Company: **MTS Systems**

Conference Title: **MTS First Quarter 2020 Earnings Call**

Conference ID: **9681358_1_WcjSnu**

Moderator: **Laura Fox-Anderson**

Date: **February 4, 2020**

Operator: Good day, and welcome to the MTS First Quarter 2020 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Brian Ross, MTS Executive Vice President and Chief Financial Officer. Please go ahead, sir.

Brian Ross: Thank you, (Shelby). Good morning and welcome to MTS Systems' Fiscal 2020 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, 10Q and 10K. 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.

Dr. Jeffrey Graves: Thank you, Brian and good morning, everyone. We appreciate you joining us on our call this morning. I thought I'd change the format slightly for this call this quarter in light of recent events in the world ranging from the optimism that a company's signing a new trade deal to the fear associated with the outbreak of a new virus. In this context, I'll share our view of the road ahead for MTS and then I'll ask Brian to review the quarter and our outlook for the full year.

As longer-term investors in the company understand, our test markets can be very dynamic as our customers adjust the timing, size or short term priorities of their investments and research and product development. These changes can be driven by market priorities such as the launch of autonomous vehicles, by changes in manufacturing technology or the introduction of new materials such as carbon fiber composites or even economic or environmental factors.

Their adjustments are magnified at MTS as the movement addition or cancelation of large orders reverberates particularly forcefully for a long lead, highly engineered custom products. In the last two fiscal years, we've seen order levels fluctuate quite significantly from the first half of the year to the second which is why we as a management team stick to providing annual guidance in attempt to supplement with color on the short term market environment that can help investors better anticipate trends on a quarterly basis.

Considering our first quarter results, this effect was on full display as we met our internal performance expectations while being short of consensus estimates for the quarter. As you will hear from Brian shortly, we're holding our full-year guidance for fiscal '20 which we expect to be driven by a much stronger revenue performance in the second half than the first half, driven by order trends and in backlog.

Looking ahead over the next several years, this short term volatility will be progressively dampened through the growth of our sensors business which is expanding organically at roughly twice the rate of our test and simulation business as well as the increased scale and market diversity of our test and simulation business.

Along with decreased volatility, these mixed changes will lead to more exciting topline growth, profitability, and free cash flow performance in the years ahead.

With those comments as a backdrop, let me next take this a step further in detail and describe the current underlying drivers for each business unit. Starting with our test and simulation business, our sales process in this case is often very long. Sometimes spanning several years and is driven by capital spending plans in our customer's laboratories. Given our current insights, we anticipate that order rates for our grand vehicle sector have now largely stabilized after an extended period of contraction over the last two years. This stabilization reflects the fundamental need for durability and performance testing, attributes that have been de-emphasized by our customers in recent times, largely due to the redirection of short term spending into safety testing for autonomous vehicles.

In other words, development of crash avoidance technology has taken precedence over durability and vehicle performance. At some point, vehicle durability and performance, areas in which MTS has been a leader for many years, will be reprioritized due to their ultimate criticality. But we're not forecasting this increase yet, instead, we're simply saying the decline has largely stopped and spending has stabilized.

Moving to the other market sectors for our test and simulation business, what we anticipate is continued strength in our material sector and test services moving forward. Materials testing is largely being driven by the expanded use of lightweight structural materials such as carbon fiber composites as well as the increased use of additive manufacturing for component fabrication. We expect this trend to continue well into the future.

Test services growth is simply a factor of our increased focus on maintaining an upgrading our install base of equipment which now exceeds $6 billion worldwide. While these trends are all positive, the most exciting portion of our test and simulation business is now our structure sector which comprises several distinct markets. The first of these is infrastructure testing which is basically high force systems that simulate extreme environmental events such as earthquakes and tsunamis.

MTS was a pioneer in this field and has maintained our leadership for decades. These systems allow our customers to develop safer buildings and bridges that are now increasingly needed in high population regions, particularly in the emerging market where population densities and GDP growth rates are the highest.

We're seeing increased investment in laboratories that support infrastructure development and we're very well-positioned to support this trend from both a technology and service perspective.

Our structure sector also includes aerospace systems which historically mean the testing of airframes and flight engines and now through the acquisition of (E2M) in early fiscal 2019, increasingly focuses upon flight simulation for pilot training and the entertainment industry.

And finally we include the energy market in our structure sector which spans from exploration to generation to transmission markets. Energy, in particularly renewable energy generation has become a strong focus for us and is central to our recent acquisition of the entities of the Danish engineering firm R&D which I'll speak to in a few moments.

So having described the underlying market trends, what does this mean in terms of order rates for our test and simulation business? While the timing of individual orders can shift between quarters, we anticipate very strong orders growth beginning in the second quarter and continuing to accelerate throughout the second half of the year. This growth will be led by exciting trends in our structure sector which we anticipate becoming the largest of our end markets by yearend for the first time in our company's history followed by our materials sector and test services.

Our ground vehicle test sector, which as a reminder includes automotive, truck, bus, and rail applications are anticipated to be roughly 25% of the test and simulation business down from roughly half of the business a year - a few years ago. This diversification of end markets has been a priority for us over the last two years. And we're now seeing the fruits of these efforts. In short, by the end of fiscal 2020, we will achieve a new balance in the test simulation business that will help ensure a smoother, faster-growing, more profitable performance in the years ahead.

To give you an idea of the magnitude of these trends, the strongest order performance for our testing and simulation business in our history was in 2015 with orders of $519 million. This year, we should exceed this level either by small or a wide margin depending upon macroeconomic risks which I'll describe shortly. We expect this to translate to year-over-year organic growth in orders of greater than 9%. Importantly, this does not include our most recent acquisition of R&D which will contribute meaningful growth beyond this level. I'll comment more on R&D as well as risk factors in a few moments.

Now let us turn to outlook for our sensor business which started the year on a strong note of near double-digit topline performance. As you know, our three largest sectors for this business are the test sector which includes laboratories that test new products as well as our Department of Defense contracts, our industrial sector which is primarily targeted toward machine automation and our position sector which comprises both industrial automation and the heavy equipment application such as earthmovers, construction and farming equipment.

In short, the test sector and sensors is very strong. The industrial sector is stable to positive and the position sector soft. With the macroeconomic factors improving, we expect demand trends in each of these markets to be stable to positive from current levels. In addition, the ramp-up of our newly acquired Endevco product lines which primarily support the test sector will add to this momentum increasingly throughout the year. We believe these trends will translate to double-digit order growth for our sensor business for the full year, building substantially upon the record orders booked in fiscal 2019.

So to summarize, our outlook for the full year in terms of order rates is very positive. For the full company, we anticipate topping the billion-dollar mark in orders for the first time ever which alone would translate to over 20% growth from the prior year record that was set in 2018. Given the timing variation and conversation of orders into revenue driven by mixed details, we'll update revenue projections as the orders are booked into backlog each quarter. And that will reflect the timing and any changes we make to our forward annual guidance.

So what could influence this very positive outlook for orders this year? On the positive side, we believe risk stemming from trade tensions have reduced since the signing of the Phase 1 trade deal with China and the USMCA in recent weeks. This has lowered the tension level with our long term customers in China particularly those that our government owns such as university laboratories enabling continued positive planning for the future.

In addition, we believe the initiatives to stimulate economic growth in China and Europe are beginning to gain some traction with increased spending on new products, new services and efficiency initiatives. This is all positive for MTS.

We do, however, see the potential for downside risk because the unknown economic impact of the coronavirus which has now spread to many population centers in China and to a growing number of countries around the world. Our primary concern is first and foremost on the health and well-being of our employees particularly those located in China. We have and will continue to take whatever steps are necessary to assist them in this time of uncertainty and to comply with guidance issued by the governments and health experts around the world.

As we now see the holiday shutdown being extended in China and the increasing barriers to normal commercial activities, we anticipate some degree of new headwinds from these measures. We're hopeful that the duration and impact will be small. We'll provide updates as needed going forward until the situation is resolved.

On a final note before I turn the call over to Brian, we're very pleased to announce the execution of the agreement to acquire certain entities of the Danish engineering firm R&D which provides MTS with another strategic technology portfolio and expands our access to important markets for our test and simulation business. With the execution of this agreement on January 24th of 2020 which is near the beginning of our second quarter, no financial results for R&D were included in the first quarter results.

Our M&A activity has served us very well over the last two years in finding high-quality testing measurement companies that have an outstanding fit with our overall strategy to expand our technology reach and to gain a strong foothold into new adjacent markets that have significant barriers to entry. The combination of these strategic factors provide for accelerated, sustainable and profitable growth.

In addition with the R&D acquisition, we expect to have minimal execution and integration risks similar to what we have experienced with previous acquisitions. As a brief reminder, let me give you some additional insight into the R&D company. The core strength and value of R&D is that the company comprises exception engineers who are experts in the design, development and manufacturing of precision high force test machines that can simulate in a laboratory even the most extreme operating environments for rotating systems.

The manufacturers of wind turbines, R&D's test systems can simulate the extreme wind, land and sea forces that are encountered over the 20-year design life of a modern wind turbine in operation.

Their systems are so accurate and powerful that they can compress these life tests into months or even weeks in a laboratory allowing dramatic reductions in the time it takes for the introduction of new turbine designs. The result is that new and even larger more efficient wind turbines can be confidently introduced into the electric utilities worldwide, accelerating the adoption of these modern clean renewable sources of energy.

Having had great success with wind turbines test systems R&D next expanded their focus more recently into aerospace where they quickly become a recognized leader in the testing of aero engine systems. This puts them on a critical path to the introduction of new aircraft propulsion systems that are more fuel efficient, reliable and cost effective for airlines around the world. With MTS's rich history in the testing of high performance materials and static structures in both wind and aerospace, the addition of R&D's technologies to the MTS portfolio will greatly enhance the value we can bring to these markets worldwide.

R&D's operating entities bring with them a strong backlog of projects in excess of $35 million which with contract duration stretching into 2021. Like MTS, they also have an exciting pipeline of new wind and aero opportunities that will help ensure exciting growth and profitability for years to come. Over the last few weeks we have already begun integrating R&D into our test and simulation business with a particular focus on identifying new opportunities in the energy and aerospace markets.

As I described previously with our exciting organic growth projections and the addition of R&D for the second quarter onward, we expect our structure sector to surpass our ground vehicle sector to become the largest sector in the test and simulation business from this year forward.

From a financial standpoint, the purchase price of R&D was structured as a combination of an initial upfront cash payment of approximately $57 million with expected payments of up to an additional $26 million being earned over the next 18 months. R&D currently delivers $50 to $60 million in annualized revenue and has strong operating margins which generate excellent free cash performance as new investments in working capital and capital expenditures are minimal.

We anticipate the acquired R&D entities will contribute over $40 million in incremental revenue in fiscal '20. It will be neutral to earnings excluding transaction costs most of which occurred in our first fiscal quarter. However, we expect R&D will immediately be accretive to test and simulation operating margins.

Now I'll turn the call over to Brian to discuss our first quarter results and our outlook for the full year. Brian?

Brian Ross: Thank you, Jeff. I will start with our first quarter results with comparisons on a year-over-year quarterly comparison unless otherwise described. Our first quarter consolidated revenue was $205.8 million providing growth of just over 1%. Our sensors business grew revenue at near double-digit in the first quarter and provided the 10th consecutive quarter with quarter-over-quarter growth delivering $85.5 million or 9.7% growth compared to the same quarter last year.

Given the timing of the Endevco acquisition very late in our fiscal year 2019, and rapid integration of the Endevco product line into MTS sensors production facilities, the growth and sensors for the first quarter was predominantly organic driven by a ramp-up of our DOD business and continuing strength in the sensors test sector. As we had expected at the beginning of fiscal 2020, test and simulation revenue declined 3.8% in the first quarter to $120.7 million mainly attributable to a slower orders' profile in the last half of fiscal 2019 predominantly led by a decline in the automotive portion of our ground vehicles sector and continued weakness in the European markets served.

It is not unusual for the orders level in test and simulation to fluctuate between the first and second half of the fiscal year which ultimately impacts revenue levels 6 to 12 months later. This pattern is indicative of a large project that we occasionally take into backlog and the volatility of the automotive market. From a growth perspective, we continue to gain momentum on great opportunities in our structures and materials markets as Jeff just discussed.

While we experienced a slower consolidated sales performance in the first quarter of the year, our full-year 2020 expectations remain intact as we expect to have continued orders and revenue growth each quarter as we progress throughout the fiscal year with a very strong second half of the year. We are on track to see our Endevco and R&D acquisitions add $65 to $75 million of revenue in fiscal 2020. Our Department of Defense business continues to grow, and we will benefit from investments that we have made to broaden and strengthen our technology offerings and support our broad geographic presence.

Moving next to gross margins, gross margin rate was 37.2%, a decline from the comparable rate of 38.5% in the prior year mainly attributable to product mixed changes and in our test and simulation business and an expected decrease in our sensors gross margins. The decline in sensors was due to mix shift, production inefficiencies described in the second half of 2019 that are improving, and the startup of Endevco production recently transferred into our sensors production facility.

As we exited the fourth quarter of fiscal year 2019 with historically low margins, we expected our overall gross margin rate to show marked improvement in the first quarter. We delivered on that improvement in the first quarter yielding an additional 230 basis points in gross margin from the fourth quarter of fiscal year 2019. This improvement was headlined by our test and simulation business going from 27.1% gross margin in the fourth quarter of fiscal year 2019 to 30.6% in the first quarter of fiscal year 2020 as we experienced better revenue mix from our improved backlog position and less revenue from the larger, lower margin jobs produced in the fourth quarter.

Gross margins included $540,000 of inventory fair value step-up charges in the first quarter relating to the Endevco acquisition compared to $445,000 of inventory fair value step-up charges in the first quarter of last year relating to (E2M) acquisition.

Operating expenses of $61.5 million increased by $1.1 million from the prior year quarter primarily driven by the inclusion of operating expenses from the acquisitions of (E2M) and Endevco. But were offset by cost containment programs and increased capitalization of investment in research and development projects focused on developing new technology that will enable test and simulation to continue as a leader in our respective markets.

We continue to manage our operating cost structure to increase bottom line performance and selectively use some of these savings to make prudent investments that are required for future growth and stability of the company. During the first quarter, we incurred $1.7 million of acquisition-related expenses related to the Endevco and R&D acquisitions compared to $761,000 of acquisition-related expenses in the first quarter of last year relating to the (E2M) acquisition.

Net interest expense of $8.3 million increased by $1.5 million compared to the prior year quarter primarily due to the increase in debt utilized to acquire (E2M) in November of 2018 and Endevco in August of 2019. Interest expense for the first quarter was slightly below our guidance range on a quarterly basis; however, with the acquisition of R&D closing on January 24, 2020, we continue to expect interest expense to be within the range previously announced of approximately $8.7 million to $9.3 million per quarter for the remaining fiscal 2020 quarters.

The effective tax rate of 17.8% for the first quarter was in line with our expectations and guidance range for the full fiscal year with no discrete benefits being recognized during the quarter. After a few years of unusually low tax expense due to tax reform and discrete tax benefits, it is important to note the following tax rates in calculating earnings per share comparisons as we experience a consolidated tax benefit of 9% in fiscal 2017 and a benefit of 38.7% in fiscal 2018.

Furthermore, we had consolidated tax expense of 11.4% in fiscal 2019. We are now expecting a more normalized rate of 15 to 19% for full year fiscal 2020.

First quarter adjusted EBITDA of $29.6 million was essentially flat versus the prior year quarter. This metric includes adjustments for $2.2 million of stock-based compensation expense which we do not exclude from our adjusted EPS, $1.7 million of acquisition-related expenses and $540,000 of acquisition inventory fair value adjustment. Adjusted EBITDA was 14.4% as a percent of revenue for the first quarter compared to 14.8% last year same quarter.

We ended the quarter with $64.1 million in cash, a slight increase from the end of fiscal year 2019. We used $5.7 million of operating cash in the first quarter which was an anomaly for us with higher acquisition-related costs, the temporary inefficiencies for moving one of the Endevco production facilities into our existing sensor's facility, the investment in working capital for inventory stocking and lower advanced payments received from customers.

During the first quarter, we had capital investments of $10.6 million to meet the growing demand in our sensors business and to address the long-term needs of our facilities, ultimately generating negative free cash flow of $16.3 million in the quarter. Moving forward, we expect a marked improvement in free cash flow coming from a return to more optimal working capital profile, higher revenue and improved bottom line performance.

We ended the quarter with total debt of $540 million, a slight increase from the end of fiscal year 2019 for positioning of the R&D acquisition and general operating needs. Our outlook for generating cash and managing debt is driven by expectations that each of the recent additions to the MTS portfolio will generate strong incremental free cash flow to pay down the existing debt balance.

We ended the first quarter with a gross debt leverage ratio of 4.08 times and a net debt leverage ratio near 3.6 times. With the completion of the R&D acquisition, the leverage will increase slightly; however, we have confidence that our financial profile of both our existing and combined businesses will decrease gross leverage to below four times by the end of fiscal 2020.

Now I would like to provide a quick update on the Endevco acquisition. The integration is on an aggressive timeline and we have already completed the move of one manufacturing facility into our sensors production facility within a span of only four months. Our integration team has done an outstanding job overcoming the inherent challenges present in a move of this magnitude over a short time span.

The second and final production facility migration is scheduled to be completed by the end of fiscal 2020 and I have full confidence that we will integrate the business successfully and build on the strategic opportunities we envision with this acquisition. Due to this rapid production migration, first quarter results were slightly muted for Endevco compared to our anticipated results; however, we continue to expect the business to deliver approximately $30 million of revenue in fiscal year 2020 as previously stated.

Customer reception to this combination remains extremely positive. The markets served by this product line continue to be solid and our execution to our plan is progressing as expected.

That concludes my comments on the first quarter results. Next I would like to add a few remarks upon our full year guidance. We are reiterating our full year guidance for the fiscal year as we continue to manage and expect fluctuations in performance by our businesses on a quarterly basis. The results for the first quarter were anticipated and included in our full year guidance projections after the end of fiscal year 2019.

For reference, the range for full year revenue is $955 million to $995 million. The range for GAAP diluted earnings per share is $2.05 to $2.35. The adjusted earnings per share range of $2.20 to $2.55 which includes adjustments for acquisition-related expenses and the range for adjusted EBITDA is $138 million to $158 million.

It is important to note that our adjusted earnings per share does not adjust out amortization expense for acquired and tangible assets related to our multiple M&A transactions nor does it adjust for stock-based compensation costs. The amortization of purchased and tangible assets decreased our earnings per share by 20 cents per share for the first quarter and is expected to impact earnings per share in the range of 80 cents to $1 per share for the full year.

The quarterly increase in amortization expense going forward will be attributable to the acquisition of R&D, any changes made in the purchase price allocation of Endevco and minor roll off of amortization expense from our M&A activity.

In summary, we are continuing to execute on a growth and diversification strategy making prudent investments across MTS to deliver sustained, long term revenue and profitability growth. Along with the efficiency and productivity improvements that create shareholder value long term. We believe that over time, this consistent focus will prove successful in building upon our legacy as a technology and customer-focused test and measurement company. And one that is more diversified and resilient to changes in the external environment and is better positioned to sustain a higher level of financial performance.

Finally, I would like to welcome the entire team from our newly acquired R&D company to the MTS family. We envision a great future together in combination with our legacy MTS team and other newly acquired businesses in (E2M) and Endevco. And we are excited for a great future ahead of us delivering excellent customer-focused technology.

I will now turn the call back over to Jeff.

Dr. Jeffrey Graves: Thanks, Brian. So as Brian just mentioned, we expect fiscal 2020 to be a benchmark year for us and one in which we see the development of a very strong backlog, exciting sustainable growth prospects and expanding margins. By yearend, we're confident that the transformation of MTS into a larger, more robust test and measurement company comprising two strong and complementary business units that have global scale and outstanding customer-base and world class technology all delivered with a passion for total customer satisfaction will become fully appreciated by all of our stakeholders.

With a slow start to the fiscal year now behind us, we will increasingly see progression in our metrics that we laid out for you in our full year guidance. Let me conclude with what we believe are the keys to our success.

MTS is a complex business that employs some of the smartest, most insightful engineers in the industry. Our story is a simple one to understand at a high level and it remains consistent. first, we need to keep executing on sensors. It's a great business with a strong leadership team that we believe will generate significant value for our customers, employees, and shareholders alike.

Second, we need to take full advantage of the strength in our non-vehicle related test and simulation equipment and service opportunities to drive growth and margin expansion. This strategy has been consistent and is showing positive results.

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

With that, Brian and I are happy to take questions and (Shelby) you can open up the line.

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

We'll take our first question from (John Frinsrev) with (Sidobe).

(John Frinsrev): Good morning Jeff and Brian. How you doing?

Dr. Jeffery Graves: Good morning, (John).

Brian Ross: Hi, (John).

(John Frinsrev): I guess I want to start with the order trends, surprisingly weak now for three quarters. Jeff, your signaling nearly a hockey stick kind of recovery this year. I just want you to maybe talk us through why you're confident of that kind of recovery especially considering the weakness you've been seeing in Europe and I suspect a continued weakness you're going to see at least in bookings coming out of China given the coronavirus. What gives you that confidence that we're going to see a sharp recovery in order trends?

Dr. Jeffery Graves: Yes, (John) it just gets - well I tell you two things. Number 1, as you know, things can vary quarter to quarter. We've seen a few like orders now in terms of actual order placements but continuing growth in our opportunity pipeline. And at some point, that just has to be relieved. At some point, you know, just the fundamentals, these - the launch of new products in the world continues. The spending on those new products continues. And at some point, you know, the pipeline builds up to a point where customers just need to place orders or they're not going to launch new products on time. So there's that underlying fundamental.

Beyond that, we are just deeply embedded with our customers and we see the timing on these orders. Now they're capital investments especially in our test simulation business. So management can always make a decision in one quarter or another to postpone an order. They're rarely canceled. They're rarely taken out of their planning. What usually happens is they're pushed off. We've seen that for a few quarters now. And our day-to-day feedback from customers is they're running out of time. They've got to get orders placed and they've got to get moving.

So as I said, you know, I try to be very clear in the commentary. We expect that to start happening in the second quarter and continue to accelerate in the second half. Now your point about the coronavirus is a good one. We're tracking it very closely. We do have a wonderful customer-base in China which, you know, expect - we expect to be out on holiday. Now they've extended the holiday.

So will that delay ordering? Will it delay, you know, normal commercial activity? You know, undoubtedly it's a headwind, (John). What I don't know is how rapidly this risk may decline and how rapidly they'll move back to normal operation. I can tell you I don't expect that demand to go away and, you know, if this runs its course and goes down I expect to have minimal impact. But it's all in the future. We just have to see how it plays out.

I can tell you we're monitoring it daily. We have extensive sales and services guys in China. We get great feedback from the ground on what's happening, and I can just tell you I feel very good about the overall order trajectory for the year. That is certainly an unknown headwind to us going forward.

(John Frinsrev): Well just making sticking with the geographic mix here, is the opportunity pipeline, is the best growth you're seeing here in North America? Does that give you some sort of confidence? And…

Dr. Jeffery Graves: Yes.

(John Frinsrev): Go ahead.

Dr. Jeffery Graves: Well now, I cut you off, (John). Go ahead and finish your question.

(John Frinsrev: And I was just saying, just on the coronavirus, I mean we've seen the past numerous times we've had deferral jobs, you know, for numerous reasons. This one almost seems like a legitimate reason that the second quarter might be, you know, weaker than expected just on that basis alone. Should we be factoring that in? Are you thinking about that? What are your thoughts about that in general? Both those questions.

Dr. Jeffery Graves: Yes, certainly the - from an ordering standpoint, you could see orders push out. Now those orders would not have turned into revenue in the second quarter largely anyway. So I wouldn't have expected a lot of that to impact the revenue and flow down performance there. But in terms of order rates, you can certainly see a push out there. Before that - before the virus emerged, I would have been even more bullish about the second quarter and orders. Now I just think it's an unknown headwind.

Back to the first part of your question, in terms of geography, yes, certainly the demand in China is terrific. We love seeing that. But I would tell you worldwide, I mean, we've - they've been, you know, trying. I think kind of quietly to increase liquidity and the investment environment in Europe. We're starting to see the flow through of that now and increasing opportunities in our pipeline. And that's broad-based, and I would expect, you know, energy and renewable energies to be a big factor there. I think that's really going with gusto now and you're going to see a lot more of that in our structures area.

And I think at some point, you know, automotive at least has stabilized. And, you know, we're encouraged to see that. And I think it'll hang in there for the rest of the year. So Europe's coming back a little bit. I don't want to oversell that, but it's doing a little bit better. And North America remains, you know, a very good environment for us across the board. I think North America our install base is big, so we have a big services opportunity. And, you know, companies are relatively cash-rich right now and able to make the investments.

Now will they depends on their outlook for their new products and things. And that can change, but right now all signs are green in terms of basically worldwide demand. Even places (John) like India, we're very pleased with, you know, the prospects in India. Now it's a small part of our business today, but you'll see us increasingly talk about that. The population density is very high, and they need infrastructure. They need to build out their infrastructure, you know, and they want to make it safe.

So you'll see, you know, our equipment that goes into building a bridge design. You'll see renewable energies, all of that stuff growing there too. So it's - what gives me encouragement is it's broad-based strengthening, you know, some areas more than others, but broad-based stabilization is strengthening. And the emerging markets strong demand growing which we're bullish about.

The risk factor we see on the horizon here is the coronavirus obviously. And we just have to see how that plays out.

(John Frinsrev): Okay, fair enough. And then just switching over, Brian, you touched on in your prepared remarks kind of a rarity of the free cash outflow for MTS in the quarter. You suggested that part of it was moving of facilities, of Endevco. Could you talk a little bit about what the Capex is suspected to be for the full year this? You mentioned debt repayments. You're going to get down to under four times by the end of this fiscal year. Maybe a little bit more on your debt repayment thoughts going beyond fiscal 2020 to 2021. A little bit of color behind cash flow, debt repayment, Capex would be helpful. Thank you, and I'll get back into queue.

Brian Ross: Yes, sure. So this, you know, last year was a higher Capex year for us then what we had projected was that it would be at an elevated level for the current year kind of around that 3 to 3-1/2 times, 3-1/2% of revenue for the full fiscal year. As we just complete some investments that we're making. So that's one item.

As far as debt repayments, we talked about a slower year of debt repayment on the actual leverage ratio, a much improved, continued improvement in the EBITDA side of the world and performance for the full fiscal year which would help reduce leverage. And then in fiscal 2021 is when we expect more rapid payment to our debt on the deleveraging side of it.

Operator: Again, if you would like to ask a question, please press Star 1. We'll take our next question from (Depa Ragnivon) with Wells Fargo Securities.

Dr. Jeffery Graves: Good morning (Depa).

Operator: (Depa), your line is live. Please speak. All right, he's not speaking, so we will move onto next question. We have again, (John Frinsrev) with (Sidobe).

(John Frinsrev): Tell you what, I'll ask a quick follow up and maybe (Depa) can chime in again. If not, I'll chime in for a third time. How's that guys? Is that okay?

Dr. Jeffery Graves: Yes, thanks (John).

(John Frinsrev): Okay, I guess I wanted to ask a little bit about the structures business. You implied that it's going to be bigger than the ground vehicle by the end of the year. I guess there's three buckets to that that I want to talk about. Bucket 1, how much is that in the inclusion of R&D? Bucket 2, how much is it ground vehicles weakening or on a year-over-year basis? I know you implied it's stabilizing. How much of that business is being down on a year-over-year basis? And Bucket 3, how much of that is organic growth within structures?

And just to tie the knot around it, I'm sorry guys, it's a long question. I wanted it to be easier. And tie the knot around it. Is the structure business, the legacy structure business, a higher margin business than the ground vehicles legacy business? Thank you.

Dr. Jeffery Graves: Well, I tell you what, I'll let Brian take that margin question at the end but let me just comment (John) on the rationale for being the largest. There's a couple of factors. I think you touched on them. Number 1, you know, certain ground vehicles and the biggest piece of that is automotive. It's come down in the last couple of years. And it had really peaked out a few years ago at half of the business. And it was driven by our success there. We were pulled in by customers around the world as the automotive market invested a lot of money in new products.

And that investment is largely continued in total, but it's shifted more to safety-related items right now for autonomy. So we've seen the durability and performance test needs that we satisfy come down. So part of it is that percentages come down and as we saw that happening, we invested preferentially in materials testing and then in structures testing. And we've been in those businesses for many years. And fortunately for us, those markets are really strong.

And what's driving them is what I mentioned; carbon fiber composites are going everywhere. And you see additive manufacturing really taking off for materials testing. Our install base is at record levels. We have a bit service opportunity there for growth. And then in structures, (John), the emerging market is really a fabulous story. It's overshadowed a lot by all the other stuff.

But when you look at the emerging market spend, their GDP growth, and their spend on infrastructure, it is really profound. And so they're investing in a lot of new building and bridge designs. We've been in that business for decades and we're absolutely the recognized leader. So they continue to build out laboratories to design new buildings and bridges, but on top of that now energy as a part of that structures element is really growing.

And we've always been involved in energy testing, you know, for drilling and even rock cracking for fracking, things like that. That are very basic to the industry, but it's always been a small part of our business. Now with renewables coming up, we anticipate wind energy being a very large industry in the future. And the issue there, (John) is those turbines need to last 20 years.

And the evolution of the technology is really fast. So they have to have a way to test them very quickly. And, you know, you can't afford to build a whole, you know, acres and acres of a wind farm and then have all the turbines fail in a limited amount of years. So you have to do this accelerated testing in a lab which we've been in and around for a while, but R&D now the R&D acquisition gives us a chance to really grow that business and be the leader in the world in testing wind turbines.

So and we see that moving. It started in Denmark largely. It expanded from there. And is now really growing fast in China and we expect India and the United States. So we love that growth aspect of that business. And then what am I - oh I'm missing aircraft, of course. So we've always been in the aircraft, airframe testing business and the components that go in the engines. What we can test now with the R&D add-on is we can test the actual rotating structure like the rotating hardware in the engine and the gearboxes, things that go into modern aircraft engines that really determine the fuel efficiency and the performance of that engine.

So now we're a holistic provider to the aircraft industry. And then with the (E2M) acquisition, of course, we've added on flight simulation. So I would tell you (John) you'll hear us, like I said, for the first time in 53 years, the structures business is going to be the biggest one for MTS by the end of the year. And I expect that to continue to grow. I think we've gotten the business back in proportion now to where it's much more balanced and we've added on a services element. All of those areas are going to grow.

Now periodically, (John) I would expect automotive to go through spending periods where it's higher. But all-in-all we want to keep it. Brian and I have said, we want to keep that percentage down. We'll get it down to 25% this year, but we want to keep it down by growing the overall -by having higher growth rates in the other markets. So the dollars can climb, but we want to have niches where we can really be successful and make money in that business.

So we've got a bit big a few years ago. We balanced the business out this year. And I expect that balance to be retained going forward. So Brian, do you want to end with a comment on margin performance?

Brian Ross: Yes sure, just real quickly, you know, I think what our expectations are is that the R&D company will add about $40 million of revenue to our existing business. So that, you know, that adds about 5 to 10% of as we ((inaudible)) up the (specters) within the sectors within structures.

As far as the structural side of the world on gross margins, we generally see those about 5 to 10 points higher and execution on those projects, even better. So original budget is set. Completion of the project within budget timeline, all of that is usually very successful for us.

(John Frinsrev): Great, so that's a mixed benefit. That's really what I was looking to hear. That's fantastic.

Dr. Jeffery Graves: Correct.

(John Frinsrev): Okay, and you know what? I'm going to get back into queue. Let other questions be asked and chimed in. But if not, I still have two more follow-ups. All right guys, thanks.

Dr. Jeffery Graves: Thanks, (John).

Operator: Again, to ask a question, please press Star 1. We'll take our next question from (Depa Ragnivon) with Wells Fargo Securities.

(Depa Ragnivon): Hey, good morning.

Dr. Jeffery Graves: Good morning (Depa).

(Depa Ragnivon): Thanks for taking my question. Hey. Happy 2020, since it's the first time we're chatting this year. But can you - this is something you've discussed extensively, but you know, I just have something to give us a little bit more comfort. Just given your commentary, you do anticipate a lot of pickup in the second half. There's a backlog of replenishment that you have in the second half. It all seems to be on track. But, you know, we don't see that. It's not captured in auto or growth trends.

So is that like a soft commitment from clients that gives you the visibility and the confidence to say that there's a pickup coming? And where I think I struggle with that is also another thing I struggle is your Q2 and Q3 comps start to stiffen a little bit. So how do you triangulate all off these and say hey, we will still grow in the second half orders, backlog wise?

Dr. Jeffery Graves: Yes (Depa), so with comps just be sure and stay straight on order comps versus revenue comps because, you know, in the test and simulation business particularly as a backlog driven business. So orders come in and then they flow through over time into revenue. So that can be a little disconnected there. But in terms of order growth, I would tell you (Depa), Q1 was clearly light and Q3 and 4 were clearly light. But with our, you know, with our customer base and this is why we - this is why I really wanted to take time on the call to go through our orders outlook because I don't like surprises in the future. And what we're seeing right now is a very strong demand profile coming.

And yes, there are risk factors. The coronavirus certainly throws a new risk factor out there. But what we see is a very strong demand profile coming which will first translate into orders growth and that I would have told you before the virus, that would have clearly started here I believe in the second quarter that we're in right now. With the virus, it's an unknown risk. And, you know, will it push out in time or not? But we saw it starting in Q2 and then going strongly through the second half of the year. That order growth replenishes backlog and some piece of it will actually translate into revenue for the year. And then that revenue will obviously that revenue growth will follow through in fiscal '21.

So most of my commentary was on the orders outlook from demand and I would tell you the same thing I said to (John) a few moments ago. That's from being embedded in our customer base around the world very deeply. And so what I'm passing onto you is the feedback we get from our customers broadly around the world and nicely as I said before, it's fairly geographically evenly distributed. You know, you see some strength coming back in Europe. You see the Americas or North America being strong. And you see growing demand in China and the emerging markets with the caveat, again, of the virus and the impact there.

But fundamental demand is growing. Order placement has been weak the last few quarters. Our pipeline is much bigger than ever. And we expect those orders to break through and start being placed. And that's the best intelligence we have today. And clearly there are always risk factors that can change the outlook. Once those orders are placed, we will continue to give you updates on revenue and EBIT flow through from our operations. Right now we're hiding guidance assuming that our initial, you know, revenue outlook and EBITDA flow through whereas modeled in the beginning of the year within that range.

So that's - we're holding to that. We're pinning it really on our outlook for orders for the remainder of the year which we believe is very strong organically. And then you add on the acquisition of R&D which will be on top of that, I believe it will end up being a very good year from an order standpoint and backlog.

(Depa Ragnivon): Okay, got it. Apologize if this was asked earlier by (John) ((inaudible)). But your DOD sensors business, how's the pace of auto release been with them? I mean you should be looking to ((inaudible)) some, you know, pretty soon. I'm just curious how the next trend of autos being release on them is looking at this point.

Dr. Jeffery Graves: Yes, we'll let you know. We'll update you every quarter on that. You know, we landed, as you know, from what we described previously, we landed the big contract. It's funded incrementally in discrete purchase orders from the OEM that we support, the systems it goes into. So I can tell you the budget that was passed from Congress to fund the DOD, I'm losing track of time now, a month ago or so, six weeks ago. Clearly, that opened the spigot for the OEMs to receive their funding on contracts and largely if I look at the broad industry, those contracts have been placed. I would expect that flow through to suppliers to continue and we're obviously a key supplier for the platforms that we on.

So I would expect that to continue. Timing on the government is an imprecise science. I know and I want to throw that out as a caveat. I can't guarantee when the purchase orders are going to come through. We still have enormous confidence that contract will be funded. The technology is really rock solid and it's going into a great platform. So we felt really good about the contract. The exact timing on purchase order placement from the government, really from the OEM, you know, via the government funding I can never be precise on. But we will update you quarter by quarter and all in all it's going to be a great program for us.

(Depa Ragnivon): Got it. Sorry, can you - is there a way, my last question, is there a way you can advise of your China exposure as it relates to may just specific region within China that your revenues are driven from? Or, you know, is there a way to just ring fence just the exposed area within China? Thank you.

Dr. Jeffery Graves: Yes, sure. Let me make a general comment and then I'll hand it off to Brian to give you some numbers (Depa). But, you know, China's been a really great market for us for 30 years. And it's driven by the same factors. You know, in the beginning they were, you know, it was university work, basic research. They were trying to ramp up infrastructure testing, you know, as they become more affluent now in the world. Their GDP has gone up. They do a lot more research on building designs and bridge designs for their population as their cities have grown.

And now you see the emergence of an automotive industry and an aircraft industry, domestic one for them that every, you know, large economy wants to have. And that flows through to supply chain. So we've been in laboratories for 30 years very broadly; materials, you know, things that go into structures, things that go into automotive. That is really ramped up in the last several years, and we see great long term potential for us over there.

It is very broad-based. You know, it basically followed the development of the Chinese economy. So we started off in the big cities, you know, Beijing, Shanghai, and down south in Guangzhou province where that first joint ventures went in and laboratories were built. And we've spread from there basically throughout the country. So we're very - we sell all over the country. We sell to laboratories and OEM laboratories all over the country and universities all over that country. We have a very broad and deep sales and service team around there, and we do most of the fulfillment out of the states here primarily.

So that's been our model. It's worked very well for us. Brian, do you want to - and we have about - we have roughly 400 employees throughout China but there's not one significant geographic region. It's mainly the big coastal cities and then spreading from there across the country. Brian, you want to add anything?

Brian Ross: Overall, our business is about 35 or 36% in Asia and about 20 to 25% of that is specifically in China. You can think about, you know, that is a ring fence around what revenue we sell into China. And, you know, a complete shutdown of the economy, you know, China everything obviously would put a ring fence down below which I don't believe is the case.

Or, you know, this thing irons itself out and we've seen, you know, maybe a little blip in the - our second quarter, the first calendar quarter here. And it irons itself out through the rest of the year. It's somewhere in between that. I wouldn't state that it is at the drastic level at this point based upon the way that we monitor that.

Dr. Jeffery Graves: Yes, specific to us (Depa) we have a handful of employees actually stationed in Wuhan and in that province there. And clearly we've taken all the precautions the government recommends and beyond in terms of protection of those employees. But it gives you a sense out of 400 people, you know, we've got a handful that located in that region. Now unfortunately for China and the rest of the world, this virus came up at their holiday period where there was a lot of travel. So we're taking extended precautions as every company, I'm sure, is in the government to make sure that people either don't travel or travel safely, that they stay in their home if they've been to that region and don't contribute to the risk of spreading the disease.

So all of those precautions we're taking. We get daily reports, and it looks very rational right now to us in terms of the actions being taken. But no one knows the future, and our hope is this subsides like past issues have. But I think Brian put a - put, you know, the ultimate ring fence around it. And I'm sure every company is doing the same. Did that answer your question, (Depa)?

(Depa Ragnivon): Yes, it does. One small clarification, is, Brian, is this considered - are you considering any impact at all within your guide at this point in time? I know you have a pretty good range within the guide, but is there any impact from this coronavirus actually in your guide?

Brian Ross: Well what I would say is that there's been a swath within that range. And before, you know, we had tried to encompass in our original guidance what could happen in the trade discussions and that's largely starting to iron itself out. And now it's being kind of swathed with the current virus issue that's out there. So I think it still encompasses our existing range for the full fiscal year.

(Depa Ragnivon): Got it, all right. That's clear. Thanks so much.

Dr. Jeffery Graves: Thanks, (Depa).

Operator: We'll take our next question from (John Frinsrev) with (Sidobe).

(John Frinsrev): Hi, guys. All right, so in the interest of time, you can make this as short as you want. Two questions, one, the services business was down both sequentially and year-over-year. Jeff, you suggested that business is going to do well for the balance of the year. Could you briefly discuss why? And two, each OEM you purchased it before the 737 max issue. Anecdotally we're hearing more simulators being put out there. Could you talk about how that business is performing relative to your expectations from then to now? How much is it performing better than expected or not as well as expected given the Boing issue? Both those two topics in how many words we can fit in.

Dr. Jeffery Graves: Yes, so again let me give you a couple general comments on this. Brian to add any numbers on top of it. So in service in general (John) is a great business for us. We have over $6 million in base now. So what we're doing, as you know, is we're calling on customers to service that base, and we're embedding our service people wherever we can, great business.

It does have a little bit of seasonality to it. Fourth quarter is generally a little bit lighter as people, you know, as customers watch their spend. Because a lot of that spending comes out of expense, customers expense line whether than CAPEX. So there's always a little bit of shading at the end of the year on that. But all-in-all I expect our service business to grow, you know, strongly going forward. You know, we've been delivering kind of high single-digit growth, you know, occasionally into the doubles. I expect that kind of trajectory to continue.

(E2M) I just love the acquisition. We're using their electric technology now in a lot of our platforms. So technology - the technology synergy is excellent. The demand profile, I believe, for flight simulation is excellent. And the - actually the incremental impact of any 737 max issue, we've not really seen. but I would (John) frankly I wouldn't have expected to see it right now. It flows through to our customers. They factor it into their capital planning and build out. I don't expect a spike. And the demand profile out there has been significant. So I don't know that we'll even really notice it. But it can't be a negative. It has to be a positive for us.

So we're very encouraged about that. We love those guys. We love the business. And I wouldn't underestimate the amusement business. I - more and more, amusement parks are gearing their high-end attractions toward flight simulation. And I think it's a marvelous business to be in. So we'll be growing in all those.

Brian, do you want to add any numbers on?

Brian Ross: You know, just in total I would say that service orders did grow about 5% within the first quarter here. So that's, you know, from last year we succeeded orders and revenue above $100 million in revenue for the first time in company history. So we're just building on the program we made to date, and we really like the profile. Plus in addition with (E2M) and the R&D acquisition, they additional service opportunity.

(John Frinsrev): Okay guys, thanks for taking all my pain in the rump questions.

Dr. Jeffery Graves: No, thank you (John) for the interest and time. (Shelby) I know we're at 10:00. So maybe I'll just say thank you all for participating in the call today. And the interest in the company. We'll look forward to giving you an update again next quarter. Have a good day, guys.

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