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CECO Environmental Corporation

First Quarter 2016 Earnings Conference Call

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PRESENTATION

Operator:

Greetings and welcome to the CECO Environmental First Quarter 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Tracy Krumme, Vice President Investor Relations. Thank you. You may begin.

Tracy Krumme:

Good morning, everyone. Thank you for joining us on CECO Environmental's First Quarter 2016 Conference Call. On the call with me today are Jeff Lang, Chief Executive Officer and President; and Ed Prajzner, Chief Financial Officer and Secretary; as well as Martin Pranger, President of our Energy Technology segment; and Steve Fritz, Vice President and Head of CECO`s Recurring Revenue business.

Steve will be briefly discuss our Recurring Revenue business and, both Martin and Steve will join us for Q&A.

Before we begin, I would like to note that we have provided a slide presentation to help guide our discussion. This presentation can be found on today's webcast and can be downloaded from our website at cecoenviro.com.

I would like to also caution Investors regarding forward-looking statements. Any statements made in today's presentation that are not based on historical fact are forward-looking statements. Such statements are based on certain estimates and expectations and are subject to a number of risks and uncertainties. Actual future results may vary materially from those expressed or implied by the forward-looking statements. We encourage you to read the risks described in our SEC filings, including our Annual Report on Form 10-K for the year ended December 31, 2015. Except to the extent required by applicable securities laws, we undertake no obligation to update or publicly revise any of the forward-looking statements that we make here today, whether as a result of new information, future events, or otherwise.

Today's presentation will also include references to certain non-GAAP financial measures. We have reconciled the comparable GAAP and non-GAAP numbers in today's press release, as well as the supplemental tables in the back of the slide deck.

With that, I would now like to turn the call over to Jeff.

Jeffrey Lang:

Good morning and thank you for joining our call. Please turn to Slide 3. Ed will walk you through the financial details in a moment, but I wanted to provide my perspective on Q1.

CECO advanced all three of our strategic imperatives in Q1. Revenues grew, margins improved, and we reduced our leverage ratio. We showed improvement in Q1 2016, despite some soft macroeconomic conditions in our Asia, North America, and EMEA regions that we messaged in the fourth quarter. We delivered record revenue, $103 million, slightly above Q4 as expected. Bookings were $120 million in Q1, 20% higher than our $100 million in bookings in Q4 and Q3, and better than we anticipated. Our backlog continued to climb, reaching a record level of $228 million, up 8% sequentially, and 49% year-over-year, and we delivered $0.18 of non-GAAP EPS in the quarter.

Margin expansion remains a key strategic imperative. Consistent with our operational excellence focus, we delivered Q1 improvement in gross margin, operating margins, and EBITDA, as well as bookings. Growing our recurring revenue is also an important strategic focus. We delivered Q1 growth as expected, and are tracking toward our double-digit growth goals. Steve Fritz will talk more on that shortly.

Debt repayment and deleveraging our balance sheet is on-track and remains a priority. Consistent with previous quarters, we've been paying-down our debt at a level of 2 times or greater, our required quarterly principal commitment. We paid down $7 million in the first quarter of 2016, lowering our net-debt-to-EBITDA ratio to 2.6 times from 3 times in Q4. We are tracking well towards our stated goal of a 2 times gross-debt-to-EBITDA leverage ratio, and expect to achieve this before the end of 2017.

We also delivered strong free cash flow generation, coupled with working capital improvement in the quarter, versus year-end 2015. Ed will talk more to those metrics, but this is an essential component of driving shareholder value, and we expect continued improvement. Turning to Slide 4, I would like to take a moment to re-clarify our strategy, market positions, and growth opportunities.

CECO is a global provider of leading engineered technology solutions in three core areas: one; natural gas power generation, emissions management, and pipeline distribution; two; air pollution control technology, and three; fluid and filtration technology. We have: A) a broad portfolio of integrated solutions, B) well-known reliable brands for critical complex processes, and C) a reputation for flawless execution, enabling us to hold key market positions of one, two, and three in most of the identified niche markets we serve. Customers place orders with CECO due to our excellent technology, high reliability within critical applications, and excellent project execution.

CECO primarily serves global industrial customers, who manufacture products for a wide-range of purposes. To simplify, they tend to use our solutions for three reasons: 1) to meet plant efficiencies, critical processes, and environmental improvements, 2) to manufacture systems in the energy segment, primarily natural-gas related, and 3) to move fluids within sophisticated manufacturing plant applications. Hence, CECO is organized into three business technology segments, Energy, Environmental, and Fluid Handling. Each segment has its own P&L, with a dedicated Leadership Team pursuing operational excellence, margin expansion, and sales focused, both on engineered equipment and aftermarket business.

Energy Technologies: With the acquisition of Peerless last year, our Energy Technologies segment, by design, is now our largest business segment comprising nearly 50% of our total revenue. We are a leading provider of engineered technology equipment for downstream of the Natural Gas Turbine Energy Plants, the Natural Gas Pipeline midstream distribution market, and traditional energy or coal markets. As you can see from the data points on the right, we are a small, but critical provider in a very large market with significant upside. We have an approximately 7% market share in a $2.8 billion annual total available market for Natural Gas Power and Natural Gas Pipelines, that is growing 5% a year for the next two decades.

The World Energy Outlook, the International Energy Agency (IEA) and the Large Natural Gas Turbine providers estimates natural gas fire power generation capacity to grow globally by 50% over the next decade. As evidence that our strategy has some traction, our pro-forma Energy business bookings were up 7% in Q1, despite a drop-off in some coal-related projects. We believe we are well-positioned to capitalize on the growth opportunities within this niche market. The Energy sector`s customers include GE, Siemens, Dominion Resources, Duke, MRC, Sempra, and Spectra Energy to share a few names with you. We believe we are well-positioned to capitalize on the growth opportunities within this CECO niche market. The estimated $2.8 billion total available niche market size represents approximately 600 Natural Gas turbine sales per year, coupled with numerous new pipeline expansion projects, and pipeline upgrades to pursue as a Company.

Our strategy is to increase our market share by focusing on the Natural Gas largest turbine manufacturers and midstream pipeline companies, to become their provider of choice on natural gas projects. We provide superior emissions management technology, global supply chain management, and flawless execution, which our customers have identified as key value drivers. As mentioned, our Energy Sector President, Martin Pranger, is joining the call today during the Q&A session, to talk about our Natural Gas growth opportunities in this segment.

Environmental: Our Environmental Air Pollution Control Technologies segment is our second largest segment, comprising 34% of our revenue. We have assembled a portfolio of leading technologies for complex industrial environments, including scrubbers, oxidizers, cyclones, and dust collectors, and the breadth of our portfolio provides us the value-add to offer customers integrated solutions to meet their critical plant requirements. The primary environmental technology, often work in concert, to eliminate pollutants, or recover process catalysts or process resources so we're able to offer customized, reliable, and efficient end-to-end solutions, we call it One-CECO, to meet the most stringent environmental processes. We believe this gives us an edge in the market place.

We have an approximate 5% market share in a $3.7 billion annual total available market served, that is forecasted by industry analysts to have a five-year compounded annual growth rate of 4.5%. So, as with our Natural Gas business, we have developed a strong position in this growing environmental products market. The Environmental Segment works closely with customer such as: DuPont, Intel, Aleris, AMD, Exxon, Chevron, General Motors, Honeywell, and Nucor; to name a few.

Fluid Handling and Filtration: Fluid Handling and Filtration is our third largest segment, comprising 16% of our revenue. Our Fluid Handling Technologies are mission critical, niche applications that are required by many chemical, petrochemical, commercial, and large process industries. We offer premium centrifugal pump technology that handle difficult liquids that are abrasive, corrosive, or at very high-temperatures. We also offer a wide range of industrial chemical filtration products, such as specialized exhaust systems for laboratory fumes. Although the Fluid Handling and Filtration segment is our smallest in size, it is our highest operating margin business, and we are excited to expand and invest in this segment. We have an approximate 4.5% market share, in a $1.6 billion annual total available market that is forecasted by industry analysts to have a global five-year compounded annual growth rate of 3.5%. Fluid Handling customers include Boeing, Dow, General Motors, Georgia Pacific, Koch Industries, Tyson and Sea-World, to name a few.

Turning to Slide 5: you will see we have strategically evolved into stronger diversification, due to diverse end-markets, as illustrated in the pie chart, providing a solid foundation to drive growth through various economic cycles. Within our three business segments, our Energy group is the largest, contributing nearly 50% of the total revenues. Our Environmental business makes up 34% of our revenue-base, with Fluid Handling and Filtration segment representing 16%.

We have a strategically balanced global footprint with approximately 40% of our sales outside of North America. Five years ago, CECO's international business was approximately 18% of the total, and we were too dependent on the domestic economic situation. Of the 40% of international revenue today, 25% comes from EMEA and 15% from Asia. Asia represents a significant long-term growth opportunity, as we have low-market share in a large total available market, and our technology solutions are needed to solve their growing challenges.

Looking now to our end-markets: 35% of our total revenue, and likely our largest near-term growth opportunity, is the combined Natural Gas Power and Midstream Gas Pipeline market, which is in our Energy segment. Industrial Manufacturing, spread among the Environmental and Fluid Handling and Filtration segment, represents 32% of total revenues. The Chemical and Petrochemical Refinery sector, part of the Environmental segment, represents 25% of revenues. Lastly, solid fuel power or coal represents approximately 8% of our revenue, with USA and in Asia where coal is the predominant energy source.

Last, but certainly not least, is our attractive recurring revenue base. We classify this as Aftermarket Parts and Service business and it represents 25% of our total revenue, across all three operating segments. Growing this recurring revenue business is an important strategic focus of ours, which applies to all of our operating businesses.

Turning to Slide 6, please. Our reoccurring revenue strategy is a key focus, and on-track, and with that, I'd like to turn the call over to Steve Fritz, our Executive leading the Recurring Revenue business for CECO.

Steve Fritz:

Thank you, Jeff, and good morning. Given our total revenue run-rate, Recurring Revenue makes up about 25% of our total revenue. This is derived from our $5 billion of products and systems installed and in-use in large manufacturing plants of our customers. That installed-base of products and systems need replacement parts, maintenance, technical enhancements, retrofits, and services. Therefore, my role and responsibilities are to help ensure our organization enables customers to obtain replacement parts, maintenance, services, and technical support of this installed-base of products and systems. We call this our Recurring Revenue business, and to be clear for Investors, this is not a separate business segment as sales are attributed to all segments, Energy, Environmental, and our Fluids business.

Coming off a strong Q4 in 2015, with Recurring Revenue sales with sequential revenue growth, our Recurring Revenue grew by double-digits in Q1. More importantly, our Recurring Revenue quotation pipeline, what we call our activity, increased 15% sequentially, which validates our Recurring Revenue growth expectations.

As we've stated before, and by our stringent definition, our low-customer connectivity, approximately 12%, represents significant growth upside. We measure a connected customer as one we've transacted business with, in the past twelve months. That is how CECO defines connected customers versus drifted or unconnected customers, so you can see that we have a growth opportunity, if we can move some of the 88% drifted or unconnected customers to this connected group. As an added incentive for us to accomplish growth of recurring business, operating margins for Recurring Revenues are typically much better than Original Equipment sales margins.

With an opportunity to leverage our $5 billion of installed-base, of more than 300,000 units, we continue to invest in our Aftermarket employees. We recently hired a Director of Services and have added additional Regional Aftermarket Sales Manager roles and numerous Aftermarket inside sales resources. Our dedicated group of 105 Aftermarket specialists, represent 10% of our total employees, and are focused on building stronger relationships with, both customer groups; those that are connected, as well as the drifted customers.

Our goal is to demonstrate value at every stage of our customer's engineered equipment lifecycle and stay connected on an ongoing basis. Doing so, will ensure that we are consulted first, as well as provide pull-though opportunities, such as engineered equipment sales. As an example, we track weekly recurring revenues by operating division around installed-base connectivity improvement, out-bound sales calls made, sales or bookings, and gross profit.

Our CECO Aftermarket University training is an enabler to gain more traction. We started the year with targeted goals of double-digit recurring revenue growth, and feel confident that this is achievable. Our business leaders and aftermarket resources continue to use weekly metrics to better understand daily actions so we can help our customers optimize their total costs of the assets they purchased from CECO in the past. Our dedicated Aftermarket employees are making more out-bound calls and creating a greater aftermarket pipeline, in order for us to capture this growth, and enhance connectivity with all customers.

We are driving margin expansion through similar standardization efforts in pricing, costing, and supply chain management with tighter controls. By focusing on pricing standards, supply chain excellence, and branding improvements, we expect to show continued improvement and meet our targeted goal of 30% recurring revenue by the end of 2018.

I look forward to answering any of your questions during the Q&A session, later on in this call. Now, I will turn it back over to Jeff to discuss the excellent progress with the Peerless acquisition.

Jeffrey Lang:

Thank you, Steve.

Now, please turn to Slide 7. As I mentioned, we are delivering on our Shareholder value creation with the performance of Peerless. Peerless delivered $31 million in bookings, $25 million of revenues, and $5 million of EBITDA in Q1. While revenues are down from last year, you'll see the significant improvement of $4.7 million operating income non-GAAP, up from an operating loss of nearly $2.7 million in the comparable quarter of 2015.

Highlighting our core strategy of running Peerless as a large integrated division within our Energy Technology Segment, we delivered significant margin expansion, exceeding our Q1 expectations. This is due to operational streamlining, improved project management discipline, with the renewed pricing standards and much more external strategic fabrication centered on an asset-light business.

We have exceeded our $15 million target of cost-out synergies and we believe the total value is now closer to $18 million. We're now on-track this year, due to pricing standards, rigorous project management expectations, cost containment, but our primary focus at this juncture, is sales and growing market share. We're now more focused on sales, investing in sales engineering efforts, sales resources, and in general, the front-end of the business to grow.

Turning to Slide 8, please: Creating Shareholder Value. The entire CECO Leadership Team is focused on three core strategic areas: Number one; is growing market share organically and recurring revenue. While we have demonstrated good progress with reoccurring revenue growth, we need to deliver improvement in our Engineered Equipment side, with better organic growth. This has been due, in part, to some softness in the regional macroeconomic environments.

Number two; as we have communicated, paying down-debt, deleveraging the balance sheet, and expanding EBITDA remain key priorities. Bringing the debt-to-EBITDA leverage ratios to 2.0 times is taking place quarterly. Our deleveraging process is on-track and each dollar of debt reduction has the potential to translate into an increased dollar of shareholder value, so this remains a core deliverable for CECO.

Number three; margin expansion activities, free cash flow generation, and working capital improvements were achieved in the quarter, and are interwoven into our operational fabric and commercial order intake activities. Ed will speak in more detail on our progress and goals for this. From a high-level, gross free cash flow was $12 million in Q1; total working capital was 19% of revenues, showing improvement of one full percentage point in Q1 versus Q4, validating our focus on cash management activities in running our business.

Finally, we view our asset-light business model as an important bright spot and competitive advantage. Greater than 70% of our manufacturing/fabrication is achieved through external strategic manufacturing partners, while improving our global supply chain. This provides us with a more nimble, higher variable cost, and lower fixed-cost model, which is a differentiator to many industrial technology companies. To support our theme, we recently signed a Letter Of Intent, to sell and lease-back two manufacturing facilities for gross proceeds of $11 million. As we strive to close on these potential transactions in Q3, the net proceeds would be applied to the debt-repayment and deleveraging the balance sheet.

With that, I'll turn the call over to Ed to provide more detail on our financial performance.

Edward Prajzner:

Thank you, Jeff, and good morning, everyone. As mentioned, I will highlight in more detail, both the GAAP and non-GAAP performance for the quarter, for both our consolidated results and three segments.

As a reminder, our non-GAAP adjustments include several items, such as acquisition and integration expenses, and the impact of acquisition asset valuation adjustments on the income statement, including higher depreciation, amortization, and earn-out expenses. Our non-GAAP presentation is intended to provide better trend analysis and assessment of our core business performance.

Beginning on Slide 9, I would like to provide a little more detail on the summary that Jeff provided earlier. Our revenue was $103.2 million for the first quarter of 2016, an increase of 27% year-over-year and 2%, sequentially. Bookings were $120.1 million, up 28% year-over-year, resulting in record backlog of $228.1 million, which is up 49% year-over-year. Bookings were also up 20%, sequentially. Our non-GAAP operating income was $10.9 million, up sequentially from $10 million. Our Adjusted EBITDA of $12.7 million was up 48% sequentially, from $12.2 million and non-GAAP EPS for the quarter was $0.18 per diluted share. Our strong free cash flow allowed us to pay down $7.1 million of debt in the quarter, which is twice CECO`s required quarterly debt repayment obligation.

On Slide 10, you will see our revenue trend for the past five quarters. Revenue is up 27% year-over-year and up 2% sequentially, although down 3.5% organically, on a constant-currency basis year-over-year, due to primarily to project timing, weakness in Asia, and softer demand in some North American industrial markets.

On Slide 11 please, see our booking and backlog trends for the past five quarters. We are pleased with our increased level of backlog at $228.1 million as of March 31, 2016, up 7.4% from year-end, and up nearly 50% year-over-year. We are also pleased with our $120.1 million of bookings in Q1 2016, up 28% year-over-year, and up 18%, sequentially. Organic bookings were down 5% year-over-year, due to weaker market conditions, primarily in the Environmental segment and Asia. Our outlook remains consistent with what it was at the end of 2015.

Continuing on to Slide 12, our non-GAAP gross margins were 30.9% in Q1 2016, consistent with Q4 2015 at 31%. Gross margin was up significantly over the prior year period, due to favorable revenue mix, and project management excellence, as well as Peerless gross profit being higher than expected and pricing management. Non-GAAP operating margins improved sequentially, to 10.6%, from 10% in Q4 2015, due to favorable mix of greater Aftermarket and the Peerless revenue.

Moving on to Slide 13, EBITDA was $12.7 million for Q1, up 48% from the prior year period and 4%, sequentially. Non-GAAP operating income was $10.9 million for Q1, up 45% from the prior year period and 8%, sequentially. These improvements are attributable to operational excellence, as well as Peerless' improvement being ahead of schedule.

Now, moving on to our segment discussions beginning on Slide 14: Revenue in our Energy segment was nearly $48 million, up 97% from $24.3 million in the prior year period. The higher revenue was driven by our Peerless acquisition, contributing $25 million of revenue in Q1. Aftermarket and retrofit opportunities continue to grow in this segment, as well as global expansion. Organic revenue was down 6% year-over-year on a constant-currency basis, due to project timing of revenue recognition.

Energy bookings of $63.9 million for Q1 were up 141% over the prior year period, with pro forma bookings up 7% in Q1. Our midstream Natural Gas Pipeline business booked $12 million in Q1 and RFQ activity remains consistent with Q4.

Moving to Slide 15, revenue in our Environmental segment was $39.1 million, down 6% from $41.7 million in the prior year period, but up 14%, sequentially, from $30.3 million in Q3 2015. Bookings at $40.5 million were down 21% over the prior year period, attributable to some North American softness and Asia slowdown. Also note, that Q1 2015 was an exceptional bookings quarter of $51 million; nevertheless, we are pleased with Q1 bookings, which were up 34%, sequentially, as some projects expected to book in Q4 were booked and closed in Q1.

Moving to Slide 16, revenue in our Fluid Handling segment was $16.6 million for Q1, up 9% from the prior year period, all of this growth being organic. Bookings were down slightly on year-over-year basis to $15.7 million, from $16.2 million from the prior year period, but up sequentially 6%, from $14.8 million. Our Fluid Handing segment has had margin expansion and recurring revenue growth, and plans to begin expanding globally into EMEA during the second-half of 2016, while leveraging the Peerless EMEA footprint.

On Slide 17, we illustrate our focus on debt repayment and deleveraging. We paid down $7 million in debt in Q1 2016, lowering our net-debt leverage ratio to 2.6 times from 3.0 times at December 31, 2015. We are on-track with lowering our leverage ratios as previously committed.

On Slide 18, we show the trend of our cash flow generation for the past two-years and the comparable quarters. We begin with gross free cash flow for each period, as reconciled to cash from operations. Our ability to generate cash flow is strong, with slightly over $12 million on a gross basis in Q1 2016, which resulted in $9.4 million of cash from operations, after interest expense and income taxes, which allowed us to pay down $7 million of debt in Q1 2016. We continue to maintain a very low-level of capital expenditures.

Lastly, on Slide 19, you will see our condensed balance sheet. As Jeff mentioned earlier, CECO is focused on lowering our leverage level to a targeted debt-to-EBITDA ratio of 2X by the end 2017. As of March 31, 2016, we had net-debt of $137.2 million, comprised of gross-debt of $170.6 million, less cash and cash equivalents of $33.4 million. This represents a net-debt-to-trailing twelve-month EBITDA ratio of approximately 2.6 times as of March 31, 2016.

The team is diligently working to bring this ratio down as committed. This is a priority for us as we will utilize our strong free cash flow, which is being fueled by working capital improvement initiatives, to accomplish this objective. We are also focused on further improving our working capital practices and wisely managing capital expenditures to maximize free cash for debt repayment. Working capital as percentage of revenues is favorably trending downward, both sequentially, and year-over-year.

At this time, I would now like to open up the call for your questions. Operator, please open the lines.

Operator:

Thank you. We will now be conducting the question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue and you may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick-up your handset before pressing the star keys. Once again, that is star, one to ask a question at this time.

Our first question comes from the line of Gerry Sweeney with ROTH Capital. Please go ahead with your questions.

Gerry Sweeney:

Hi, good morning everyone. Thanks for taking my call.

Jeffrey Lang:

Good morning, Gerry.

Gerry Sweeney:

I was wondering if you could give me a little bit more detail on some of the margins in the segments, specifically, and this probably relates to where margins expansion is going to come from in the future, but I remember 2015 Energy segment had that big Saudi gas project, margins were a little bit lower in that segment. Wanted to see how Energy finished out 1Q '16 and are we going to see some margin improvement and how that's going to build up?

Jeffrey Lang:

Gerry, good morning. You know, if you refer to Slide 12, that's kind of our margin slide. You know, we're thinking the trends on gross profit and operating margins could be indicative for the remainder of the year, given what's going on. A lot of the good things we're doing to grow margin, coupled with some of the soft things that are going on around the world, regionally, so we're thinking the margins we're experiencing in Q1 could be indicative for the remainder of the next couple of quarters.

Gerry Sweeney:

Okay, perfect, and then you did talk about a little bit about macro headwinds buffeting some of the segments. I mean, is that specifically into the Environmental Services segment, and does that continue to be China and I would say lower industrial production in the US?

Jeffrey Lang:

Correct, you're exactly correct.

Gerry Sweeney:

Okay. Any—you know, what is the tone in the end-market? Is that still trending down or any signs of stabilization?

Jeffrey Lang:

Right; good question. You know, if you refer back two-months ago, when we communicated Q4's results and outlook, if you refer to Slide 6 on our Q4 Earnings Deck; our outlook in the market, and RFQ activity is very consistent with what we messaged two months ago, Gerry. In our view, there's a lot of good things going on at CECO, there's a couple—there's a few regional macro things that are a bit of a drag on the business, but primarily what we stated in the outlook in March of 2016, is pretty much what we're seeing today in the outlook, nothing's really changed in how we view the outlook for the rest of the year.

Gerry Sweeney:

Got it, I appreciate it. I'll jump back in queue.

Jeffrey Lang:

Yes, thank you.

Operator:

Thank you and our next question comes from the line of Brian Drab with William Blair. Please go ahead with your questions.

Brian Drab:

Hi, good morning. Congrats on a solid set of results in a tough environment.

Jeffrey Lang:

Thanks. Good morning, Brian.

Brian Drab:

So, just another question on bookings here so they're up 20% sequentially. Is that what you'd expect from your normal seasonal trends or can you talk a little bit more about what drove that sequential increase in the quarter?

Jeffrey Lang:

You know, if you look at the past couple of quarters, I kind of view it as the last two quarters our bookings average was around $110 million per quarter, Brian. As we are very consistent with our last quarter message, we expected a little more bookings in Q4, and it happened that those bookings we expected in Q4, some of them fell into Q1. So, you know, Q4 was $104 million, Q1 was $120 million; of course, the Team is—we are very focused on organic sales and reoccurring revenue, that's one of our top three initiatives. But I kind of view it as our average bookings run-rate for the past two quarters is $110 million, is kind of how we think about it.

Brian Drab:

Okay, great, and then just maybe a few more questions to help us model, and I'm not sure how much detail you're able to give us in any of these metrics. But organic revenue is own, low single-digits in the first quarter, do you expect that we'll see that kind of low single-digit decline throughout the year, or how do you see organic revenue trending, organic revenue growth declines trending throughout the year?

Jeffrey Lang:

You know, we're viewing it pretty consistent from our message a couple of months ago. You know, there's a lot of things that are driving growth within the business, as we talked about our Natural Gas business is growing, and the activity is up, probably 10% or 15%. Steve just mentioned the reoccurring revenue pipeline has grown maybe 15% quarter-over-quarter, so there's a few things that are driving the front-end of our business nicely. Then there's a handful of things that are, you know, the Asia environment is still soft, the industrials in North America, which impacts our Environmental Technology business is soft. So very consistent with how we messaged the outlook in March so I'm thinking the outlook in the next couple of quarters could be pretty consistent with what we're seeing in Q1.

Brian Drab:

Okay and then, I might have missed this part, but you talked about gross margins. Obviously, ahead of expectations, I think you said you expected gross margin to be essentially flat year-over-year, and we saw nearly 500 basis points of expansion the first quarter. What do you expect for the balance of the year for gross margins? Can we sustain these levels?

Jeffrey Lang:

Yes. First off, Q1 of '15 had low margins, and Q1 of '16 had very good margins, so I think if you look at the trend of the past three or four quarters, and what we delivered in Q1. I think you should see some consistency from that point on the gross profit and the operating margins, so we view Q1 as pretty indicative for the rest of the year. Ed, you want to?

Edward Prajzner:

Well, Q1, Brian, benefited from some favorable mix, I mean Peerless did quite well in Q1, with some of the recurring revenue picking up, that's helping, as well. But as we said, that's being buffered a little bit with some of the softness in Asia, taking away a little on the gross margin line. But, all in all, we feel very comfortable that the Q1 margins, gross and operating for that matter, are fairly indicative of what you'll see for the remainder of '16 so that's a very good indicator of what we feel the rest of the year is going to look like.

Brian Drab:

Okay and then, maybe this one's for Ed, but on op ex. Are we seeing further cost synergies on—related to the PMFG acquisition, as we move through the year, or is this op ex, which was about 20% of sales in the quarter as a good kind of ballpark number for us to expect for the balance of the year in terms of percentage of sales for op ex?

Edward Prajzner:

Yes, that's definitely a good number. If anything, it'll all be contingent on the revenue level, the ratio, but no, the $18 million now of cost-out synergies for Peerless, we feel very comfortable that's been achieved on a run-rate basis. You saw that sort of come in and that's why—in the Q1, and that's why Q1's percentage dropped a little from Q4, but where you are now, the 20.5% is a good number. It could be a few bips up and down, as the year goes on, with revenue, but that's a good absolute dollar of SG&A to carry-forward now and a good ratio to use, Q1 for the remainder of the year.

Brian Drab:

Okay, thank you. I'll follow-up more later.

Jeffrey Lang:

Thanks, Brian.

Operator:

The next question comes from the line of Ryan Cassil with Seaport Global. Please go ahead with your questions.

Ryan Cassil:

Hi, guys. Thanks for taking my questions.

Jeffrey Lang:

Good morning, Ryan.

Ryan Cassil:

If I could just go back to margins for a second here, and dig in a little bit. It looks like, based on the slides, Peerless had about a 19% margin in the quarter, which puts the legacy business margin just below 8%. Could you give some color just on the drivers there and you talked about the margin profile remaining kind of steady throughout the year. Is that the way we should think about where the legacy business is right now, in terms of margins?

Jeffrey Lang:

Yes, the weighted mix, and bear in mind, as well we kind of said this during the prepared remarks, on the Slides. Peerless is a division of the segment now. It's no longer a public company so there's some costs that—it's being tracked purely now as a division, not as it was in the past, so its margin may be a little bit higher then the rest of the business. There is still a corporate, you know, overhead that's not—that we track sort of separately, that's not in the segment pieces, but regardless that weighted mix you're seeing out of the margins is pretty indicative. So what you're seeing for the respective pieces of legacy CECO versus Peerless would hold up, going forward, as our expectation.

Ryan Cassil:

Okay. Is most of the Aftermarket being booked or being accounted for in the way you're breaking out Peerless? Is that going with Peerless at this point?

Jeffrey Lang:

Correct, all the Aftermarket—yes, Ryan, all the Aftermarket business that we're working very diligently on growing, expanding the revenues, and expanding the margins flows through the business units. So, the answer is yes. But, I think the Q2 margins on gross profit/operating margins is kind of how we're thinking about the business for the next couple of quarters. There's a lot of things that impact the margin; volume, leverage, operating expenses so we're feeling pretty confident that we can maintain that for the next couple of quarters. As we go through Q2, we'll certainly give you an update if we see any upside or downside, but we're thinking the margin profile in Q1 is indicative of how we're viewing the outlook for margins for the next couple of quarters.

Ryan Cassil:

Okay, on a consolidated basis. Okay.

Jeffrey Lang:

Correct.

Ryan Cassil:

Then last for me, could you just talk about the trends in the combined cycle power market, and whether you saw any improvement there? Sorry, if I missed that.

Jeffrey Lang:

Right, so the Energy business is seeing a lot of activity. Martin Pranger, the President of our Energy Group will speak to that.

Martin Pranger:

Hi, Ryan. Good morning, this is Martin. So what we're seeing in the energy sector and what Jeff has already stated in the script, is that we anticipate that over the next decade, over the next 10-years, the installed capacity will grow for gas powered power plants about 50%, and that's globally. There's a couple of reasons for that, what we're seeing globally is there is an abundant amount of natural gas, the carbon footprint for gas fired power plants and combined cycle power plants is roughly 30% lower than (inaudible) fuel power plants. All the (inaudible) factors are that the gas power plants are very good in fast ramping up and down and that's important, with more and more renewable being installed on the grid, and the renewables are causing more (inaudible). So, yes, we see a good upside. If you look to the bookings last quarter, we saw about 7% organic growth, and that's what we're anticipating for the full-year.

Ryan Cassil:

Okay, great. Thanks, guys.

Jeffrey Lang:

Yes, thanks, Ryan.

Operator:

Thank you and once again, as a reminder, you may press star, one to ask a question at this time. You may press star, two if you would like to remove your question from the queue.

Our next question comes from the line Bhupender Bohra with Jefferies. Please go ahead with your questions.

Bhupender, your line is live. Please check if you are muted.

Bhupender Bohra:

Hi, good morning, Ed and Jeff.

Jeffrey Lang:

Good morning.

Bhupender Bohra:

So, my first question on the recurring revenues here. The target to grow the recurring revenue to 30% of the total sales by 2018. Maybe, Jeff, I believe you had spoken on previous calls to about how you're going to grow that. Can you remind us like some of the drivers, some of the catalysts, like how that is going to grow to 30%? Which particular segment would we see that?

Jeffrey Lang:

Well, first off, we're very focused on that deliverable and those action items within the organization. But I think Steve, would do a better job communicating what we're doing, and how we're going to achieve that. Steve?

Steve Fritz:

Good morning. Yes, we see growth in all of our segments. We've identified growth in the Energy segment, in the Environmental, as well as Fluid and Filtration. We're going to do that based upon looking at our portfolio and targeting these 10% of our employee population as dedicated employees so we work on things like winning value proposition for something as simple as selling parts, as well as our additional return on investment-types of products and solutions that helps our customers find increased efficiency gains across each of the portfolio items. So, it's a wide range, we see growth in each of our segments, it's a three-year journey to get to the 30% recurring revenue by the end of 2018. As far as Q1 is going now, as supported by co-pipelines, we see some significant progress through the year, and we'll continue to invest in that journey.

Bhupender Bohra:

Okay, so it seems like (inaudible) where would be the largest installed-base, right now, Energy being the biggest segment here. That would be the potential opportunity for you to grow the Aftermarket business, right, I believe so?

Steve Fritz:

Yes, sure. So our functional makeup of our recurring revenue business is about 50% of it does today, come from the Environmental Technology segment. Having said that, there's quite a few assets in that installed-base, and at the same time, we have a significant number of assets that in our Fluid and Pump business has a large number of installed-base assets that we continue to work with our channel partners, to grow that area as well. So, I think from my perspective here, we're going to grow the Environmental business, which basically is the 50%, the other two segments are about 25% each so we see significant growth opportunities across all three.

Bhupender Bohra:

Okay, got it. Thank you. On just a follow-on, for Jeff, on the—Jeff, you have been talking on the previous calls about like on the (inaudible) the dashboard internally, which you track from project perspective. Can you give us some color? Like how is that looking and (inaudible) track (inaudible) you know, (inaudible)?

Jeffrey Lang:

Sure. Are you referring to the quotation pipeline?

Bhupender Bohra:

Yes, that was it; I think it was the quotation pipeline.

Jeffrey Lang:

Of course. In a nutshell, we view the outlook and the pipeline very similar to what it was two months ago when we communicated Q4. You know, certainly we see the Environmental Technology sector a little more related to the Industrial, that outlook is pretty similar, the RFQ activity is pretty flat. The Energy activity, which is linked Industrial/Commercial and a couple of other excellent end-markets, is probably up slightly, modest single-digits. That would be our Fluid Handling sector, then of course, the Energy segment which Martin is leading, we're showing the RFQ activity is probably up 7%, 8%, 10% on the RFQ dollars. But, by and large, and of course, Asia activity is relatively muted, and a little slow. We see that as very consistent this year and we're certainly try to achieve flat rev—or flat bookings in Asia in a down market.

But, in terms of the outlook, and the RFQ activity we view it very consistent from two-months ago, and how we're looking at our bookings and revenue.

Bhupender Bohra:

Okay, thank you, and the last one on pricing. We haven't talked about pricing here, can you give us some color on how the pricing is actually going to look in the quarter—(inaudible) if you could give us some color? Thank you.

Jeffrey Lang:

Right. No, good question. The pricing management has been probably up a little bit, but keep in mind, with commodity prices coming down and 70% of our manufacturing footprint is external fabrication, there is a lot of capacity now to have manufacturing/fabrication improvement in your pricing. So, if commodity pricing has come down and sale prices have come down, we're able to improve our gross margin, or to maintain gross profit integrity through the pricing challenges that occasionally we see. So, gross profit showed some uplift in the quarter, and I think that was due to pricing management, and our global supply chain and our ability to leverage our strategic fabrication partners around the world.

Bhupender Bohra:

Thank you.

Jeffrey Lang:

Thank you.

Operator:

Our next question is coming from the line of Gerry Sweeney with ROTH Capital. Please go ahead with your questions.

Gerry Sweeney:

Hi, I just wanted to do a couple more follow-up calls, a little bit of a higher level than the—a little bit detail. On the higher-level side, on the Energy, midstream looks like it's done very well, bookings were up I believe you said 12% quarter-over-quarter. I know this is a late cycle play; I'm just curious how that area plays out, maybe not this quarter, but next couple of quarters? Do you have any insight into that? Obviously, lower prices for a long time, you know, may impact some of the spending on that front? Just any thoughts on that front?

Jeffrey Lang:

Are you referring to the Midstream Natural Gas Distribution?

Gerry Sweeney:

Yes.

Jeffrey Lang:

Yes, the pipeline business. No, we've studied that quite a bit in preparation for the call and our RFQ activity over the past couple of quarters for our midstream pipeline business is consistent and relatively flat. We track the number of quotes and the number of dollars per quote and we're showing a consistent pipeline from the past quarter, when we messaged so we don't see that improving. We don't see that declining, it's pretty consistent, the midstream pipeline activity that we're focused on in the Energy sector.

Gerry Sweeney:

Okay. Is there an opportunity for the Fluid Handling to move into that segment at all? Any cross selling opportunities?

Jeffrey Lang:

Not so much in the midstream. We have a broad distribution channel for our Fluid Handling and Filtration business and there are opportunities in the Energy sector, as you know, you've talked with our Energy sector President Gerry D'Alterio, but not so much on the midstream.

Gerry Sweeney:

Okay.

Jeffrey Lang:

But there are other opportunities across.

Gerry Sweeney:

A couple a little details; you're carrying about $33 million of cash on the balance sheet. How much do you actually need to sort of run the business on a day-to-day basis?

Edward Prajzner:

A good question, Gerry. A lot of that cash is not domestically held at our various international locations. We do work to pull it back and repatriate it to the US as much as we can. You're probably, you know, ideally if none of that foreign cash was there, you could operate at maybe $20 million as a minimum number, definitely larger then we need it to, and we do continue to pull it back domestically as long as it's tax neutral, or to our advantage to do so. But $20 million is the lowest you could probably effectively drive the cash balance on it.

Gerry Sweeney:

Then, real quick, you did mention—I think you sold two assets in the quarter. One, did you say $11 million? When do they close? Three…

Jeffrey Lang:

Gerry, in my script we messaged for several quarters, we talked about selling non-core assets, and we talked about continuing our asset-light model, which has a very favorable effect on our balance sheet, and our leverage ratios. We signed a Letter Of Intent to sell two manufacturing facilities. One was a CECO facility, one was a Peerless facility, to sell it and lease it back to continue the processes.
We signed the NOI last week and we have anticipation to close on that transaction in July. The gross proceeds would be around $11 million and, obviously, the net proceeds would be something less then that given closing costs and so forth. So, we're hoping in Q3 it closes, and the net proceeds of that transaction would be to pay down debt and de-lever the balance sheet.

Gerry Sweeney:

Got it, I appreciate it. Thank you.

Jeffrey Lang:

You're welcome.

Operator:

Thank you and once again, as a reminder you may press star, one to ask a question at this time. Our next question comes from the line of Julie Li with Drexel Hamilton. Please go ahead with your questions.

Julie Li:

Good morning. Thank you for taking my question. My first question is also on Recurring Revenue, to improve on that strategy do you expect to add more sales into the team? If so, will that—should we expect more SG&A spends in the future quarters?

Steve Fritz:

Hi, Julie. This is Steve Fritz; yes, thanks for the question. We do expect to continue to invest in our dedicated Aftermarket employees. As we stated, we're at 10% now, we're tracking the booking ahead, and these dedicated Aftermarket employees they have very quick payback periods, right, so yes we will expect to invest. We hope to do that in each of our segments, moving-forward, throughout the year, and we see very quick payback on them based upon the relative nature of book in turn for recurring revenue.

Julie Li:

Great, thank you, and my next question is on Asia market. I'm wondering if you have a similar product structure in Asia, compared to other regions? In terms of you breakout into Environmental and Fluid and Energy?

Steve Fritz:

We do, CECO Asia's a region and it's a platform to sell the three business segments portfolio into the end-markets. That's the strategy and similar in North America, similar in EMEA so yes, we do, and we're very focused on selling our portfolio to the end-users in all the parts of Asia, principally in China.

Julie Li:

I'm wondering if most of the headwinds, you just mentioned softness from industrial markets, bigger impact into Environmental segment in China?

Jeffrey Lang:

Sure. Sure, that is correct.

Julie Li:

Can you share more color on the competitor's space? Did you see a similar impact on competitors or how's your pricing compared to your co-competitors in China? Are you gaining more market share in the past three quarters?

Jeffrey Lang:

You know, very good question. When we compete against the China national or private companies, we do very well. One of the things that has led us into Asia for the past 10-years is CECO's technology is very good; it's above average. We have R&D taxation and innovative tax benefits around the world, acknowledging that our technology is well-received, and there's demand for it so, the CECO technology is better then what our competitors are providing on the ground in China, and that's a driver of our business. That's part of our integrative solution strategy, that's part of the One-CECO that we're delivering there.

Number two, from a cost perspective, we continue to refine our supply chain and our fabrication model in Asia to remain very competitive. We've consolidated our manufacturing footprint, we also have several external strategic partners that build products for us at high-quality and low-cost, and we're certainly leveraging that low-cost region. We're very competitive from a pricing perspective and we're going on our twelfth year there so we—99% of our employees are Chinese Nationals. We use all China manufacturing and so we're in good shape from a cost perspective.

Julie Li:

Thank you very much. That's very helpful. I'll jump back in the queue. Thank you.

Jeffrey Lang:

Yes, thank you.

Operator:

Thank you. Ladies and gentlemen, this concludes today's question-and-answer session. I would like to turn the floor back to Jeff Lang.

Jeffrey Lang:

Thank you for joining our call. Have a good day.

Operator:

This concludes today's conference. You may disconnect your lines at this time and thank you for your participation.