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Greg Anderson
The LGL Group, Inc.
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Operator: Good morning, everyone, and welcome to the LGL Group Q2 2011 Earnings Report. At this time all participants are in a 'listen only' mode. Later you will have the opportunity to ask questions during the question and answer session. You may register to ask a question at any time by pressing the 'star' and '1' on your touchtone phone. You may withdraw yourself from the queue by pressing the pound key. This call also has a visual PowerPoint component in addition to the conference call. To view the PowerPoint, please click on the 'join the meeting' link you received in your invitation and included in the press release announcing today's call. If you need assistance seeing the presentation, please press 'star' 'zero' on your touchtone phone and an operator will assist you. I will be standing by if you should need any assistance. It is now my pleasure to turn the conference over to the company's Chief Accounting Officer, Mr. LaDuane Clifton. Please go ahead.

LaDuane Clifton: Good morning and welcome to today's call. Joining me today is our President and CEO, Mr. Greg Anderson. Before we get started today, I want to let you know that we prepared a slide presentation for your reference that may be viewed as part of today's web conference. Presentation materials are also available from our website at lglgroup.com. I ask that you locate those and use them as a reference for today's call. This call will be recorded and will be available for playback later today on our website. Other financial information and recent press releases are also posted there and I encourage you to take a look in there and see what we have available. Please note that our comments today are covered by the Safe Harbor statement. During this call we may include certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, non-GAAP financial measures may be presented as well. These statements are based on management's current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from those expectations due to changes in global, political, economic, business competitive market and regulatory factors. More detailed information about those factors is contained in The LGL Group's filings with the SEC. I want to remind you if any time you need assistance during the call and the web conference, please press 'star' 'zero' for the operator. At this time I'd like to introduce our President and CEO, Mr. Greg Anderson.

Greg Anderson: Thank you, LaDuane, and good morning everyone. If you would turn to page three of our slide deck, the agenda for this morning's call, I'll give a brief introduction. Of course we'll cover the business highlights from second quarter, just what's going on with financials and our capital structure, cover off again on our strategic growth initiatives, and of course take your questions. From a business highlights perspective, we did have a positive book to bill for the first half and the second quarter, so that was encouraging. Our Telecom market segment did show some strong activity really for new orders all the way through the first half. Again, I'd reiterate that our demand from our MISA market, which stands for Military Instrumentation Space and Avionics, that market segment has been softer in the first half although I would say that the avionics piece has shown some strength and some improvement.

Just to elaborate a little bit more with regard to the military aspect, again we're not really in the ammunitions platforms, we're really more in the radio and those types of communications. It's approximately 25% to 30% of our overall revenue and with the uncertainty in the federal budget, we think we have felt some impacts there and that's really mostly in our repeat orders. On the other hand, we are working a number of significant contracts in that area that is for new business. So as that gets awarded, we believe that there is some potential with this regard. Our order backlog at the end of the second quarter was just a little over $12 million which was essentially unchanged when we compare it to how we ended the first quarter. Our revenues for the second quarter were $9.6 million, down notably as compared to a year ago, but up 4% to 5% over the first quarter.

When we take a look at margins and costs and earnings, our growth margins for the second quarter was 31.8. It was down just slightly off the first quarter. I think that was 32.6 and we did have some operating efficiencies there that contributed to that difference. Otherwise, there really isn't anything of note to mention. Again, a significant change from Q2 of 2010, there those margins were obviously favorably affected a year ago by the additional revenue and just the spreading of those fixed costs. Variable costs or what we call variable costs in the first half of the year were comparable. We did have Q2 pre-tax earnings of $540,000.00 and that turns into $0.21 of diluted EPS pre-tax. Net income was $346,000.00 with earnings of $0.13. Our EBITDA dollars for the second quarter was $773,000.00 and we did continue to generate cash from ops all the way through the first half of the year totaling about $1.7 million.

As we look at Q3 and the back half of 2011, we are cautious against our repeat orders. We do have a number of new contract wins in play. How they'll come in could be impactful. The repeat business in some areas, we just don't have a lot of visibility to it. We'd like to think that it's going to improve in the military sector but at this point we've got to remain cautious. We think Telecom is going to be stronger. Major OEMS, they are giving us sort of a mixed market report, so even in the Telecom side they're probably not quite as bullish as they were a quarter ago. The electronic manufacturing services area, the contract manufacturers, the Flextronics, the Celesticas, the Sanminas, the JBLs, the benchmarks, they're not quite as bullish as they were a quarter ago as well in general. That's my read on it as I take a look at their quarterly earnings releases. So I think we have a bit of a mixed market condition in both the OEMs as well as the contract manufacturers. Semi-conductors, they are predicting which is oftentimes a leading indicator for our industry. They are predicting growth for it for this year. A lot of it is really semis that go into end-use consumer applications. Now the applications do end up requiring front end wireless infrastructure and backhaul. So at least it's a leading indicator that some spending is going on in that area.

In the financial highlights and our capital structure, again our quarterly income statement as we look back over the last twelve quarters, I mentioned second quarter came in at just under $9.7 million and that gives us, with margins of 31.8 in EBITDA of about 8%. I mentioned our order backlog was essentially flat as compared to the first quarter and again, probably lightest in the military aspect. The overall capital structure is as strong as the company has ever been. Our assets are at $31 million. Our net working capital is $19.3 million, cash balance remains at $11 million, and we do have a new line of credit and that line is now open at $6 million with no draws against it. The company has shared a new metric. It's an adjusted working capital and really to look at how effectively we're using our working capital less cash, and that is at $9.2 million at the end of June, an improvement.

Most notably, at the end of June the company did enter into a new credit facility with JP Morgan and Chase. That was a nice step forward and again one of I'll call the strategic efforts that we've had underway to really get our banking in line with our company and strategic objectives of our growth initiatives. So as an example, JP Morgan is obviously an international bank and where we have our international locations we're just able to simplify in all those transactions as well as have access to banking in those markets. So we think that's a nice step forward and that just rolled over and took place on essentially June 30th or July 1st. I'll also mention that it's being a local bank for our headquarters down in Orlando. Non-GAAP to GAAP of our adjusted working capital for your reading, and the strategic growth initiatives, I've commented on these on a number of times, we continue to make good investments we think are good investments on the organic and core business side. We're being asked by our customers all the time to engineer new formats and active programs. As of today, we've got a lot of design work going into front end wireless infrastructure for our major OEMs. Those are potentially large opportunities. What we end up winning for new contracts there is still speculative but that technology is now in the sampling phase and going to essentially large Telecoms.

On the MISA side, just to give an example of some of the new products, we're underway doing what are called the [coolable] filters. It's a large market opportunity. Maybe $20 to $30 million could be the potential. We're a non-player there today yet we have our OEMs asking us to participate in that market. Obviously we have to engineer, there's an incubation period, we have to sample, so it's not all going to be immediate revenue but we really think that I'll call it our inbox for organic engineering is really strong at present. We are still actively pursuing joint ventures any way we can get to, so IP positions and mostly when I speak to IP I'm talking about the areas or products that we don't participate in today. Again, with that we hope we can get some margin in growth that expands and makes us wider and more important to our OEMs. We continue to work the flexibility there in our supply chains and have conversations underway with Asian suppliers on whether we should have deeper relationships to really again improve our manufacturing flexibility and serve our OEM customers.

On the M&A side, a good bit of my time and the Board of Directors is spent on trying to look at synergistic acquisitions. We've covered that with you on a number of calls. I just want to assert during this call that that is an active part of my time and the Board time as we look to find acquisitions that would be complementary to our highly engineering precise kind of business. We think it's just better to be [unintelligible] frankly but we want to do that thoughtfully. So that's an active and ongoing process that myself and the Board are participating in. Investments in Greenfield are still on the sheet. At present it is not active. So at this time I'd like to entertain your questions.

Operator: At this time if you would like to ask a question, please press the 'star' and '1' on your touchtone telephone. You may withdraw your question at any time by pressing the pound key. Once again to ask a question, please press the 'star' and '1' on your touchtone phone. We'll take our first question from the site of Hendi Susanto with Gabelli & Company. Please go ahead.

Hendi Susanto: Hey, Greg and LaDuane, good morning. First question, how much revenue comes from Telecom and do you see sustaining demand in Telecom will continue into the second half of 2011?

Greg Anderson: I'll answer that first on a historical sense. Last year, Telecom was about half of our revenue and frankly in the front half of this year it's probably going to end up being more than that, and frankly on a mixed basis will likely be for the whole year. Our outlook in Telecom is at this time, even with some of the softness being reported, we think we've got some programs and orders coming in. We actually believe that again to be our strongest market. If you ask me, we're going to have to wait for those orders to be placed and for us to shift them, but actually our outlook for Telecom is solid to strong.

Hendi Susanto: Then about the low cost in the India facility, how much production will this facility handle going sometime in the near future?

Greg Anderson: We continue to look towards making investments in our India facility. Obviously we believe we have a differentiated cost position there and frankly we know that's what it takes to compete. So today, it probably covers maybe at least 50% of our revenue in our company. It's very thoughtful that when we design new products and the supply chain if we have to build that internally in most of those types of devices there really aren't contract manufacturers that can do those up-mark kinds of devices, we will make those investments in our India facility. So I would look for India to be incrementally expanded around our core business as we look to bring on some of these new products.

Hendi Susanto: Then in Asia, what kind of business opportunities are you pursuing?

Greg Anderson: We have two parts of that, Hendi. One of them is an awful lot of our existing OEMs, if not all of our existing OEMs, have now set up some element of design and certainly component purchasing basically in their Asian arms. So the Ciscos, the Ericssons, the CNS, I mean they all have that Asian component now and it's a growing sense of how they do business. So obviously, we are there to represent ourselves. We have our Shanghai office that we opened in March of last year. It's actively participating with our existing OEMs. So it appears like it's the same company but in a lot of ways it's really an expansion because we're now tying into the programs that they're doing in-country over there. When it comes to the pure Chinese OEMs themselves, for the most part we are still approaching I'll call them the smaller companies to try and get maybe more of what I would call a tier two in size. We've done an awful lot of sampling. I saw actually a presentation yesterday where we have 57 design wins in-country in China with new OEMs this year. The book to bill on that, well, you first have to get - there's an incubation period but at least we are beginning to grow business in that region. Our presence today in-country with I'll local OEMs hasn't been strong but we do see some growth there.

Hendi Susanto: LaDuane, How should we model LGL's corporate tax in the next several quarters?

LaDuane Clifton: Over the next couple of quarters you would expect a similar effect of tax rate that you see in Q1 and Q2 which is about 36.2%. That's our estimate of the full year and that would be a reasonable number of really a normalized rate from this point. Looking into 2012, the rate will be similar as well.

Hendi Susanto: Thank you.

Operator: Just as a reminder, if you would like to ask a question, please press 'star' '1'. We'll take our next question from the site of Larry Moats with Moats Office Properties. Please go ahead.

Larry Moats: I just had a couple of questions with respect to your cost structure. Could you comment on what the fixed administrative costs are for LGL? I know you've got it as one line - engineering, selling and administrative - and just trying to get an idea of what the fixed overhead is.

Greg Anderson: Are you asking the public company cost per se or all fixed? I'm trying to define your question a little bit further maybe.

Larry Moats: What your administrative costs are.

Greg Anderson: Okay, I'll let LaDuane answer that.

LaDuane Clifton: Of the percentage of total ESG&A, administrative costs are probably about 25% roughly of that number, and with the balance going in our engineering and sales efforts.

Larry Moats: So you're talking roughly $2.5 million?

LaDuane Clifton: It's a little bit less than that so more on the 20%, around $2 million total.

Larry Moats: Okay and that includes all your director's fees?

LaDuane Clifton: Yes, the public company.

Larry Moats: And the set of compensation and so forth and so on?

LaDuane Clifton: Yes.

Larry Moats: Okay. Then in terms of the new plan with regard to bonus compensation for the Board and management, could you elaborate on what exactly has to happen for those benefits to be accrued? In other words, it's been a rocky year. I mean I'm sure that you've done a great job on the one hand coming out of the red, but on the other hand the stock's gone from 36 to 8.

LaDuane Clifton: Yes, that's a great question, Larry. In the description of the plan both in our 10-K, you can see a description of the plan. It talked about a model that is based on creating a bonus pool that's built off of EBITDA. And so to the extent we have positive EBITDA, there may be a portion of that that could be set aside for a bonus. Obviously, as EBITDA is modest then that bonus pool would be smaller as a result. So I think that's the best description if you look at the 10-K or in the proxy you'll see that description of how that plan is structured for that.

Larry Moats: Yes, I read that and I think it had three or four different ways you can approach it. At least that was the way I interpreted it. But I guess what I'm trying to get at is the baseline in terms of how much does the EBITDA have to increase to get X amount of bonus money? What's the baseline? Are you basing it on 2011 profits as compared to 2012 as we get into 2012?

LaDuane Clifton: I see. Yes, it's really based over we're looking for initially there's an element which is how the shareholders equity grow over a three-year period, so we look at how it grew over an average period. Then we set aside a certain amount of the 25%. After that we establish a bonus pool, but those specific amounts are always subject to current business conditions. So even though we do have a modest accrual included as we look at the full year's results and where we're headed, it's always in the discretion of the Board to take a look at those levels. So it would be difficult to predict that at the moment.

Larry Moats: Well, in other words there's a lot of subjectivity that goes into it.

LaDuane Clifton: Well, we try to maintain that flexibility so that we can always be responsive with where we are currently. So if you looked at the end of 2010, we were being careful with our cash position and make sure our balance sheet was in line and we took a stand where we actually paid a portion of bonus as shares [unintelligible] of stock for example, for restricted shares invested over time. Of course that gives us the flexibility to align it with shareholders, creating shareholder value and have those incentives aligned for management. But that's an example…

Larry Moats: So you guys don't win unless the shareholders win?

LaDuane Clifton: Absolutely.

Larry Moats: Okay. That's if the stock goes down and then it's not good for you guys.

LaDuane Clifton: No, we're in it together, so to speak.

Larry Moats: Okay. Greg, on the gross margins, incremental revenue, incremental costs, I know that in your presentation it's 31.8% based on the second quarter. Just a ballpark, if revenue goes up $1 million in the next quarter over the current quarter, what's the incremental margin on that?

Greg Anderson: Our list on the incremental margin frankly is historically it's mixed dependence on - but in my opinion it's quite good for our components business, almost half.

Larry Moats: Okay, very good. So in terms of your pay structure, I mean there's a lot of room for some very nice profitability.

Greg Anderson: Absolutely. We get some upside and the nice part about our business is these are very specific and custom components. Our OEMs do not like to – frankly, they don't like to redesign them. Once you're in, you're in. So it lines you up for that sticky revenue stream. There's not much I can do if our OEM is also in a slump and not buying product or not selling product.

But when they do come back having these strong what we call a preferred supplier positions really enables us to reap the benefits and then have these long sticky revenue streams. It just doesn't take much from an incremental factory supplier to pass these and to fill those orders, and that's where we get that nice lift from. So the upside really almost all goes to bottom.

On the saving of structural costs, that's an active part of our ongoing management process as well. Just recently, in really the second quarter of this year, so this past quarter, we again reduced our US risk footprint. We had two buildings up in South Dakota. We had moved all of – we had some SG&As right across two locations. We essentially erased or lowered our US footprint by probably over 10,000 square feet by consolidating it to one facility up there. Then we moved all those SG&A costs down into our headquarters in Orlando and it obviously saved some costs there as well. So we continue to push on the structural costs during these tougher times and I'll call these down-business cycles. We have to flex our staffing as well, we recognize that. So that's our job as management to make sure we keep our costs in line in these down cycles.

Larry Moats: That's attributed to your overall manufacturing structure, how much can your volume increase before you have to make no significant capital expenditures?

Greg Anderson: If it's off of what our repeat orders are today, it probably could flex 30% to 40% from where we're at today, maybe even 50%. If it is new platforms, that's where we run into CapEx. Most of what we do ends up being I'll call it an extension of what we're at so it ends up being incremental and would stay within I'll call it inside of our typical business spend which is usually 1.5% of revenue. Now, occasionally we may have to look at investments outside of that, and putting in that CapEx again, we'd probably put most of that in our Delhi facility. I'm being a bit evasive there I know, but I would say for most business, it's going to be incremental and inside of what we've had as a past business practice. From time to time we will certainly entertain those kinds of investments that would require more than that and bring those to our Board for evaluation. Frankly, we have some of those opportunities on the table today and they're in discussion.

Larry Moats: One last question, do you have any estimates on what your profitability might be for the rest of the year?

Greg Anderson: I'll let LaDuane respond to that.

LaDuane Clifton: Yes, we don't tend to give a lot of guidance but I would say that even on the 8% range we really target 10% EBITDA. We want to be in the 12% to 15% in terms of our goal. But the first half business cycles are probably similar to where we'll be from a cost perspective. So that's probably the best guidance I can give you.

Larry Moats: So that means even a flat – I'm not sure I…

LaDuane Clifton: I think the first half is indicative of the second half.

Larry Moats: Okay. Alright, thank you very much. I appreciate your answering all the questions. Good luck.

LaDuane Clifton: Thank you, Larry.

Operator: Once again if you would like to ask a question, please press 'star' '1'. We'll take a follow-up question from the site of Hendi Susanto with Gabelli & Company. Please go ahead.

Hendi Susanto: Greg, what are the opportunities in commercial avionics in contrast to just the military avionics business?

Greg Anderson: Frankly, they're good for us right now. Commercial avionics is much stronger and so even though it's not –I'd say it's probably less than 10% of our company's revenue, the number of repeat orders coming through, commercial is strong and we have a couple of new contracts in play there that really go into small jets. I would put them in – they would be notable. So we are actively designing for commercial avionics and it's certainly an active area for us. I don't think we'd probably see a present – it's not one of those where we would probably exceed 10% of revenue but we're certainly actively designing and growing right now.

Hendi Susanto: Thank you, Greg.

Operator: There are appears to be no further questions at this time.

Greg Anderson: Okay, well, in closing, thanks for joining our call today. Obviously our business is cycling and we are putting the disciplines and the energy and the assertiveness into rebuilding where it was last year. Our customer positions, they do remain strong, so it's not a situation where that has changed. I believe our customers are softer and as a result we are. I mentioned our strategic growth initiatives, management's efforts there, and the Directors are really putting I think a very real amount of energy there and hope that we can report on some of those in the near future in the public domain. Again, thanks for joining our call. I look forward to you joining in the future.

Operator: This ends the LGL Group's Q2 Earnings Report call. If you have any further questions, please send an email to Greg Anderson at ganderson@lglgroup.com or to LaDuane Clifton at lclifton@lglgroup.com. Thank you for attending. You may now disconnect.

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