Company: **MTS SYSTEMS**

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

Conference ID: **8744810**

Moderator: **Laura Fox-Anderson**

Date: **February 4, 2019**

Operator: Good day and welcome to the MTS First Quarter 2019 Earnings Conference Call.

Today's conference is being recorded. At this time I would like to turn the conference over to Mr. Brian Ross, MTS Senior Vice President and Chief Financial Officer. Please go ahead.

Brian Ross: Thank you, (Karen). Good morning and welcome to MTS Systems' Fiscal 2019 First 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 for our call this morning. As usual on our call today Brian and I will highlight the performance for the quarter and our view to the rest of the year, but I have to say at the outset this quarter the most significant change is the exceptional growth in our backlog of new business.

At the end of our first quarter of fiscal 2019, our backlog exceeded $500 million for the first time in our company's history, representing a 24% growth in consecutive quarters and a whopping 45% growth year over year. These figures are exceptional for us, particularly considering that we ended our fiscal 2018 on a high note with a record backlog to that point in time that positioned us well for fiscal 2019.

This sales performance reflects the strength of our technology offerings, our broad geographic exposure and the span of our market verticals in both the Sensors business and our Test and Simulation business. As many who have followed our company are aware, our focus in recent years has been on executing a growth and diversification strategy, capitalizing on our market-leading sensors and test and simulation equipment, along with a strong focus on providing optimal service to our valuable customers across the globe.

In short, we're leveraging the strong core technologies in both of our business units and prioritizing the launch of new products and services in adjacent markets to both accelerate our growth and diversify our market exposure. While momentum has been building for some time, this quarter I believe it's become very clear to everyone through the consistent momentum and order rates and the dramatic increase in size and quality of our backlog. We expect to see this momentum continue, translating to sustainable value creation for our customers and our shareholders alike.

While we've been very pleased with our organic orders performance and backlog growth, another example of our continuing diversification strategy is our acquisition of E2M Technologies last November. As a reminder, E2M complements our existing simulation business from a both a technology perspective and through entry into new high-growth adjacent markets: flight simulation and entertainment, which is commonly referred to as theme parks.

While the acquisition of E2M occurred late in our first quarter, the integration has gone well and our expectations for delivering top-line growth, as well as accretive margins to MTS, in fiscal 2019 remains unchanged. This is a model we would expect to continue to executing opportunistically in the future.

With these general comments out of the way, let me share a few more details on our first quarter fiscal 2019 financial performance, which Brian will add more detail to shortly. In the first quarter, we generated orders of $125 million in our Test and Simulation business, which is a 15% increase over prior year, and orders of $98 million in Sensors, which is a 28% increase over the prior year. These results reflect a continuation of the positive momentum we'd established in fiscal '18 when we finished the second half of the year with then record orders of $456 million for the six-month period.

Test and Simulation orders in the first quarter were again supported by strength in the Structures and Materials markets, with continued growth in services. Orders in ground vehicles continue to be weaker than historical norms, as our customers continue to invest heavily in safety-related testing of new vehicles. However, we did see a slight uptick in orders for the quarter compared to the same prior-year period. Our continued efforts to drive and improve balance of orders across the higher growth Test and Simulation markets that we serve is paying off.

From a Sensors perspective, we had another record orders performance in the first quarter of fiscal 2019 after having just set a record for sensors orders in Q4 of '18. This continued momentum is coming from broad strength across all end markets, including both the industrial and test markets, which led to another outstanding orders performance and resulted in a book-to-bill ratio of 1.26 in the first quarter. Most importantly, the strength in our orders and increase in our backlog is the underlying reason we have confidence in our ability to achieve double-digit top line growth in Sensors moving forward.

The first quarter orders included the second purchase order associated with our Department of Defense contract, giving us a total of two funded orders of roughly $20 million each, which are now included in our backlog. As a reminder, our DOD sensor contract, inclusive of all options, totals approximately $187 million over the next five to seven years.

From an overall company perspective, we're very pleased with our backlog position. Our performance from this perspective in the quarter was very, very strong. We believe this is a significant leading indicator of our ability to deliver on our expectations for growth and expansion in profitability in fiscal 2019. More importantly we believe the market dynamics which we are experiencing will continue to provide momentum and further strengthen this key leading metric.

Moving to our top line performance, revenues from our Test and Simulation business were up 6.2% in the first quarter compared to the same prior-year period, reflecting solid follow through from our strong orders performance in the second half of 2018. We believe this is repeatable as we continue to take advantage of opportunities in the non-ground vehicle sectors of our Test and Simulation business, namely materials and structures, as well as test and simulation services, which have all been experiencing growth.

In addition, E2M will expand its contribution to our revenue base in the Test and Simulation business as we fully integrate it throughout the remainder of the year. As I mentioned last quarter, we're working hard to diversify our business within the Test and Measurement space, reducing our overall exposure to ground vehicle development markets over the longer term. While this market segment has been a part of our business for decades, it brings with it somewhat higher volatility which can be disruptive to our workforce planning and our financial performance.

Therefore over time we'd like to preferentially grow in adjacent markets where we see increasing demand trends and where we can leverage our world-leading technology experience in force and motion control. As a result of these efforts, Test and Simulation equipment sales to our ground vehicle customers was approximately 25% of our total revenue in Q1 of '19, down from its historical levels of 35 to 40%, and we expect our long-term target of 15% to be achievable.

Demand for our sensors products continues to be steady as industrial markets across key geographies were supported by economic strength and favorable market trends. Sensors revenue growth of 2.6% in the first quarter compared to the same year - prior-year period was strictly attributable to the timing of shipments and will increase throughout the year, driven by our strong backlog position and continued robust sales.

Of note, during the quarter we had minimal shipments on our two purchase orders associated with the DOD contract, which were approximately $40 million combined and longer term in nature. We expect these orders to turn to revenue equally in fiscal 2019 and 2020, which is a slight deviation from the normal commercial order-to-revenue cycle for our Sensor business.

Over the next three quarters we expect revenue to increase related to these DOD orders, as we have now completed the reconfiguration of our production lines to support higher volumes and we will be ramped up to full production by the second half of this year. With the outstanding orders performance in Q4 of fiscal '18 and Q1 of fiscal '19 and continuing broad market strength, we continue to expect fiscal 2019 to be another year of double-digit growth for our Sensors business.

As for our view ahead, for our Test and Simulation business while we continue to plan for volatility in the Ground Vehicle sector as we move through '19, the growth in our 12-month opportunity pipeline indicates increasing stability in this market vertical. We expect our Structures market to be stable with a slight positive trend but, as always, lumpy quarter to quarter due to the size of individual projects that characterize this sector.

Test and Simulation services again had an excellent first quarter and we continue to believe our Service business is an underpenetrated and underappreciated part of our core Test and Simulation business. Benefits from this portion of the business will be increasingly impactful to our customers and to our shareholders in the quarters and years ahead.

From a Sensors perspective, I'll repeat what I said last quarter. Our end markets remain healthy and our new product pipeline strong. We simply need to keep doing what we've been doing. That is focusing on execution and providing unparalleled total customer satisfaction. We're positioned very well in sensors.

One other popular question that I'd like to address is our business in China and trade tariffs. As many of you know, we've focused on our China markets for many years and they represent an area of significant growth for our company. We continue to see strong demand in this region, with an increase in year-over-year orders. In addition, we've experienced only minimal macroeconomic impacts from the tariff enactments and we feel we're well positioned to navigate not only the import and export challenges but can also minimize any long-term efforts of raw materials inflation.

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

Brian Ross: Thank you, Jeff. I will move right into our first quarter fiscal 2019 results with focus primarily on year-over-year quarterly comparisons. Jeff already touched upon orders, backlog and revenue performance so I will start with gross margin. Our gross margin rate for the quarter declined by 160 basis points compared to the first quarter of fiscal 2018 but held fairly steady with the fourth quarter of fiscal 2018.

Test and Simulation gross margin rate decreased by 160 basis points due to the continued investment to improving sustainable long-term project execution tools, the E2M acquisition inventory fair value adjustment from purchase accounting valuation, and a slight increase in variable compensation expense. An important metric to call out for our Test and Simulation business is that income from operations increased from 4.7% to 5.8% of revenue when comparing current quarter results to last year, which shows a concerted effort by our team in improving overall bottom line performance.

The gross margin rate for our Sensors segment declined 140 basis points versus the same quarter results in fiscal 2018 because of production inefficiencies incurred from the introduction of new products and a mix shift from lower revenue in the high margin Energy sector being replaced with revenue from lower margin markets. Compared to the fourth quarter of 2018, we saw a nice sequential rebound back to near 50% gross margin, which is our target for this business, proving that the unusually low margin in the fourth quarter was temporary in nature.

In addition, both segments have ongoing programs that have begun to lower their cost structures and drive productivity improvements. Operating expenses of $60.3 million decreases by $1.1 million from the prior-year quarter as we continue to manage cost closely to keep our expense leverage aligned with the needs of our business and to be prudent to any investments we undertake to drive profitability. We achieved this decrease despite incurring acquisition-related expenses of $800,000 and an additional intangible amortization of $400,000 from the acquisition of E2M.

Net interest expense of $6.8 million was consistent with our prior-year quarter, which is attributable to our significant pay down of debt in fiscal 2018, offset by the additional funding drawn on a revolving credit line for the acquisition. We continue to expect interest expense to be $6.5 million to $7.5 million per quarter for the rest of fiscal 2019.

The effective tax rate of 6.2% for the first quarter includes an additional discrete tax benefit of $1.3 million due to the true up of, and finalization of, the measurement period for the tax act that was enacted in December of 2017. Without the discrete benefit from the tax act, our tax rate would be 17.8%, in line with our guidance for the full fiscal year effective tax rate of 15% to 19%.

Fourth quarter adjusted EBITDA of $30.1 million increased 12% versus the prior-year quarter with improved top line and bottom line performance from our Test and Simulation business. Our improved performance in Q1 yielded us GAAP diluted earnings per share of 54 cents per share, and our adjusted diluted EPS was 59 cents per share. Our EPS performance for Q1 has us positioned well to achieve our full-year diluted EPS guidance, which I will talk about shortly.

We ended the quarter with $70.4 million in cash, which is in line with where we ended fiscal 2018. We ended the quarter with total debt of $466 million, which is up about $78 million from the beginning of the year. We drew approximately $80 million from our newly renegotiated revolving line of credit to pay for the acquisition of E2M. Total acquisition costs are expected to be no more than $1.5 million, of which we recorded $800,000 in Q1 2019.

Going forward we expect strong free cash flow and available cash balances to help us pay down our debt. As a reminder before this deal, we had reduced our debt for eight consecutive quarters and we currently forecast our leverage ratio to decline to 3.5 times or below by the end of fiscal 2019 through a combination of debt payment and improved adjusted EBITA performance.

I would like to discuss a few points regarding our E2M acquisition. We are executing nicely on the near-term integration strategy, which is enabling E2M to execute on their 2019 financial performance. We continue to project the E2M business to deliver top line revenue of approximately $30 million for fiscal 2019, with strong operating margins that are accretive to MTS Test and Simulation margins.

The results of E2M's operations are included in our Test and Simulation business unit. E2M hit all our marks in the quarter, indicating progress for the full year, even with having only been included in earnings since the purchase date of November 21, 2018. We have recorded preliminary purchase accounting amounts in our consolidated financial statements and amortization of $400,000 within G&A for intangible assets acquired as part of the acquisition. We expect to record a total of $3 million in amortization expense for fiscal 2019, or approximately $900,000 in each of the remaining three quarters.

In addition, we recorded a preliminary $1.7 million inventory fair value adjustment that increased inventory during the quarter. Approximately $400,000 was recognized through cost of sales in the first fiscal quarter of 2019 with approximately $1 million to be recognized in the second quarter and approximately $300,000 in the third quarter, all of which costs are recorded as additional cost of sales.

Beginning in fiscal year 2019, we adopted the new revenue recognition standard under ASC 606, as issued by the governing bodies. While there is a relatively immaterial impact to revenue and earnings, the effort and expense incurred to prepare for and to adopt this standard over the last couple of years should not be overlooked, and I would like to recognize the finance and accounting teams, along with the entire MTS organization, for their work with the adoption of this standard.

Moving on to our guidance. We remain confident in our fiscal 2019 full-year guidance of revenue of $830 million to $870 million, GAAP diluted earnings per share of $2.30 to $2.60, and adjusted EBITDA of $122 million to $142 million. These expectations are supported by our outstanding first quarter ending backlog, our return to growth in our Test and Simulation 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 addition, we are introducing a new guidance metric this quarter: adjusted diluted earnings per share. We believe this metric puts us more in line with other industry players and makes it easier for you to compare us to other companies. For fiscal 2019, we expect adjusted EPS to be $2.42 to

$2.72 per share. The reconciliation to GAAP earnings per share can be found in Exhibit F of our press release. The add-back adjustments include acquisition-related expenses, restructuring charges and the fair value step up of inventory for the acquisition or E2M.

In summary, we are pleased with our financial performance for the first quarter of fiscal 2019, especially with the phenomenal backlog delivered by both businesses. We were well served by our strategy that includes expanding our portfolio of products in rapidly-growing sensors markets and staying focused on meeting the demands for new test and simulations due to evolving technologies and favorable demographics. As part of the diversification piece of our 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.

I will now turn the call back over to Jeff.

Jeffrey Graves: Thanks, Brian. So to reiterate, we're off to a solid start to the year. The clear highlight for Q1 was the significant growth in our backlog during the quarter and the support it provides to our outlook for growth and profitability in the year ahead. While this backlog growth rate may be hard to improve upon, we do expect overall strength to continue in each of our business segments as we move through the year

As I stated last quarter when we introduced our thoughts on fiscal 2019, we're strongly focused on three key tenets. First, we need to keep executing on sensors. Second, we need to continue taking advantage of the strength in our non-vehicle related test and simulation opportunities. Third, we need to successfully integrate our newest acquisition of E2M Technologies without any loss of momentum in their current business, which is on an excellent trajectory. So far we're executing well on each of the tenets and anticipate continued success moving forward.

With that Brian and I are happy to take your questions. (Karen), I'll turn it to you.

Operator: Thank you. If you would like to ask a question, please signal by pressing star 1 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. Again press star 1 to ask a question. And we'll pause for just a moment to allow everyone an opportunity to signal for questions.

Our first question is from John Franzreb with Sidoti & Company. Please go ahead.

John Franzreb: Good morning, Jeff and Brian.

Jeffrey Graves: Good morning, John.

Brian Ross: Morning, John.

John Franzreb: Jeff, I'm going to start off where you started off with the backlog and end it for that matter. Could you just talk a little bit about the strength you're seeing in both materials and structures and what's driving that demand?

Jeffrey Graves: Yes, John. It's a few very specific things. Thanks for asking. On the materials side, there is an absolutely - absolute explosion in two key areas. One is the use of advanced materials like carbon fiber composites. They are quickly moving from, you know, high end large aircraft application to smaller aircraft and on now to ground vehicle and many other applications. The carbon fiber composites are just booming, and with that the need for end customers and developers of the material to test those materials. It's - it requires an awful lot of testing in order to develop the design data.

So advanced materials is one of it. And you can lump in there new aluminum alloys and some other lightweight high strength materials. But that whole wave of light-weighting of vehicles is really sweeping many industries. The second broad-based driver of our materials test business is additive manufacturing. You know, the - with the advancement in the equipment technology for making parts through additive manufacturing, their ability to make really exotic geometries is increasing very fast.

The unusual part though is the material properties you get when you additively manufacturer something are often very unique so they have to be tested, and we've been spending a lot of money on R&D to develop that capability and we're now fielding equipment that's very targeted toward the additive manufacturing market for testing. So in materials those two broad trends are really driving it and it's very global.

I would tell you from, you know, US, Western Europe, China, India and elsewhere, those two trends are very global. On the structure side, John, there is a fairly clear interest in developing safer, more reliable civil infrastructure, meaning buildings and bridges, and we have a unique very long-term position in making test equipment to test the impact of earthquakes and other seismic events or even tsunami events on that civil infrastructure. So we're doing very well in that area.

That tend to be, as you know, large, lumpy projects but with the increased storm activity in the world and earthquake events, a lot more countries have a need and the money to invest in basic understanding of how to design and build buildings and bridges that are safe. So we're selling a lot of that equipment around the world and it's something that we are I think very uniquely and well positioned for. So that.

And then you've got the usual -- in structures -- you've got the usual aircraft expansion. There's new aircraft being launched, and we're very good in that business as well. So you've got the ongoing trends for the aircraft manufacturing and other heavy vehicle type applications that require what we would classify as structural testing activities.

John Franzreb: Okay. Now did some of those jobs come in earlier than you anticipated in the first quarter and as a result that was a big unexpected order intake in Q1?

Jeffrey Graves: I wouldn’t say that, John. You know, the large structural stuff is a bit unpredictable. So, yes, one order did come in. It wasn't, you know, abnormally large so it didn't unduly influence the backlog but we might have expected it Q2. It really came in Q1. But we've got other things out in Q3 and Q4 which may shift forward or backwards as well. So, as you know, structures is just a bit of a lumpy business.

But we also had, I would point out, a fairly significant order in Q1 of last year in the structures area as well so the year-over-year comparison is still very valid. So I wouldn’t say it's unusual. I was pleased to get a large order in Q1, but it didn't unduly shift the backlog.

John Franzreb: Okay. And then, so can you just give us a sense of what Test was, the backlog legacy, you know, if you exclude E2M what it kind of looks like on an organic basis?

Jeffrey Graves: Go ahead, Brian.

Brian Ross: Yes, so, John, overall if you look at where we ended the year last, our backlog was roughly about $415 million, really strong orders here within the quarter, and we saw sequential growth, you know, roughly in the 10-plus percent range. So that's the organic without the acquisition.

John Franzreb: That's test organic or companywide organic?

Brian Ross: That's - sorry, companywide organic, and that's split between both businesses.

John Franzreb: So what would test organic be because I know you have a double-upping in the DOD job in the quarter also?

Brian Ross: So the growth within the corner as far as backlog for Test alone from year end -- sorry, let me look at the last year.

John Franzreb: It's ((inaudible)) 346 I believe.

Brian Ross: So without that amount…

John Franzreb: Jeff, can I ask you one more question?

Jeffrey Graves: Yes, that's okay. Go ahead and then Brian will be checking the numbers for you, John. Go ahead.

John Franzreb: All right. You know, I guess one more question around if materials is doing so well and structure's doing so well, it sounds like ground vehicle is the offset here. Can you talk a little bit about what's going on in ground vehicle, especially in light of what we're seeing in lower production rates and sales expectations in calendar 2019?

Jeffrey Graves: Yes, John. We've seen what I'd - what I would tell you, factually we had a slight uptick in ground vehicle test orders. It's still well below historic norms but we did actually have a small uptick in orders. So I would interpret that to mean that, you know, people are starting to spend money again on durability and performance testing for ground vehicles, you know, primarily cars. There are a lot of new products being launched and they - our customers had to preferentially spend their money on safety but we see some of that coming back now.

I still anticipate it to be choppy but it was nice to see a little uptick. It didn't contribute substantially to orders and backlog but it was nice to see an uptick and not a drawdown in vehicles. So it was on - certainly on the low end of performance but it was at least stable and growing a little bit. So, Brian, you want to come back to that?

Brian Ross: It was about 10% growth from the year end, so roughly if we're at 346, you add that same amount, ((inaudible)) number.

Jeffrey Graves: So it's the test growth rate that John asked about it?

Brian Ross: Yes.

John Franzreb: Great. Thanks a lot guys. I asked a lot. I'll get back into queue.

Jeffrey Graves: Okay. Thanks, John.

Operator: Again if you'd like to ask a question, please press star 1. Our next question is from Rich Kwas with Wells Fargo Securities.

Rich Kwas: Hi. Good morning.

Jeffrey Graves: Good morning, Rich.

Brian Ross: Good morning, Rich.

Rich Kwas: How are you? How are you doing?

Jeffrey Graves: Good.

Rich Kwas: Just a few questions here with regards to the DOD business, the $20 million, the two contracts. I think, Jeff, you mentioned something about -- or maybe it was Brian -- talking about the contribution equally. What do you mean by that in terms of - is that the dollar amount equally over the next three quarters? And then what's the cadence of that full $40 million? How does that roll into the numbers here? What's the timeframe?

Jeffrey Graves: So, Rich, in Q1 we had very little, very minimal contribution in revenue from the bookings on that. So if you remember, we had a $20 million PO in Q4 and another $20 million here in Q1. We had virtually no revenue in Q1 from that, and quite frankly we spent the end of our fiscal '18 and early '19 in reconfiguring the production line for this anticipated volume that's coming. So we landed the two POs, one in Q4, one in Q1 here. We had virtually none of the revenue in Q1. It will ramp through Q2 but we really won't hit full production stride on those purchase orders until the second half of the year, Q3 and 4.

And that comment about splitting it, what that'll really translate to is we'll realize about half of the revenue from that $40 million here in Q -- and correct me, Brian, if it's different -- in fiscal '19 and about half in '20.

Brian Ross: That's correct.

Rich Kwas: Okay. Okay. So equal. And so it sounds like this is going to be within the 20 for the year for '19. The majority of that should be booked in FQ4, right? Is that the right way to think about it?

Jeffrey Graves: Yes. It should turn to revenue. Yes, the POs firm. It's in backlog. It should turn to revenue in the second half of the year, Rich.

Rich Kwas: And then as we think about '20, that run rate continues over the balance of the four quarters of '20, it should be relatively even contribution over the course of '20?

Jeffrey Graves: Yes, correct. I would expect, given the run rate in the second half of the year, it'll - that PO would be primarily fulfilled I'm thinking, Brian, first half of '20.

Brian Ross: Yes.

Jeffrey Graves: And then we're again, Rich, we're very optimistic. That full contract's $187 million so we've now booked $40 of it. With all the options on it, it's worth $187 million. So, you know, if this military funding continues in things we would expect that to live into its potential looking out into '20 and beyond.

Rich Kwas: Okay. And then I guess on the ground vehicle side if we - some of the other industrial players and automation companies have talked about weakness in project activity, weakness in MRO, inclusive in the US, North American market, when you look at that business, I know you - I realize you have an uptick in orders here on a year-over-year basis, a slight uptick, but when you look at the business, regionally speaking, are you seeing any sort of meaningful weakness when you look at China, Europe, North America and, you know, China's been weak in terms of underlying retail sales for a period of time at this point. Europe has - is starting to soften up recently. Just curious in terms of what you're seeing around that activity, particularly on the auto side within the ground vehicle.

Jeffrey Graves: It's interesting, Rich. From our perspective, the overall spending levels have been down but from a geographic perspective, it's very uniform, you know, across Europe, the states and China. And the frustrating thing for us has been, you know, our orders are derived from their spending on new product testing and they have been developing a lot of new products, they just haven't been doing the type of testing that requires our equipment. It's been more safety testing.

So again, we, you know, we anticipate at some point that trend will shift back but what we're seeing right now is pretty uniform performance around the world and at a historically low level but stabilizing, okay? So we did see a slight uptick in orders, and I don't want to oversell that. It wasn't glamorous but it was nice to see it, at least the arrow pointing upward and not downward, and it's pretty uniform around the world. So that's what I can tell you about it. They do have a wonderful array of new products they're developing. They're spending a lot of money on it but unfortunately a lot of it's going into safety. From our perspective, it doesn't fuel out business much.

Rich Kwas: Okay. So it's pretty uniform, nothing significant across the various geographies.

Jeffrey Graves: Correct.

Rich Kwas: Okay. And then just a housekeeping question for Brian with regards to the restructuring here that was taken in the quarter. Was that for the core business and was that in costs of goods sold?

Brian Ross: No, so it was - the restructuring was just kind of the ending piece of what we took action on in China over a year ago, so as that program rolled out. And it's, you know, there's some sitting in cost of sales, yes, and a little bit in the operating line.

Rich Kwas: Okay, so it covers both. Okay. Great. All right. That's all I had. Thanks so much, guys.

Jeffrey Graves: Thanks, Rich.

Brian Ross: Thanks, Rich.

Operator: And we'll take another follow-up question from John Franzreb with Sidoti & Company.

John Franzreb: Yes. Jeff, could you just help me understand why you can't participate more in the safety side of the business in ground vehicle, especially since you mentioned earlier, you know, the safety side is what you're benefitting from in the structures market? I mean I'm also curious if E2M brings something you could also leverage into the ground vehicle market. Could you just, you know, talk a little bit about that, the greater dynamic there?

Jeffrey Graves: Yes. Sure, John. The - very specifically, the safety that is done now, the safety testing that's done now in automotive is for crash avoidance, so it's related to these new, you know, more autonomous cars avoiding a crash. Historically it's been survival of the crash and, you know, that's very specific crash flood kind of equipment and stuff. We were in that market very early but this is many, you know, it's a couple of decades ago. We were in that market early. We didn't participate broadly and don't now.

But the money they're spending now, John, is on crash avoidance and it's really track testing, so getting out in real world environments and trying to avoid a crash. So that equipment is not mature, the equipment that's used for that. It's very OEM-specific and it's a very fluid market. So we've not found the right entry point in crash avoidance testing and, you know, we can't really at this point identify what a good return on the investment would be. So we haven't participated largely. The OEMs have many be a do-it-yourself shop in that arena and doing a lot of track testing.

So that's the story on safety. Eventually the durability of the car, the aerodynamic performance of the car, the equipment that we make to support that will come back as a need but right now it's been predominantly safety testing. You asked a good question about E2M. We have - with the E2M technology and expertise, we have a broadened capability for simulating driving environments, so doing driving simulators, and that does open an opportunity because those are used much more extensively in autonomous vehicle development to look at the interface between the car and the driver during autonomous driving.

So we do have an opportunity there and it's - but we also have some marvelous other opportunities in flight simulation and in entertainment that we're clearly going to exploit. So what we continue to do in, you know, ground vehicle simulation we will do activities there in a very focused way but it will compete what we do in other market adjacencies.

John Franzreb: Got it. Got it. And you touched on China in your prepared remarks. I'm sorry, were China orders up for you in the quarter?

Brian Ross: Yes. Overall China we, you know, I would say it's a little bit flat for us right now but we did have a slight uptick in the order, so if you think of revenue and orders. But we're still seeing kind of our same type of business. In 2018 we talked about really nice growth there. It's moderated slightly but we're still in pretty good position for it.

Jeffrey Graves: And, John, the way to think about that continuing demand is, you know, we sell equipment, as you know, into new product labs and R&D labs and China's spending a boatload of money in that area to develop an automotive industry and, you know, aircraft industry and to expand basic research. So there is a continuing demand for testing equipment in those areas that we see as fairly robust.

John Franzreb: Okay. And I guess two more questions. Jeff, it seemed like you are optimistic about your service revenue as it unfolds in 2019. Is there any particular reason? Are you having more success, you know, with customers? Can you just talk a little bit about that?

Jeffrey Graves: Yes. John, services is being very well received and it's, you know, we continue to grow, you know, high single digits, occasionally the double-digit level, of services orders and revenue and the margins have improved now. They're nicely accretive to the overall Test and Simulation business. So we love that business. Customers love that business.

We are rate limited by how many people we can hire and train. You know, we went through a wave of retirements. There's a lot of people that do that work are career-long people. We went through kind of a wave of retirements over the last few years that we had to replace, plus we had to grow. So we've been doing a lot of hiring and training of service techs around the world. We have about 350 today, roughly, spread around all of the major continents we do business on, and they do a tremendous job. Customers are very happy with them.

So we continue to hire and train, you know, about 10% - it translates to about 30 to 40 people, say, a year, and we continue to grow that business organically. There's not much we can do in the vein of an acquisition to accelerate it but we will continue to hire and train and grow. Customers love it. They can source this very high tech maintenance kind of work and service work to someone else instead of doing it themselves. So it's a good deal for them, it's a great deal for us, and we love that business.

I think it remains kind of underappreciated in the market but we are right at that $100 million mark now and it's an over $1 billion kind of an opportunity for us out there but at least half of which is very strong margin business. So we continue to invest heavily in it and even from an R&D perspective, for software upgrades, spare parts, things like this to keep our equipment running, which is designed to run for decades. So it's - we view it as a great part of the business. We expect it to continue to grow high single-digit kind of levels, maybe occasionally a double-digit level going forward. So it'll make more and more contribution to the business.

John Franzreb: Okay. And one final thing. On the R&D line, maybe this is for Brian, I know in the past that, you know, you can shift personnel from R&D to, you know, COGS or whatever depending on the job cycle, but it's gone down meaningfully in the last two quarters. I wonder if there's any reimbursements there, anything going on that line? What are we thinking about the total R&D spend for fiscal 2019?

Brian Ross: Yes. So it should be relatively in line with where it is for Q1, give or take a couple percent, but as far as reimbursement, there's not, so. But I would say that we're pretty solid on the ground with our R&D expenses as we see it now.

John Franzreb: Okay. Thank you guys for taking my questions.

Jeffrey Graves: Thanks, John.

Brian Ross: Thanks, John.

Operator: And with no further questions in the queue, I'd like to turn the conference over to Dr. Graves.

Jeffrey Graves: Thanks, (Karen). So thank you all very much 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. Thank you and have a great day.

Operator: This concludes today's call. Thank you for your participation. You may now disconnect.