.

John Franzreb: All right. I got plenty more. I guess the first question, Jeff, last quarter you talked about how the shift to electronic vehicles has increased the testing of safety as opposed to durability and that's kind of been a push out for you.

Yesterday, GM announced a similar kind of shift in its production to more EV products. Any initial thoughts about how that's going to impact your order book in the coming year or so?

Jeff Graves: Yes, it was an interesting announcement by GM yesterday, John and it is completely consistent with what we see and hear from our customers broadly that the growth of autonomous vehicles and electric vehicles is where the future is at. And, of course, their truck and heavy vehicle market as well is very robust.

But, you know, companies are paring back on traditional vehicles and introducing these new high technology autonomous cars. And the issue, the primary issue they have faced in that whole trend is safety. They've just got to make sure they master safety.

And yet right behind that, John, sits durability, which is as you know is what we do for a living. We do durability testing for vehicles. And so our --it's interesting. What we see in our pipeline, John, for the next 12 months is a whole lot of durability projects out there for vehicles. But the issue is those things just keep getting bumped out because of short-term priority on safety testing for these new cars.

So, you know, we're to a point, John, we have been for the last couple of quarters where we just say, look, we are certain the demand will come back because even autonomous cars or electric cars have to be tested for durability. They have to be because of warranty requirements for the manufacturers and what the insurance company will hold them to.

So it has to happen. It just keeps getting pushed out in time at the expense of safety. And, you know, I can understand their prioritization. I don't blame them. It's a bit frustrating for us. But we are just focused on the other segments and making sure that the rest of test, we live into the full potential for growth.

And we're really pleased with that growth. It's just the vehicle stuff has been tough. And Brian already pointed out until we see it consistently roll through, we're not going to say, you know, the trend has changed.

So what we say today, what we said in the last quarter or two, is we just expect continued sluggishness in that part of our market, but the rest of it is going to grow very nicely.

So I was thrilled that we set a record. I don't know if this went by everybody or not, but we set a record for second half performance in test orders, a 50-year record in orders, basically without the vehicle segment being strong at all.

So it tells you the strength of the other parts of the test business and that led us to an all-time record in backlog. We've never gone into a new fiscal year with a backlog of $415 million. We've never been over $400 million before in backlog.

So we're pleased with sensors. We're pleased with the other parts of test. Test vehicles remains frustrating. And, you know, it's out there. It is being pushed out but eventually at some point that will break through.

John Franzreb: Okay and I guess I have a litany of questions here on China. It's been an important market for you. You discussed some of the tariff implications. Could you talk a little bit about slower GDP growth in China if that's impacting you, A?

B, if China is going to look to bring their own new car here in the states by 2020, are you planning testing on that platform? And C, have you see any kind of retaliatory actions against US companies in China, maybe less aggressive buying your products? I guess those are three quick buckets I have been thinking of.

Jeff Graves: No, great questions, John, all the way around. On the last item, no. I mean it's because we sell equipment into laboratories, new product labs and for validating designs and basic research for materials, things like that, there's been no - and it's a relatively niche market around the world.

There has been no attempt at either rejecting US equipment or broad applications of tariffs. So virtually no effect on the business.

Now if they ratchet it up in the future, we may get accidentally caught in tariffs somewhere. But it's not a direct focus of anyone on this industry.

In terms of China growth, we continue to be really pleased with our China growth trajectory. China, you know, if you look at their evolution and their economy, they're going to have an automotive and an aircraft industry. And they're going to have all the basic materials to support those industries over time. They're determined to.

We supply equipment into university laboratories and product development labs to test and validate those materials all the way up to full-scale vehicle. So, you know, it is a nice market for us. We expect it to continue.

Unless we accidentally get caught in the tariff, we don't think it'll be a big deal. We have an ability to reprice most of our business every day because it's project driven test business.

So right now, you know, we're pleased with the trajectory. Even if it slows down a little bit, we are in the core of what's growing for them so it should have minimal impact on us, I would guess, going forward. Brian, you have anything you want to add on that?

Brian Ross: No, I think that's good.

Jeff Graves: Okay. And from a working relationship, John, it has been fine. I mean bear in mind, I think the number we're using is -- there is 165 new Chinese automotive companies out there. You know, they're trying. They're pushing really hard into electric vehicles because of the pollution issues in China. And they want to be an exporter of those cars. And we sell the best test equipment in the world to test those vehicles. So we expect it to be a -- you know, continue to be a very good market for us.

John Franzreb: Okay and shifting back to E2M. I don't think I heard any kind of EBITDA multiple that was applied to the acquisition. Could you provide that or maybe talk us through what you find an attractive internal rate of return on an acquisition like this, you know, some kind of metrics around the purchase itself and what made it so attractive?

Jeff Graves: Brian, on the latter part of that, I'll hand off to you for anything you want to say. I would tell you again, John, we're not going to comment on the profitability of E2M nor their growth rates, well, with the exception of saying we think it will be solid double-digit growth.

And the biggest reason, John, is that it's a very limited competitive base, customer base out there. We don't want to get close to talking about pricing and margin.

So we're not going to talk about that except to say it's accretive to test. It's accretive in terms of gross margin, EBIT margin, EBITDA margin to our test business today. So we're pleased with that. Brian are there any comments you want to make in terms of overall direction on acquisition?

Brian Ross: No, I think just overall when we think about what we did with PCB and getting a number of fillers that we focus on, if something like this were to come about, you know, first and foremost financially that's a piece of business that we want to look at if those metrics and nice growth, good cultural fit with the management team to be able to help run this business with us ((inaudible)).

Jeff Graves: I will add, John, one more thing is we love these businesses that are much like our current sensor and test business that are low capital intensive businesses. We basically design and assemble products. As you know, we don't spend very much on CAPEX. We don't need to.

And it really frees us up to generate a lot of free cash flow to spend in whatever manner we want for growth, for reinvestment for growth, for dividend performance. In this case, we're de-levering our balance sheet.

E2M fits that profile very nicely. They are a design and assembly type of company that very much fits the MTS model of strong free cash flow generator.

John Franzreb: Okay and one last question. I might have missed this, but the gross margin profile within test, within your backlog, is it the same as it was six months ago or is it getting better?

Jeff Graves: It should be on an improving trend now, John. Because if you look at it, our worst gross margin performing part of that business was the full-scale vehicle business in general. And part of that was we were doing a lot of custom work, a lot of first of the kind custom works. It was a big drag on the business.

The percentage of that is much reduced now. And we're in a position where we've been building backlog in the more standard product areas and service areas. So you should see a general trend upward in terms of both gross margin and EBITDA margin moving forward.

John Franzreb: Okay, thanks guys. I'll get back in the queue. Thank you for taking my questions.

Jeff Graves: Thanks, John. Good questions.

Operator: Thank you very much. Ladies and gentlemen, as a quick reminder, if you would like to ask a question, please press star 1 on your telephone keypads now. Our next question will come from Jeff Russell, ClearBridge Investments.

Jeff Russell: Good morning, guys. Just so we can all understand what you've put into the range of estimates for next year on the revenues. Sort of on the low end, high end, what are the implicit assumptions for that ground vehicle test business? And the same for the EBITDA range, sort of what is the upside/downside case on end market conditions that you are assuming bracketing that range of forecasts? Thank you.

Jeff Graves: Yes, I think - and Brian, I'll let you comment as well. But I would tell you our assumption right now is, you know, because of how much we were surprised in the first half of the year at the ground vehicle segment softening for us as customers diverted their spending into safety, we are making no assumptions on improvements until we actually see them.

So we're assuming - I mean it is not dead in the water. It is moving along. It's soft by historical measures the ground vehicle segment of test. But we're assuming no real change for fiscal 2019 going forward.

We are assuming growth then because you can see the overall test business is growing. We are assuming growth in the other segments. And let me just go through them and kind of an order of increasing excitement.

So the large structural testing that we do for civil structures, you know, earthquake simulators, things like that, it's been a really very nice business for us. We expect it to be stable to growing in the next year.

You know, it's unfortunate with the tragedies that happen in the world with earthquakes, but it has stimulated governments to invest in facilities, largely university facilities, for simulating earthquakes and other tidal events from the oceans.

So we expect that business to be stable and growing. And it's really a great business for us. We occupy a really nice niche in that business around the world.

We expect the materials test business and services to grow quite nicely. Materials test is proving to be an excellent business. We've been in it for 50 years.

We took a strong focus on it over the last two years and nicely the timing has been good because carbon fiber composites and additive manufacturing are really taking off in the world. And it is driving a lot in our test business plus basic materials.

So materials test is growing at really nice rates. And then test services of course has been growing darn near double-digits. So we expect that kind of growth rate in general to continue in test.

So we like all of that. And to John Franzreb's earlier question, it brings more standard products, better margins in principle to us and a more predictable business. So we like those trends.

At some point, we'll get on one of these calls and say, wow, the ground vehicle business is back and it's great. But right now, we're just saying until we see it, we're not going to believe it. And it's not really baked into our '19 -- no changes are really baked into our '19 forecast on ground vehicle. so we'll get growth without that.

And like I said, I was very pleased to have record six month performance in test orders. And at the end of '18, the second half of '18, it was 20% up over the first half. And it was all driven by non-vehicle markets so material services and even structures. And we expect that trend to basically continue into '19. And our revenue growth will be dictated by those other markets. Okay, that's the test business.

Obviously sensors, we've already said, you know, record backlog, great book-to-bill. We expect sensors to grow at 10% plus rates on the top line. We did 21% EBITDA margins last year and those should expand in '19. So we're really pleased with that trend. Brian, anything you want to add?

Brian Ross: Yes, the only thing that I'd like to add, I guess, is, you know, the ranges that we put out there really are dependent upon, you know, the markets that we see. Our execution is not something that we question in there. It's more just how the markets respond.

We've obviously seen a lot of volatility in the public markets here in the last month. John mentioned the GM announcement and so forth, but it's really market driven.

Jeff Russell: And could you also go through the debt structure fixed versus floating where it stands pro forma?

Brian Ross: Yes, so we were just below -- total amount of about $40 million at the end of the year in debt and most predominantly in our Term Loan B. Most all of it is what I'll say floating rate but we've hedged against that to fix some of it, approximately 60% of the Term Loan B.

And then we used our revolver facility to pay for the E2M acquisition. So approximately adding $80 million to that. So it is a floating rate, but we have fixed it through the hedging side of it predominantly.

Jeff Graves: And you meant just under $400 million, right? Just under $400 million?

Brian Ross: Yes.

Jeff Graves: Yes. So, yes, you said 40. So just under…

Brian Ross: Thank you.

Jeff Graves: Christmas is coming. Just under $400 million of debt is what Brian meant at the beginning of that.

Jeffrey Russell: So rolling it all up, of the $400 million, how much is now either hedged or fixed?

Brian Ross: Approximately 60%.

Jeffrey Russell: Thank you very much.

Jeff Graves: Thanks.

Operator: Thank you. Our next question will come from John Franzreb, Sidoti & Company.

John Franzreb: Yes, just one minor point. Your stock-based compensation guidance kind of indicates that it will grow from $7.3 million at the midpoint to maybe about $2-1/2 million more in fiscal 2019. Am I understanding that properly and if so, why?

Brian Ross: Yes, so the number in our guidance also reflects as far as the one-time expenses that we had in there. So the $8-1/2 to $11 million also reflects what we've stated for one-time expenses. The rest is basically just stock comp and in the current year we have a range - we've historically had about $6-1/2 to $7-1/2 million. Some years it's been higher. And so it does reflect some of that stock comp.

John Franzreb: So stock comp is not going up significantly more? It's other one-time items in there?

Brian Ross: It is a combination of both. Stock comp will not go up depending on the term of significance, but it could go up to where it has been in the last year.

John Franzreb: Okay. Thank you, guys.

Jeff Graves: Thanks, John.

Operator: Thank you very much. Speakers, at this time, we have no further questions in the queue. So I'll hand it over to you for our closing remarks.

Jeff Graves: Thanks, (Chantal). So thank you all for participating in our call today and for your interest in our Company. We look forward to updating you on our progress again next quarter. We'd also like to take a moment to wish you all a very Merry Christmas and a happy holiday season. Thank you and have a great day.

Operator: Thank you very much. Ladies and gentlemen, at this time, this now concludes today's conference. You may disconnect your phone lines and have a great rest of the week. Thank you.