Company: **MTS Systems**

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

Moderator: **Laura Fox-Anderson**

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

Brian Ross: Thank you Stephanie. Good morning and welcome to MTS Systems Fiscal 2019 Third 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 measure can be found in our earnings release. I will now turn the call over to Jeff.

Jeffrey Graves: Thank you Brian, and good morning everyone. We appreciate you joining us on our call this morning. Having executed well through the first nine months of our fiscal year, our performance is headlined by another strong quarter of topline growth. Revenue was up almost

[01:38] 20% from the prior year quarter, virtually equaling our record performance in our fiscal second quarter of this year. This brings our year-to-date topline growth rate to 15% reflecting 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. By all measures, we consider this to be a great achievement in today's marketplace, and we look forward to finishing the year in a solid fashion.

While our Test and Simulation business continued an exciting year of growth, in the third quarter, our Sensors business also accelerated, delivering nearly 7% revenue growth in the quarter compared to the prior year. This brought our year-to-date growth rate for sensors to 3.4%, and we expect to see further acceleration in the topline performance in our fourth quarter. Our sales performance reflects the strength of our technology offerings, our broad geographic presence, and the expansion of our market verticals in both our Sensors and Test and Simulation businesses. This topline performance reflects the increasing success of our growth in diversification strategy, capitalizing on our market-leading Sensors and Test and Simulation product technologies, combined with delivering premium service to our customers across the globe.

Consistent with the message that I've been delivering all year long, we continued to leverage the strong core technologies in both of our businesses and prioritize the introduction of new products and services in adjacent markets to accelerate our growth and further diversify our market exposure. While being very pleased with our topline performance and continuing trends, we also continue to focus intensely on our profitability, and are, once again, very pleased with our progress in this area, as reflected in both our adjusted EBITDA and earnings performance.

In short, we'll continue to execute on our strategy of making prudent investments in the business to support sustained long-term growth, along with efficiency and productivity improvements. We

[03:40] believe that over time, this consistent focus will prove successful in creating a test and measurement company that is more resilient to changes in the external environment, and is better able to sustain a high level of financial performance.

Looking back on the acquisition we completed in our first quarter of this year, E2M Technologies had another strong quarter and continues to perform through our expectations, as we initially described at the beginning of the year. In addition to opening new exciting markets for flight simulation and entertainment, we continued 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.

While our third quarter performance was exciting in and of itself, our accomplishments continued in the following weeks. In early July, we took advantage of an attractive interest rate environment to complete a $350 million bond offering. Our ability to effectively communicate our business strategy and execution plans to a large, new audience of fixed income bond investors was well received. I was pleased with the strength of demand and the final outcome. Our new desk[?] structure will allow us to further execute on our growth and diversification strategy in the years ahead.

Finally, just last evening, we were pleased and honored to announce the acquisition of the Endevco product lines from Meggitt LLC. Founded in 1947, for over 70 years Endevco has been a market leader in high performance sensors for testing applications. They are a well-known and highly respected name in laboratories and research environments around the world. We're extremely pleased to add this suite of sensor products to our existing market-leading portfolio of sensors. The combination of the PCB and Endevco brand names is a natural fit, and we'll continue to strengthen our market-leading technology offerings to customers around the world. As stated in our earnings release, the purchase consideration for the Endevco assets was approximately [05:40] $70 million. We expect these products to contribute approximately $30 million in revenue annually moving forward.

Given the timing of the close this week, we did not expect this transaction to have a material effect on our Q4 or fiscal 2019 performance, but it will certainly provide for a very exciting growth prospects in the years ahead. We'll be providing more detail on the exciting outlook for our Sensor business as well as for our Test and Simulation business at our upcoming Analyst Day be held here in Minneapolis on September 4th.

Let me now share a few more details on our financial performance through the third quarter before handing the call over to Brian for further discussion. Looking first at orders, in the third quarter, we saw a decline from the prior year largely attributable to the timing on order placement. In our Test and Simulation business, we generated orders of $104 million, a 26% decrease over the prior year. However, this order volume largely excludes an exciting new order that we received from the US Army valued at over $30 million, inclusive of all options. Similar to the large sensor contract that we announced last year, this project contains options which are funded incrementally, and as such will not be reflected in orders or backlog until each increment is approved by the Department of Defense. Under this new contract, we will design and build the world's largest road simulator for the US army, capable of testing multi-axial vehicles weighing up 100,000 pounds under a wide range of simulated road conditions. Once complete, this system will reduce the cycle time for new vehicle testing by up to 80%, allowing the army to field new technologies more quickly and reliably than ever before.

This is a great example of how we leverage our existing expertise and intellectual property, honed over five decades into expanded applications, to provide amazing solutions for our customers. The sheer scale and engineering content of the stimulator is a testament to the confidence

[0:07:41] customers have in MTS to build world-class test and simulation equipment for their specific and often extremely demanding applications.

Service orders for the Test and Simulation business were a highlight in the quarter, increasing 10% from the prior year, while most of the equipment sectors experienced a slight decline. Our Sensors business saw a continuing demand for new products and added $77 million in orders during the third quarter, down only slightly from the prior year. We continue to see broad strength across most of our sensor in-markets, particularly in the Americas region, including both our industrial and test sectors.

However, on a relative basis, 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 general weakness in the European economies. For the first nine months of the year, we generated orders of $361 million in our Test and Simulation business, a 2% increase over the prior year. This, in addition to $254 million in sensor orders, a 6% increase over the prior year, provided a combined company orders growth of 3.5% for the first nine months of our fiscal 2019.

Having summarized our sales drivers, let me next give you some color on our backlog position. From a consolidated perspective, we ended the quarter with a total company backlog of $443 million, which remained significantly higher than historical levels, and is 17% higher than where we were at this same time a year ago. The reduction in backlog from Q2 was driven by the acceleration in our revenue conversion rates and strong production execution in our Test and Simulation business, coupled with a slight reduction in order volume.

Our operations team in the Test and Simulation business continued to deliver on improved production efficiencies and the excellent management of our supply chain. With the investments

[09:39] we continue to make in our operations, we expect these trends to gain further momentum as we complete the year and move into fiscal 2020.

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 2019 and beyond. We believe that the fundamental markets we serve, which are supported by secular strength and new products investment and industrial automation around the world, continue to be positive, and that the shorter-term macroeconomic volatility experienced in our third quarter will correct itself over the long-term. This bodes well for both of our businesses.

Moving next to our topline performance, revenue from our Test and Simulation business was up 28% in the third quarter compared to the same prior year period. This performance reflects outstanding follow-through from our strong backlog position at the end of the second quarter. Our production execution in the first nine months of fiscal 2019 generated a 23% increase in revenues for our Test and Simulation business. We continued to take advantage of opportunities outside of ground vehicles for our custom simulation business, and particularly in our materials tests, in our test services area.

In addition, E2M has expanded the revenue based in our Test and Simulation business, and is performing well in both the flight simulation and entertainment markets as we expected since we acquired the business late in our first quarter. We remain very optimistic about – regarding the continued upside potential associated with the continued integration of our businesses in the months ahead.

We continue to diversify our Test and Simulation business and reduce our overall exposure to ground vehicle development markets through expansion into adjacent market verticals. The award from the US Army after the quarter ended is a prime example of core technology, that we intend to leverage and deliver to our key customers with our market-leading ground vehicles test

[11:36] and simulation solutions. While we continue to view the testing of new ground vehicles as attractive, we recognize that it brings somewhat higher volatility, which can be disruptive through our workforce planning and our overall financial performance. Therefore, our objective is to broaden our market participation, gaining more consistency in our growth and greater efficiency in our engineering operations. With a continued strong focus on adjacent markets where we see favorable demand trends and where we can leverage our world-leading technology expertise in force and motion control, we're beginning to see the benefits of this effort.

While overall sales have increased year-to-date, revenue from our ground vehicles markets have reduced from a historical norm of roughly 45% to 40% today. Looking forward, we expect continued declines in this revenue percentage as indicated by the orders profile in our third quarter, which showed ground vehicle orders at 35% at total. This trend gives us confidence that we will attain our target of 15% in the future while continuing to grow the overall Test and Simulation business. Through this shift in business mix, we expect to experience more consistent growth, decreased volatility, and improved profit margins in the Test and Simulation business.

Looking next at our Sensor business, we continue to expect to grow sensor 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, 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 the second quarter, we expect the growth rates to accelerate and indeed, we delivered 7% growth in Q3, setting a new record for sensor revenues. Given the general market outlook and our strong backlog of sensors for the US military, we would expect this acceleration to continue in our fourth quarter and through fiscal 2020. With this expected strong finish to the year, our full-year fiscal 2019 revenue growth for sensors is expected to be in the 6% to 8% range.

[0:13:46] This topline performance should allow us to deliver our targeted sensors gross margin and adjusted EBITDA margin performance of roughly 50% and 20% respectively.

With a strong outlook for sensors demand in the industrial and test markets, and a continuing opportunity represented by our Department of Defense sales, we remain extremely bullish about our sensor business in the coming years. With a 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 business just this week will further accelerate these positive trends, making for an even more exciting future ahead.

So in summary, we're pleased with our market position and performance trends through the first nine months of fiscal 2019, and looking ahead, it's informative to describe the expectation for each of our business units. For Test and Simulation, while we expect no significant change in our ground vehicle sector, we anticipate growth in our materials and structures equipment sectors and our expanded markets for simulation. In addition, test services will continue to grow as we complete the fiscal year and beyond.

Given the strong revenue performance through the first nine months of the year, we expect slight moderation in growth in the fourth quarter for our Test and Simulation business, which will still provide strong year-over-year performance for this business unit. From a Sensors perspective, after a lot of heavy lifting in the first half of the year and into the third quarter related to several key new product introductions, we anticipate a strong finish to the fiscal year with double-digit revenue growth in the fourth quarter from a year ago level perspective.

With this acceleration in our topline, we expect improved margin performance of both the gross and adjusted EBITDA margin level. To deliver this performance, we simply need to keep doing

[15:38] what we have been doing; that is focusing on execution and providing unparalleled total customer satisfaction.

And finally before handing off to Brian, let me comment on the situation in China and the impact of trade tariffs on our company. As many of you know, we've had success in our China markets for many years, and they continue to represent an area of significant growth potential for us. To date, we've experienced minimal macroeconomic impacts from the tariff enactments, and believe we're well positioned to navigate not only the import/export challenges, but also to minimize any long-term effects of raw materials inflation.

However, as with most companies, the longer that the tariffs remain a headline in the news, the more we could potentially see a degradation in the market, simply because the effect this situation is having on the global macro economy. Indeed, for the first time in recent history, we experienced a degree of softness in orders from China in our third quarter. Now, we're given the robust investments that the Chinese continue to make in new product development and in their domestic university basic research infrastructure, we remain very bullish about our long-term future there.

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'll start today with some exciting events that occurred following the close of our third quarter. I'd like to start by providing a little more background on recent changes in our capital structure. The first is the successful senior unsecured bond offering completed on July 16th 2019; and second, the expiration of term of our tangible equity unit offering completed in July 2016, both items occurring subsequent to our quarter end.

[17:21] We have continuously monitored the debt and equity markets to determine what type of security offering would provide the optimal structure and liquidity that we believe supports our business strategy and keeps the cost of capital for MTS in an optimum range. With these considerations in mind and with the rate cuts just enacted by the federal government already been priced into the markets, we believe that our timing was excellent.

After meeting with a large number of fixed income investors, we were very pleased with the overwhelming interest in our company and our bond offering. This enabled us to conclude with an interest rate of 5.75% and with the initial offering being upsized from the initial $300 million offering to $350 million. With the success of this offering, we are able to completely pay off our existing revolving line of credit balance which was used to acquire E2M Technologies in November 2018, as well as pay down over $200 million of our Term Loan B debt, while retaining approximately $50 million in cash on our balance sheet.

This recapitalization and the resulting liquidity position put us in an even stronger position to execute on our strategy of growing the company both top and bottom line and provide even greater long-term value to MTS and our shareholders. In addition to our bond offering, our tangible equity units offered in July 2016 related to the acquisition of PCB fully converted subsequent to quarter end. As you might remember, the DEUs[?] contained both the debt and equity component to them. With expiration of these units we paid the final debt installment and settled the remaining equity component on July 1st 2019, further optimizing our capital structure.

Of note, this conversion does not impact our EPS calculation as we have reported earnings on a fully converted basis since the offering was completed in 2016. Our ability to manage our preexisting debt position through both company performance as well as pay-down of principal contributed to our success in the senior bond offering as we continued to manage our debt and capital in a very efficient manner.

[19:33] On the heels of the completion of our bond offering, just yesterday, we announced the acquisition of the Endevco sensor assets for Meggitt Corporation. As Jeff mentioned in his remarks, this is another great milestone in our Sensors business, which builds further on the legacy of our MTS and PCB brands, adding another highly respected brand with a distinguished 70-year history of providing technology-leading sensor products into the test markets worldwide.

From a financial standpoint, as Jeff mentioned, we paid approximately $70 million for these assets and expect approximately $30 million in revenue on an annualized basis. More context, as well as an exciting vision for our sensor business, will be provided at our upcoming Analyst Day event. From a financing standpoint, the acquisition of Endevco was supported through cash and borrowings from our existing balance sheet with only a slight increase in our leverage. Due to the timing of the transaction near the midpoint of our fourth quarter, we would expect no measurable impact on our forecast for the fiscal year. Guidance for our fiscal year 2020 will be included as usual when we announce our yearend results in November.

Now, I'll move on to the third quarter fiscal 2019 results, with focus primarily on year-over-year quarterly comparison. Jeff already touched upon orders, backlog and revenue performance, so I will start with gross margin. While there was again another significant increase in our consolidated gross margin dollars in the quarter, our gross margin rate for the quarter declined by 260 basis points versus the prior year quarter and 200 basis points year-to-date. This decrease is primarily attributable to the change in revenue mix between our two businesses as growth in our Test and Simulation business was more significant than our Sensors business. With its lower gross margins, this mix shift towards Test and Simulation tempered the consolidated gross margin percentage.

Looking at the individual businesses, Test and Simulation gross margin rate decreased by 170 basis points in the quarter versus the prior year quarter as we worked through certain large custom projects that generally carry a lower gross margin than the overall business. Although a

[21:54] decrease in gross margin rate, income from operations for Test and Simulation increased from 3.7% to 7.4% for the first nine months comparison to last year, which shows a concerted effort by our team to improve overall bottom line performance.

The gross margin rate for our Sensors business declined 190 basis points versus the same prior year quarter, primarily due to the production inefficiencies related to the introduction of an abnormally large number of new products. For the first nine months of this fiscal year, we have seen the margin rate decline to 48.9%. However, we expect to see the margin rate for the Sensors business return to approximately 50% for the fourth quarter, which is our ongoing target for this business, as a result to the focus on resolving previously mentioned manufacturing inefficiencies.

In addition to these impacts caused by the change in our products mix, both businesses continued their ongoing programs, which have begun to lower their cost structures and drive productivity improvement. We continue to manage costs closely to ensure expense leverage aligns with the needs of our business and to be prudent in the investments we undertake to drive profitability. These efforts have resulted in an improvement of 3.2 percentage points in operating expenses as a percent of revenue for the first nine months of this fiscal year.

Operating expenses for the quarter of $62.1 million and $185.6 million for the nine-month period have increased by $2.1 million and $6 million respectively when compared to the prior year same periods, mainly due to the additional cost from the acquisition of E2M as well as additional variable compensation expense from the strong performance of the businesses. We also incurred acquisition-related expenses of $1.1 million and an additional intangible amortization of $1.1 million in the first nine months of fiscal 2019 as a result of the acquisition of E2M.

Total acquisition costs for E2M are expected to be no more than $1.5 million for the year. Net interest expense of $6.7 million increased slightly in the quarter due to the additional drawdown of

[24:16] the revolving line of credit for the acquisition of E2M. Our expectation for interest expense for the year has changed solely due to our new bond offering. We expect interest expense to be $32-33 million in fiscal 2019, with an additional $50 million of debt equating to approximately $700,000 of additional interest in the fourth quarter of fiscal 2019; and non-cash interest charges of $5.4 million for the write-off of capitalized debt issuance fees related to our Term Loan B, which was significantly reduced as part of the bond issuance.

The effective tax rate of 16.1% for the third quarter is indicative of our overall annual expected effective tax rate range for the year, excluding any discrete items for which we recorded a minimal amount in the third quarter. The effective tax rate for the nine-month period was 14%. Our guidance for the full fiscal year effective tax rate is 15-18%. However, we do expect certain discrete tax items to occur in the fourth quarter.

For the third quarter, adjusted EBITDA of $35.4 million increased 27% versus the prior year quarter, primarily driven by improved top and bottom line performance from our Test and Simulation business. On a year-to-date performance basis, the adjusted EBITDA for our Test and Simulation business has increased by 380 basis points in fiscal 2019 to nearly 13% of revenue, and our Sensors business is hovering near 20%.

Our performance in Q3 yielded gap diluted earnings per share of $0.70 per share, a 49% improvement over the prior year, with a nine-month gap diluted earnings per share of $1.97. To remind everyone, our fiscal year 2019 nine-month diluted earnings per share of $2.62 includes an additional $1.32 recorded in our Q2 2018 results in relation to the discrete benefit for the Tax Act. Our adjusted diluted EPS was $0.71 per share for the third quarter and $2.07 for the nine-month period in fiscal 2019.

[26:35] Our EPS performance for the first nine months of the year has us positioned well to achieve our full-year diluted EPS guidance, which has only been updated due to the additional interest expense anticipated in Q4 2019, as a result of the factors mentioned earlier.

We ended the quarter with $76 million in cash, which is in line with where we ended fiscal 2018. We generated $19.3 million of operating cash for the quarter and $50 million year-to-date, with $32.6 million of free cash flow year-to-date approximately 5% of consolidated revenue.

We ended the quarter with total debt of $472 million, a slight decrease from the end of the second quarter 2019. The debt portion of our tangible equity unit issuance from July 2016 was fully extinguished on July 1st, 2019. Going forward, we expect strong free cash flow and available cash balances to help us pay our debt down. Our gross debt leverage ratio at the end of Q3 was 3.53 times, with our net debt leverage ratio at 2.97 times. We expect that our leverage will increase by the end of the fiscal year to be at or below 3.75 times gross leverage due to the Endevco asset purchase, inclusive of the additional $50 million of debt from the upsizing of our senior unsecured bond offering.

E2M continues to hit all the marks we set for the acquisition driving optimism for long-term potential of this business. For the first five months of the year, we have recorded preliminary purchase accounting amounts in our consolidated financial statements and amortization expense of $2.1 million within G&A for intangible assets acquired as part of the acquisition. We expect to record a total of $3 million in amortization for fiscal 2019 or approximately $900,000 in the first quarter of 2019. In addition, we recorded a preliminary $1.1 million inventory fair value adjustment, which increased the inventory balance upon acquisition. The total amount was recognized through cost of sales during the first nine months of 2019 with no more expense to be recognized going forward.

[29:03] Moving to our guidance, due to the strong revenue performance in the first nine months of the year, we are increasing our fiscal 2019 full year revenue guidance range to $875-895 million, and our adjusted EBITDA range to $128-138 million. The decrease in our GAAP diluted earnings per share expectations of now $2.15 to $2.35 and adjusted EPS of $2.30 to $2.50 is almost solely attributable to the non-cash write-off of debt issuance cost for the Term Loan B pay-down, which is expected to be an expense of approximately $0.22 to earnings per share.

The reconciliation to adjusted EBITDA and GAAP earnings per share can be found in our Exhibit F and G in our press release. The continuation of our strong backlog position, growth on our Test and Simulation business throughout the first nine months of the fiscal year, coupled with significant increases in topline growth rates in the second half of the year in our Sensors business have been strong contributors to our solid performance expected for this fiscal year.

For many of you that have long followed MTS, you will remember that Test and Simulation business often experiences quarterly fluctuations throughout the year. Given the timing of our backlog turns and strong performance year-to-date, we expect revenue in the fourth quarter of the year to be slightly down for the first three quarters of the year for Test and Simulation. However, it will still be notably step-up from our prior year comparison.

In summary, we are very pleased with our performance trends throughout the first nine months of fiscal 2019, especially with strong topline and bottom-line performance of our Test and Simulation business. And as I just mentioned, we expect our full year performance to include strong fourth quarter revenue growth from our Sensors business. We continue to be well-served by a strategy that includes expanding our portfolio of products in the rapidly growing sensors markets, staying focused on meeting the demands for new tests and simulations solutions due to evolving technologies and favorable demographics, and continued diversification into adjacent high-growth markets.

[31:24] As a final note, I hope to see you at our Analyst Day on September 4th as invitations are been sent out this week. Our entire team is engaged and excited to share with you how we will capitalize on the opportunities in front of us. For those institutional investors that do not receive an invitation, I encourage you to reach out to us for further information on how you can participate. I'll now turn the call back to Jeff.

Jeffrey Graves: Thanks Brian. So to reiterate, we're pleased with our performance trends through the first nine months of the year, executing nicely on our backlog flow through to revenue and our orders momentum. The clear highlight for the third quarter was the eighth consecutive quarter of record revenues in our Sensors business, along with continued revenue growth in our Test and Simulation business, all while maintaining a robust backlog and the support it provides to our outlook for growth and profitability for the rest of the year.

As we've mentioned over the last year, we've continued to invest in our Test and Simulation business, and are starting to see the return on those investments, both on the top and bottom line. These investments are proven to be very beneficial in not only the organic growth of the core business, but in our ability to integrate E2M and maximize its positive contribution to MTS to date.

For our Sensor business, we look forward to an exciting fourth quarter with strong organic growth expectations and margin performance, and to an exciting year ahead in our fiscal 2020. We continue to focus intently on four key tenets for the remainder of the year. First, we need to keep executing on sensors, leveraging the hard work and new product introduction from the first nine months to deliver accelerated growth and margin expansion. Second, we need to successfully integrate the Endevco product lines, realizing the benefits from this iconic brand and further acceleration of our sensor business. Third, we need to continue taking advantage of the strength in our non-vehicle related test and simulation opportunities. And fourth, we need to continue to successfully integrate E2M Technologies into our test and simulation business without any loss of [33:29] momentum in their current business, which is on an excellent trajectory.

To date, we're executing well on each of these tenets, and anticipate continued success moving forward. We look forward to describing in more detail our company's long-term performance outlook, and on the vision for each of our business units at our upcoming Investor Day on September 4th here in Minneapolis.

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

Operator: Thank you. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Please limit yourself to one question and one follow-up question. Again, you may press star one now to ask a question. Our first question comes from Deepa Raghavan with Wells Fargo Securities.

Deepa Raghavan: Hey, good morning all. Two questions from me. Jeff, can you discuss test outlooks, just given the order decline? Looks like if I were to add back the $30 million different order, you talked about the order declines would have been like mid-single digits. How do we think about momentum exiting fiscal Q3 into Q4? And so far in July, I mean, you only have two more months, right? So if you can discuss just the momentum going in, and also if you can discuss some of the steps that you're taking to protect margins there?

Jeffrey Graves: Yeah, now great questions Deepa. So let me start with the commentary on the results of our backlog. Backlog to date is up 17% for the first nine months. So given our backlog and our expected returns into revenue and margin performance, that means we're well set for Q4. Obviously, what we said was we expect a kind of a deceleration there, but still some nice growth and that really brings us to the end of the fiscal year. So we feel good about that.

[35:25] Your first question around orders outlook, it's always a difficult one. I would tell you our -- because in Test and Simulation, they tend to be larger orders and that makes for a lumpier profile. On the bright side, our opportunity pipeline is extremely robust. We have a very good visibility into our 12-month pipeline; it again sits at over $1 billion as it has for the last couple of years, so that's comforting that there is good secular demand in the business. There's good demand, and I would say that broadly geographically. On a short-term basis, there's always worries and this – the worry of the day, obviously, are the events in China and the general slowdown in Europe, both of which we've seen in order intake rates in the third quarter here.

On Europe, Europe is more of a general kind of malaise there. But with the liquidity position their bankers have taken and all of that, it looks still like a very good market and we're bullish on that as we always are.

China is obviously much more volatile, and predicting directionally which way that goes is always hard in the short-term. I would tell you I love China in terms of our long-term outlook. They are trending on large investments in their commercial laboratories for development of automobiles and car and airplanes and all of the cascade down into their basic industries. So they continue to invest large amounts of money in those areas for long-term infrastructure builds. They continue to invest a lot in building a bridge design, and earthquake simulation, a lot of the good basic research that goes on with building cities and bridges and infrastructure. So all of that looks very good for the long-term.

The question is always around short-term performance, and I don't have any great wisdom on that. Clearly, Q3 was not tremendous in terms of order rates in China, but at the same time, it's good and solid. So I love the long-term outlook. The short-term outlook is iffier[?]. I will remain optimistic that they get the trade issues settled relatively soon. And with that, I think there's a lot of good pent-up demand for our products from a secular standpoint.

[38:04] So all of that's to say, I can't shed an enormous amount of light on the short-term. And again, Q3 was a tougher quarter in terms of order intake rates, and we wait to see. But given our long-term pipeline and our outlook, I remain very bullish on China in general, and we're a very well diversified company. So sorry, I can't be a little bit more quantitative than that, but again our backlog being up for the first nine months, substantially gives us the nice buffer. And my hope is they get these disputes settled fairly quickly and we get back to some nice growth there.

Deepa Raghavan: Got it. So, second question on defense spending. I mean, that's been on a multi-year high, I mean, just at least from a US perspective. And it seems like that will stay that way for some time. Should we continue to think about continued opportunity stream for you guys looking ahead? I mean, what's your view on momentum there since your initial win and how much has been added since then? How do you know – that seems to be one end market we could have a non-consensus, non-cyclical view on, so just curious how do you see momentum there, just given the government[?] is situated[?] to spend there?

Jeffrey Graves: Yeah, great question Deepa. So clearly, we benefited from military spending. We've historically never been a large supplier to the military, and even on a total basis now, we're still not a large player, but it has been a really nice uplift for our business. We've got some compelling sensor technology for basic military platforms, which is I think highly sustainable as they continue to build out the military. So not only have we talked about the contract we've landed, but we see more opportunities on the horizon there, and that's really encouraging to us, and the proof will be in the future. But there's some good build-out of basic platforms in the military that are being refreshed, which I think it bring us some benefit. And now what you see in the Test and Simulation side of the business is the funding is getting down now on to the basic infrastructure for the military, which really had not been invested in for years. This new road simulator that we're doing for the US Army, fabulous project. I mean, it's been talked about for several years, and now they actually are placing – have placed the contract with us that will bring them good, basic simulation capability for decades to come.

[0:40:38] So I think you're still seeing the flush out, if you will, of the military spending in the economy. I don't think we're unique in that way, but we are very well positioned, both on the sensors and the test and simulation side of the business. So I'm very bullish on it. I think it will continue to provide a lift for several years to our company.

Deepa Raghavan: Got it. Brian, a question for you. Can you talk about the guide here? I mean, revenue outlooks are better, leverage not that strong, and the EPS range is still pretty wide. I mean, how should we think about the high end versus low end, given you have only two more months to go? What are the risks there? What's the upside and back to one of my earlier questions, how are you planning for margin protection in this environment? Thank you.

Brian Ross: So as far as the overall range being pretty good, I would state that overall as we look at the business, we've talked about a good growth trajectory for our Sensors business when you think about it overall. So that could certainly help with some upside and as we've got to the end of some of our operational inefficiencies with new product introductions that we've had, we could certainly see a lift from margins there. In addition to the test side of the world, we do have a pretty large backlog that feeds the fourth quarter revenue for us. In addition, we take orders that will ship within this quarter, and it's just the mix of what we see in there.

So we certainly are focused on margin and production efficiencies within our Test and Simulation business, so there's just a range in there that we see that. I do want to make sure, and I think that we pointed it out specifically that really the only decrease in our guidance range was just because of a pretty large amount of write-off of non-cash expenses for our EPS change. Otherwise, you would see in there just a general increase in the overall EPS.

Deepa Raghavan: Yeah, got it. But can you talk about margin protection measures you may be taking to your end? Just give us a [inaudible] backdrop?

[0:42:50]

Brian Ross: Yeah, so overall, over the last couple of years, we've been very diligent on the orders that we've taken. And we took a lot of first-of-a-kind orders preceding up to the first couple of years where we did have some margin degradation. So we've already implemented the process of making sure we get the right economics on deals and ensuring that we can fulfill those in the timeframe that we need to and the cost that we need to. Ad then as we look at the orders profile in the future, we continued to be very diligent about that as well.

Jeffrey Graves: So Deepa, if you look at our backlog in Test and Simulation, which it is a backlog-driven business. As Brian said, we're pleased with the with the margin profile in backlog being a strengthening profile, so that's good, where the risk is very manageable in backlog. We've implemented a number of changes there to better balance the risk profile of execution with the total volume. And then as we said, we should see acceleration in our Sensor business. While test may be coming off of the highest growth rates they've experienced this year, it is still growing, but over the – off the highest growth rates, we should see an overall lift in margin from just the overall business mix towards sensors with their higher margin performance.

Deepa Raghavan: That's very helpful. I'll pass it on. Thank you.

Jeffrey Graves: Thanks Deepa.

Operator: Thank you. Again, a quick reminder, if you'd like to ask a question you may press star one now. Our next question comes from John Franzreb with Sidoti & Company.

Jeffrey Graves: Good morning John. John, we're not getting anything on this end.

Operator: John, if you muted your phone, please unmute.

[0:44:53]

Jeffrey Graves: Like we [inaudible] you speechless, John.

Brian Ross: Operator, why don't we ask for more questions and give John some time if he needs to hop back on?

Operator: There are no additional questioners at this time.

Jeffrey Graves: Okay. So just to wrap up, 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 and hope to see you at our Analyst Day in September. Thanks and have a great day.

Operator: Thank you ladies and gentlemen, this concludes today's presentation. You may now disconnect.