Transcript of
Astec Industries
Investor Update
October 2, 2017/9:00 a.m. EDT

Participants

Steve Anderson – Vice President of Administration and Director of Investor Relations
Benjamin G. Brock – President and Chief Executive Officer
Richard J. Dorris – Executive Vice President and Chief Operating Officer
David Silvious – Chief Financial Officer

Presentation

Operator
Greetings, and welcome to Astec Industries' Investor Update. At this time, all participants are in listen-only mode. A question and answer session will follow the formal presentation.

I would now like to turn the conference over to your host, Steve Anderson. Thank you. You may begin.

Steve Anderson – Vice President of Administration and Director of Investor Relations
Thank you, Sherry. Good morning, and welcome to the Astec Industries conference call to announce our acquisition of RexCon LLC and the additional investment required for our wood pellet plant business. My name's Steve Anderson, and I'm the Vice President of Administration and Director of Investor Relations for the company. Also on today's call are Benjamin G. Brock, our President, and Chief Executive Officer; Richard J. Dorris, Executive Vice President, and Chief Operating Officer; and David Silvious, our Chief Financial Officer.

In just a moment, I'm going to be turning the call over to Ben, but first, I'd like to remind you that any forward-looking statements that relate to the future performance of the company are intended to qualify for the Safe Harbor liability established by the Private Securities Litigation Reform Act, and that any such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions and factors that are included in our financial news release, and others are contained in our Annual Report and our filings with the SEC.

At this point, I'll turn the call over to Ben.

Benjamin G. Brock – President, and Chief Executive Officer
Thanks, Steve. Thanks, everyone for joining us on the call today on such short notice. As you saw in our releases issued this morning, we made two significant announcements. First, we announced that we had initiated significant design upgrades to our customer's Georgia and Arkansas located wood pellet plants to meet full production rates. And second, we announced the acquisition of substantially all the assets and liabilities of RexCon LLC, one of the leading full-line concrete batch plant manufacturers in the United States.

Let me first begin by discussing the added investment in our customer's wood pellet plants. In the last 45 days we identified significant design issues at our customer's Georgia and Arkansas wood pellet plants driven by the need for both facilities to achieve full production rates. Upon learning of these design flaws, which were different at each plant, we identified a clear path at both sites to achieve the necessary results for our customers in the near term.

As many of you know, one of our core values is delivering superior service to our customers, and we have a high level of confidence that we have identified the issues and are underway in making the necessary upgrades to achieve full production at both sites. On Friday, we completed an updated analysis of the necessary all-inclusive investment needed to deliver on our commitments to our customers, which we expect to negatively impact our third quarter earnings by $0.54 to $0.58 per share. There is no doubt we are very disappointed to be announcing this added investment, but I wanted to make sure we provided swift disclosure of the adverse impact on our overall financial results for our third quarter as well as make the necessary improvements to the plants to maintain our high level product for our customers.

By way of background, our financial investment in the pellet plant business started in December of 2010 when we opened a work order to design, build, erect, and operationally run a five ton per hour prototype pellet plant on our property at our Astec, Inc. subsidiary. The prototype plant started up in September of 2011and ran through May of 2012 and gave us the confidence to pursue the largest order in our history at the time with Hazlehurst Wood Pellets in Georgia. The last segment of that order was received on January 30, 2014. Due to market conditions, the plant was not pushed to run at full capacity. It was also run on natural gas as the fuel source. Marketing conditions have since improved, and as a result the plant needs to run at full capacity with wood as the fuel source.

As we look to ramp up production rates a series of the design flaws were uncovered, and we are working diligently to correct them. We have been working with being fired on wood for some time, but we only recently identified the ultimate fix as we attempted to ramp up production. Our experience at the Georgia site gave us the confidence to pursue the largest single order in our history with Highland Pellets in Arkansas. The last segment of this order was received in March of 2016. This plant has also been running at low production rates, and as we ramped up production we found design flaws as well that are different than those we experienced in Georgia.

I want to reiterate the design flaws we uncovered in Georgia and Arkansas were identified in the last 45 days. In addition, to avoid any confusion, in Arkansas these upgrades are unrelated to the construction related cost issues we experienced last quarter, which we believe are behind us. While the design issues are not identical at both sites, they each require our full attention and effort to get them to full production. We are confident in our ability to do so for our customers, and the investment we have announced is the amount that we believe will cover the entire cost associated with completing our commitments to our customers with regards to production rates.

Despite today’s announcement, we are very confident in the near term and long term outlook for pellet plants and our success at these sites will put us in a strong leadership position for orders as we move ahead. Including today’s announced charge we will have invested approximately $31 million over seven years to get into what we believe is a $100 million per year business. We believe that the investment is a good one for our company.

In the last 7 years we have remained profitable, acquired 6 companies, added capacity at several subsidiaries, had a very successful ConExpo show with 33 new products, and grown our cash on hand, all while remaining debt-free. In addition, our balance sheet remained strong, our core infrastructure business is very good, our energy business has attractive tailwinds, and our international business has continued to be ahead of last year. Turning now to our announcement of our acquisition of RexCon, we are very pleased to welcome RexCon to the Astec Industries’ family of companies. RexCon is a successful, profitable company with a reputation for innovative technology and dependable quality products. We are a match culturally and in our approach to business.

RexCon joining our family of companies reflects our stated strategy to continue focused growth both organically and through acquisitions of strong companies that serve the infrastructure, aggregate mining and energy industries. RexCon will continue to operate as RexCon, Inc. in Burlington, Wisconsin and will join our energy group. We thank Jake Jacobs and Mike Redmond for their collaborative efforts in making this transaction happen, and we are pleased that they will continue to run and grow RexCon as a part of the Astec Industries family.

With that, I will open up the call for questions. Again, thank you, everyone, for being on the call.

Operator
Thank you. At this time, we'll be conducting a question and answer session. Our first question is from Mike Shlisky with Seaport Global. Please state your question.

Q: Hi. Good morning, guys. I guess I want to first touch on the pellet plant question, especially in Georgia. I'm a little bit confused here. At what point were you aware that you needed to make these upgrades? I guess I'm confused as to why this wasn't known when you first built it, that the nat gas fired version of it wasn't enough to sustain full production. Was that a very sudden kind of realization?

Secondly, why is Astec paying for an upgrade to a customer plant? I just need a little more color on that. Thanks.

Benjamin G. Brock – President, and Chief Executive Officer
Thanks, Mike. This is Ben. Originally, when the plant was bought, Hazlehurst did not go for the long-term supply contract, was really going more on the open market when the private supply of pellets, they got more per ton. It got warm in Europe and that market fell apart, so market conditions really went down and the need for large scale production there wasn't necessarily there. If you'll recall, we agreed, we went longer on the loan to December of 2018. When we did that, they were facing that but also they helped us get in the business. They did a great job with us and gave us something to show, and that actually led to us being able to get the Hazlehurst order.

We knew we needed to fire on wood. We started working on that, did a lot of work on that, and really didn't find that we had the issues that we needed to fix until the last 45 days when we tried to ramp up to full production on wood. We run well on natural gas, have really pretty good success on that, pleased with that. They are running pellets. They are selling pellets. But we need to run full production on wood if they are going to get a long term supply contract that they have an opportunity for.

I hope that answers the question. But until we stared to ramp up and go full bore on wood, we knew we had to do it, couldn't identify the issues that, I hate to say reared their ugly head, but that's kind of what they are. And we're working on it now as we speak.

Q: So, the upgrade to wood was known at the outset and it was other changes to the design to accommodate that, that's what the costs are for the third quarter?

Benjamin G. Brock – President, and Chief Executive Officer
Right. Each line at Hazlehurst is 15 tons per hour, and so until we really had to ramp up and run on wood at full production rate we didn't identify that on the lines. And that is our design flaw, that's not the customer's to fix.

Q: Okay. So, it was an EPC type of change order.

Benjamin G. Brock – President, and Chief Executive Officer
Yes and no. We're not EPC on that site, but it's an equipment supplier issue, for sure.

Q: Okay, okay. Just as you look at other pellet plant orders that you're probably pursuing out there in other business, does this issue, or these issues combined, do they make you have to go back and evaluate your current bids and current other project negotiations, or are those going to be unchanged going forward?

Benjamin G. Brock – President, and Chief Executive Officer
That's a good question, Mike. We are definitely reevaluating those as we find out what we found out. We are not going to accept a new order until we're across the line at these two sites. We don't think that would be a good idea, although we do have several inquiries.

We feel like at Georgia, timing-wise, we actually thought we'd be early November. The hurricane that came through Florida dumped a lot of rain and wreaked havoc on things down there, so that delayed us. We're probably into November, the first week of December on finishing there. Then April 15th is our furthest out date that we believe we'd be finished and proving out at Arkansas. We actually have a timeline that shows earlier than that internally, but that's our drop dead date is April 15th.

Based on that, we would anticipate another order sometime in Q2, with some of that volume having a good chance of being in Q4. We'd have to be probably pretty lucky to have it in Q3, so we're looking at in the range of maybe $15 million in pellet plant revenue in 2018, and then that would be a piece of a larger plant. We have very good confidence in this business and seeing it as a $100 million business going forward, and that would be in 2019. We see it as being a profitable business in goods and gross margin.

Q: But, just to be clear, the current bids and current projects don't need to be re-drawn up and redone?

Benjamin G. Brock – President, and Chief Executive Officer
We're going to have to study them. I think at the numbers where we are, we're okay. If we'd have known the things we had known going in, I still think on the equipment side, pricing-wise, we're still going to be in good range.

Q: Okay, okay.

Benjamin G. Brock – President, and Chief Executive Officer
Then, the other thing I would add to it is we are not going to be a construction company going ahead. If somebody else wants to be the full EPC contractor, that's great. We're going to be equipment suppliers. We're not construction guys, we found that out, so we are happy to be a part of a bigger group that's doing that, but our expertise is in supplying equipment. So, we aren't going to be taking on the general contract going forward.

Q: Got it. And just one quick RexCon question for me. You noted that it's profitable in your comments, but is it more profitable than Astec? Is this going to be an accretive deal in the near to medium term?

Then, secondly, on RexCon, I'm curious why you're putting it into the Energy Group. It doesn't sound like the products here are meant to support those kinds of products but more the infrastructure type products, so your comments as to why it ended up in that group.

Benjamin G. Brock – President, and Chief Executive Officer
Well, first of all, they're profitable, they'll be accretive. They're in the range of what I would say our top third of divisions operationally, so very successful. We have placed them in the Energy Group to be close to CEI, as it also makes the concrete plants in addition to other products.

What we do ask of all of our subsidiaries, and we'll eventually, long term, ask RexCon is to try to serve two of the three target industries that we sell into, so like for Astec the announcement that we're making today, they make asphalt plants for infrastructure. The wood pellet plants are an energy product, so there will be probably long term a little diversification there.

That being said, we're always looking at our groups and making sure the alignment makes sense, and we'll reserve the right to change it down the road. But for the moment we feel comfortable where they are. But it's a great question because it is kind of an infrastructure-related product, for sure.

Q: Okay, fair enough. Thanks very much, Ben.

Benjamin G. Brock – President, and Chief Executive Officer
Thank you.

Operator
Our next question is from Mig Dobre with RW Baird. Please state your question.

Q: Good morning, guys. This is Joe Grabowski on for Mig this morning. I was going back through the last several conference call transcripts, and back in July of 2016 you talked, and my question's also on Hazlehurst, you talked about needing to burn wood exclusively on each line and so you were replacing the burners and you were testing them, improving the new burners. In October of 2016, you said line two is now running and has met the production targets in early start up. So, is this the same issue that you were talking about last summer that they needed to burn wood exclusively and you were swapping the burners? It seemed like that had been done, and again, at least in October line two had met its production target and really nothing was mentioned on this issue the last several calls. Is this the same issue about switching to burning wood?

Benjamin G. Brock – President, and Chief Executive Officer
Kind of, Joe. The only thing is that as we ramped up and needed to get all three going, another thing we've run into is a baghouse issue related to the dust that's created from burning the wood. We could get up to the 15 tons per hour, and we would run for some time, and then we would hit a wall on dust collection, and so we were trying different methods to get there. But the absolute need to get to 45 tons really hadn't surfaced at that point. It's there now, so there's baghouse related issues.

Also, we're burning wood that has bark in it, that has sand in it, and at the temperatures that we use in the combustion chamber, when it gets hot it creates glass build up that needs to be cleaned out. That won't necessarily go away 100% but we're trying to make it to where the time between cleanouts is long enough that it makes sense. So, we're working on the combustion zone a little bit there.

Then, the ash that's created with that wood and the bark wood will build up in the coils that have pins on them in the heater and we're fitting an apparatus to be able to just blow that off the pipes because that hurts your heat transfer. So, it's not just the burner this time, there's things behind the burner that have surfaced as we've gone to higher production rates.

Q: Okay. And I guess—I'm sorry. Go ahead.

Benjamin G. Brock – President, and Chief Executive Officer
No, we need to do it consistently for long periods of time, and they need to be running pellets at a high volume with those long term contracts.

Q: Got it. And what's your level of confidence that the fix has been identified and that this will be it as far as additional expenses for these two plants?

Benjamin G. Brock – President, and Chief Executive Officer
Very high confidence.

Q: Okay. Alright. Is it safe to say at this point that Hazlehurst and Arkansas really aren't going to be profitable all-in?

Benjamin G. Brock – President, and Chief Executive Officer
I think it's still fair to say, David's here, but zero at Hazlehurst, and there is about a 5% gross margin still in at Highland.

Q: Okay. Alright, but again just to repeat from earlier, now that you've identified these fixes and once the fixes have been tested out, if you were to book a plant, in Q2 of next year that the gross margin of that going forward would be acceptable, favorable?

Benjamin G. Brock – President, and Chief Executive Officer
It would be favorable.

Q: Okay. Alright, I guess those are our questions. Thanks.

Benjamin G. Brock – President, and Chief Executive Officer
Okay. Thank you, Joe.

Operator
Our next question is from Stanley Elliott with Stifel. Please state your question.

Q: Hi, guys. Good morning. Thank you for taking my question. On the throughput that you had for the Arkansas plant, could you tell us maybe how short you were in percentage terms, or maybe even tons per hour terms on what you were supposed to guarantee and what you actually were running?

Benjamin G. Brock – President, and Chief Executive Officer
I think probably four lines at 20 tons per hour is the guarantee. We've had one of the lines up to that, and over it actually, but not for a long period of time. Where we're undersized is in the front end at the Hammermill site. It's mainly related to the particle size that they need at the press, and along with that there are some things in the main plant that we need to fix too. By the time you upsize the green Hammermill capacity, the electrical, the site work, the controls of that, and the related things within the main plant, it's a big number.

Thankfully, we've identified we have very high confidence in getting there. So, they're different issues, there are different burners at each site, and so the creation of the dust, we don't anticipate that being an issue at Highland in Arkansas because they're different type burners. But it's more of a front end issue that gets related through the whole plant to the press for the particle size at Arkansas.

Q: Because you're guaranteeing a certain amount of throughput, should you have other issues with the plant going forward, is there a chance for additional charges down the road, or how do we think about that?

Benjamin G. Brock – President, and Chief Executive Officer
I would think about in that we've tried to anticipate everything in the number that we've released today. We have high confidence that we have captured the cost necessary to get across the line in both places.

Q: Perfect. And did you say, what is the cash outlay for these charges?

David Silvious – Chief Financial Officer
The cash outlay will be about $25.6 million on the cash side. A portion of that winds up in inventory. The rest of it goes through the income statement, which is the charges that we described to you.

Q: Alright, switching gears to RexCon. CEI, I guess had been working on some batch plants. What's the difference between the RexCon batch plant and what you guys are working on? Is this more product reach? Is this maybe the CEI plants weren't coming along quite as fast as you had hoped? Help us with the rationale behind all that.

Benjamin G. Brock – President, and Chief Executive Officer
Yes, on both. Now, the CEI design is different than what Rex is building. RexCon is known for their drum mixers. They're a company that's very well known in the industry. Jake and Mike bought the company in early 2003. They've done a terrific job. I'd say their facility is fantastic, it has to be the newest concrete plant production facility in the maybe in the world, and it's all built with concrete. But that's a story for later. But traditional mainline plants, a lot of crossover in customers, probably 70% of our customers are in asphalt and concrete today. We were walking through the plant and there's an order for a customer that took delivery on an asphalt plant last year sitting right in front of us when we walked in the doors on Friday. Then, you have different technology at both places.

Both places sell direct, so there's an opportunity to work together on that. RexCon also does quite a bit of outsourcing, so there is a potential to bring some of those products inside. But I would also tell you that we're not going to do anything quickly there. They're doing very well. We need to learn the business and see what all those opportunities are, because they're doing so well we don't want to tinker too much. Maybe we can get synergies out of purchase parts and steel prices and those types of things we probably could help them with, but there's some things that they do manufacturing-wise they can help us with, which is pretty exciting. So, it's a good addition as far as that goes. But they do not build the twin shaft pugmill that CEI builds, and it's just a different approach to mixing concrete.

Q: Perfect. And then, lastly, would you guys care to comment on the 5% to 10% organic number that we talked about earlier in the year, especially with the rains and so forth?

Benjamin G. Brock – President, and Chief Executive Officer
Still probably thinking on the top line, 5% is achievable, a lot of activity in infrastructure, activity on the Agg side too related to infrastructure, and a little bit of challenge on the energy side, like we said in the release, so still an opportunity to get to the 5%.

Q: Perfect. Thank you, guys.

Benjamin G. Brock – President, and Chief Executive Officer
Thank you.

Operator
Our next question is from Nick Coppola with Thompson Research Group. Please state your question.

Q: Good morning. You touched on this earlier, but maybe to just ask slightly differently, it sounds like you need to revisit how you're designing new pellet plants. Does that impact your cost of manufacturing and does it impact how competitive your offering is at all going forward?

Benjamin G. Brock – President, and Chief Executive Officer
Nick, good question. I think based on everything we're doing here, and knowing that on the other side we're going to have a really good plant, the pricing is still going to be very much in range in the industry. So, we're excited about it when we get to the other side of this. We're not necessarily excited about what we're going through, but on the other side of it we're going to have a really nice plant that starts up really well.

Still in the scheme of pellet plants, when you look at Highland, even with the April 15th date, and we're really working hard to beat that by quite a bit, but that's still one of the fastest startups of a large scale pellet plant in the United States. So, taking in the big picture, as hard as this is for us internally and not liking what we're announcing today, the long term for us looks really good and we do have active people looking at pellet plants with us. But we just want to be finished with these two and know exactly where we are and supply the best plant for them when we sell one. So, excited about the future, not in love with the news today, but the future looks really good in the pellet plants for us.

Q: Okay. Then, I wanted to ask about the fuel source again as well. Is the industry standard to use wood versus nat gas? I assume wood might be more expensive than nat gas. How does that impact the value prop for your customers in the dynamic here?

Benjamin G. Brock – President, and Chief Executive Officer
Sure. It comes down to where it's going, so for the sustainability piece of the utilities in the UK they need to burn wood for renewable fuel. If you want the ten-year supply contract, you're going to burn wood. If you're going to other markets, industrial private market, home heating, or other type markets, natural gas is an option. But they're also limited on natural gas, too, at the Hazlehurst site, so ultimately they need to run wood.

Q: Okay. Alright. Thanks for taking my questions.

Benjamin G. Brock – President, and Chief Executive Officer
Thank you.

Operator
Our next question is from Jon Fisher with Dougherty and Company. Please state your question.

Q: Good morning. A couple questions on each topic this morning. On RexCon, what is their capacity utilization right now, and how much backlog, or new business pipeline, are you also acquiring in this acquisition?

Benjamin G. Brock – President, and Chief Executive Officer
On the utilization side we didn't ask that question there, but I can see in there, my gut feel is about 80%, which is pretty good. Backlog-wise, we probably need to answer that at the end of the quarter, but it's in line with the rest of our company. They have work.

Q: Okay. And then on the wood pellet plant issues, just a counting question, I want to make sure, the $0.54 to $0.58 charge, that all runs through cost of goods sold, correct?

David Silvious – Chief Financial Officer
Basically, it'll all run through gross margin. Due to percentage of completion accounting, on the Arkansas pellet plant there's a portion that will run back through sales. So, there will be a debit to sales, a reduction in sales, along with a charge through cost of goods sold, and the net of all that is the result that winds up in the $0.54 to $0.58.

Q: Okay. Thanks. Then, the final question on the wood, I guess this is more of an Astec Industries question. You had talked about exiting this year, a 24% gross margin was the target. Next year, you had thrown out a 25% gross margin target to exit next year with. I'm not sure how much the market believed either of those bogies, but do you care to reiterate, any sort of conviction or walk away from either of those targets for exiting this year or next year for gross margins?

Benjamin G. Brock – President, and Chief Executive Officer
I think we'll probably wait until the third quarter call for that, Jon, if that's okay.

Q: Okay. Thank you.

Benjamin G. Brock – President, and Chief Executive Officer
Thanks. We'll provide that at the call.

Q: Okay. Thank you.

Operator
Our next question is from Chris Meeker with Franklin Templeton. Please state your question.

Q: Good morning, guys. Can you remind me again what the revenue contribution from the wood pellet plants was in 2016 in year-to-date along with the proper contribution?

Benjamin G. Brock – President, and Chief Executive Officer
David's going to look that up. While he's looking up that, do you have another one, Chris, maybe while he's checking that out?

Q: Sure. How does the setback on the Hazlehurst plant impact the receivable that's outstanding?

Benjamin G. Brock – President, and Chief Executive Officer
Right now, it does not. We don't plan on that being an effect. They are running it, selling pellets out of the plant. It's just at a low level, and this will help them secure a ten-year supply contract, and so we don't anticipate that changing.

Q: When do you expect the receivable to be paid?

Benjamin G. Brock – President, and Chief Executive Officer
December of 2018.

Q: Thank you.

David Silvious – Chief Financial Officer
In 2016, we had about $135 million in revenue on the Arkansas plant and about a 21.5%, 22% gross margin, which was about $29 million of gross margins.

Q: Just on the plant itself?

David Silvious – Chief Financial Officer
That's correct.

Q: Okay. Then year-to-date 2017?

David Silvious – Chief Financial Officer
Well, I can give you, yes, I can give you through Q2.

Q: Yes, that's fine.

<u>David Silvious – Chief Financial Officer</u>
Yes. We had about $16 million in sales, and we had about $4.4 million of a loss on gross margins, so a net negative gross margin. Remember that in Q2 we took a $4.5 million hit on construction-related issues at this plant specifically.

Q: Okay. And then looking further out, assuming the problems are fixed, what would be the target normalized gross margin and operating margin that we should expect on the wood pellet plant business standalone?

<u>Benjamin G. Brock – President, and Chief Executive Officer</u>
In range to slightly higher than our major equipment, probably higher.

Q: So a 7% EBITDA margin or so?

<u>Benjamin G. Brock – President, and Chief Executive Officer</u>
I think it would be, I think you could say higher than that.

Q: Okay. Thank you.

<u>Benjamin G. Brock – President, and Chief Executive Officer</u>
Alright. Thanks.

<u>Operator</u>
Ladies and gentlemen, we have reached the end of the question and answer session. I would like to turn the call back to Steve Anderson for closing remarks.

<u>Steve Anderson – Vice President of Administration, and Director of Investor Relations</u>
Thank you, Sherry. Although today's the first day of our quiet period, we did want to bring you up to date with the acquisition of RexCon and the additional investment needed in our wood pellet business as soon as possible and to allow time for your questions. So, your participation on this conference call is very much appreciated.

As our news release indicates, today's conference call has been recorded. A replay of the conference call will be available through October 16, 2017 and an archived webcast will be available for 90 days. We'll have a transcript available as well, which will be on our website within the next seven business days. Again, all that information's in the news release sent out earlier today. This concludes our call. Thank you all very much for your time.