Air Industries Group Earnings Call

Monday, 14th November 2022

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Participants

Lou Melluzzo

Mike Recca

Howard Halpern

Operator: Hello and welcome to the Air Industries Group Earnings Call. My name is Josh, coordinator for today's event. Please note that this conference is being recorded and for the duration of the call your lines will be on listen only. However, you will have the opportunity to ask questions at the end of the call. This can be done by pressing star one at any time on your telephone keypad to register your question. If you require assistance at any point, please press star zero and you will be connected to an operator.

Except for the historical information contained herein, the matters discussed in this presentation contain forward looking statements. The accuracy of these statements is subject to significant risks and uncertainties. Actual results could differ materially from those contained in the forward-looking statements. Due the company's SEC filings on Forms 10-K and 10-Q for important information about the company and related risks.

EBITDA is used as a supplemental liquidity measure because management finds it useful to understand and evaluate results. EBITDA excludes the impact of noncash depreciation and amortization charges, stock-based compensation expenses and nonrecurring expenses and outlays. Prior to consideration of the impact of other potential sources and uses of cash such as working capital items, this calculation may differ in method of calculation from similarly titled measures used by other companies. I want to hand you over to your host, Lou Melluzzo, president and CEO, to begin today's conference. Thank you.

Lou Melluzzo: Thank you, Josh. Good afternoon, everyone, and thank you for joining us today. We saw a significant increase in new business activity in the third quarter and we made further progress in our strategic initiatives. However, supply chain challenges persisted, delaying our receipt of both components and raw materials which impeded our shipments and third quarter sales.

Fortunately, the supply chain issue seems to be improving and we hope that trend continues, but it still had an impact on the third quarter. Net sales for the third quarter of 2022 were $13.3 million or 5% lower than the second quarter of 2022 and 7.6% lower than the third quarter last year. Primarily as a result of the sales decline, the net loss for the quarter was $142,000 and adjusted EBITDA was $801,000.

We expect our fourth quarter sales to be stronger than the third quarter, with stronger sales growth as 2023 progresses.

We did see sequential growth across several platforms in the third quarter, reflecting the benefits of our diverse customer and platform base. Those included the US Navy's Advanced E-2D Hawkeye Aircraft and the F-35 Joint Strike Fighter Aircraft. We are looking forward to the remainder of this year and 2023 with a great deal of excitement based on the current level of quoting activity that seemed to take off following the Farnborough Air Show. We also see evidence that the government entities responsible for procurement, such as the Defense Logistics Agency, are increasing their level of activity.

Our confidence is also based on our major new business wins thus far this year. For example, in the past nine months, those have included and most recently a five-year, $2.2 million long term agreement (or LTA) for the Black Hawk helicopter bringing to 12 the number of Black Hawk LTAs we have received this year, with a combined estimated value of over $30 million. The latest win was for the manufacturer of a quadrant, which is a complex assembly that controls the gearbox for the tail rotor of the Black Hawk. The award for this LTA was accompanied by an immediate purchase order for $500,000. The other Black Hawk LTAs in 2022 included flight control assemblies and other flight critical products.

Separately, we received an order worth $2.8 million for engine components to be used on the F-404 jet engine, which powers frontline fighters and trainers around the world, including the new Boeing-Saab T-7A Red Hawk advanced jet training aircraft. In April, the first T-7A Red Hawk rolled off the production line at Boeing, the first of 351 aircraft to be delivered to the US Air Force under terms of a $9.2 billion contract awarded to Boeing in September of 2018. The production aircraft sports the iconic Red Tail, symbol of the famed Tuskegee Airmen of WWII.

Earlier this year, we were also awarded a $12.4 million contract to produce complete main, nose, landing gear and isolator components for the US Navy's E-2D Advanced Hawkeye early warning aircraft. Deliveries are scheduled to begin this coming year and be completed in 2024. As a reminder, the E-2D and its earlier variants have been an important platform for our Long Island subsidiary for decades, and we manufactured a complete ready to install gear as a tier one supplier to the original equipment manufacturer.

And in January, we announced a new $6 million life of program LTA specifically for a turbine engine exhaust case for the PW4000 jet engine. The exhaust cases are used mainly on the Boeing 767s, Airbus A220 and the Embraer E2 commercial aircraft. These exhaust cases are roughly five feet in diameter and a highly engineered critical engine component. We manufacture those exhaust cases components at our Sterling Engineering facility in Connecticut. So, this win was especially important as it met one of our key corporate objectives at Sterling Engineering, and that is to transition a larger percentage of the product mix into long term agreements and to further tap the potential of the subsidiary.

Our capital investment program is aimed at further supporting this objective. I am pleased to report that the last couple of weeks a new $1.2 million high tech machine tool was installed at Sterling. This machine will expand our capability and improve efficiencies on the PW4000 case and several other parts already under our roof. In addition, our new in-house paid facility is fully operational and undergoing qualifications. We will continue to focus on bringing key processes in-house, including grinding needle edge, non-destructive testing.

While we see an abundant opportunity in the aerospace industry in the coming years, we believe an important potential new platform for our future growth includes nuclear submarine components – an adjacent market that is a natural fit with our capabilities. We have determined that the need for proven, reliable suppliers to that industry is substantial. We have started to make small but important inroads into this market and have won several orders for submarine components for both our complex machining and our Sterling Engineering business.

Let me reiterate that I said in in today's news release. We are excited about the many opportunities that are emerging in our marketplace, including in defence, commercial, aerospace and now nuclear submarines. And we remain committed to manufacturing products that can meet or exceed the exacting safety standards and performance demands of these industries we address while continuing a capital investment programme that makes us even more valuable partner to our customers.

Now let me turn the call over to Mike Recca, our CFO, for the financial recap, which we will follow with a question and answer and some concluding remarks. So, with that, Mike.

Mike Recca: Thank you, Lou. Let me provide some additional detail on the results for the third quarter in nine months. As Lou said, sales for third quarter were $13.3 million, bringing the year to date sales to $39.3 million. That's $4.2 million lower than the $43.5 million for the nine months of 2021. Now, the primary cause of sales decline was due to a delayed shipment that we discussed and decline in shipments for Black Hawk helicopter product. We have announced that we are finishing an old and beginning new LTAs with Sikorsky and these last for approximately five years. These are all for Black Hawk products.

In the transition from an old LTA to a new one, it's normal for orders for product and the shipments of product to be a little choppy. One reason for this can be the older LTA may have lower prices than the new, and customers therefore have an incentive to buy ahead at the lower prices and delay ordering the new higher prices. Shipments to Sikorsky in Q3 were significantly lower than the quarterly for the first half. This is caused by fewer orders received early in the year. For the fourth quarter, we are very confident that these shipments will return to normal. For all our other aircraft platforms, there were no major variances in shipments.

Gross profit. Gross profit in the third quarter was $2.2 million or 16.9% of sales, versus $2.0 million or 14% of sales in the prior year. For the nine months, gross profit was $6.7 million, or 17.1% of sales versus $6.4 million or 14.7% of sales for the nine months of 2021. I need to remind you that for our larger subsidiary, we use the gross profit method of calculating inventory and thus gross profit varies for interim periods of the year. This estimate of gross profit is then refined following our year-end inventory count and valuation of that inventory.

Last year, in the fourth quarter of 2021, the gross profit percentage was increased to update the estimate that had been used for the prior three quarters of 2021. At this time in 2022, it's not possible to determine whether the gross profit percentage for this year end will be increased, decreased or remain the same as has been estimated for the first three quarters of the year.

Third quarter operating expenses decreased by nearly $100,000 from the second quarter of the year, but increased $236,000 from the third quarter of last year. And we're up $346,000 or 6% for the nine months. These increases reflect very obvious inflationary pressures that are present throughout the economy, but also included in operating expense in Q3 of this year and thus in the nine months was about $130,000 in employee severance costs resulting from some management employment changes that we made in September.

Operating income remained positive for all periods. Third quarter operating income declined by $81,000 versus the second quarter of this year and was lower by $8,000 in the third quarter of 2021. And for the nine months, operating income declined by $18,000.

Interest rates. Despite recent rate increases, our interest expense remained essentially flat for all periods. For the past several years, our interest rate has been at 0.65 percentage points or 650 basis points below the prime rate with a floor of 3.5% per year. The first Federal Reserve actions raising interest rates did not affect us. They did not affect the floor, but they do now. But the prime rate of 7% today, our rate has risen to 6.35% for the year, and that will be what we pay going forward, hopefully for not too long.

The net loss for 2022 third quarter was $142,000 as compared to the loss of $7,000 in the second quarter of 2022 and a net loss of $66,000 in the third quarter of 2021. For the nine months of 2022, our net loss is $177,000 versus net income of $21,000 in the prior year.

Balance sheet. Our balance sheet remains strong. There were no major changes during the year. Our accounts payable and accounts receivable remain very well controlled. And as I discussed last time in May, we renegotiated our term loan with Webster Bank to finance further investments in machinery. We increased the amount of the term loan to $5 million and added an equipment line of credit for an additional $2.0 million. This $2.0 million can be used to finance 85% of the costs of new equipment and all advances on the term loan, including a new line of credit amortized over seven years. That's 84 months.

As we mentioned, we are making investments. We have aggressively invested in new machinery this year and will spend in excess of $2 million. The line of credit that we negotiated facilitates this investment.

Now, before I turn the call back to Lou, let me comment on an initiative we announced after the end of the third quarter. On October 4th, we announced a one for ten reverse stock split, which became effective on the October 18th. This action was proactive. It was not done as a result of any threatened action by the stock exchange. But we also, believe it broadens the base of potential investors in the stock. And with that, I'll turn the call back to Lou and look forward to any questions you might have.

Lou Melluzzo: Thank you, Mike. Let me provide a brief summary of my comments today. We saw a significant increase in new business activity in the third quarter and made progress in our strategic initiatives. However, supply chain challenges impeded our third quarter shipment and sales. Even so, we are optimistic that we can deliver stronger sales for the 2022 fourth quarter and expect stronger growth as 2023 progresses.

Our product and platform diversity, our new business wins in 2022 and the current high level of quoting activity combined are the basis for our confidence for the remainder of the year and for 2023. To further support our opportunity and growth, we are continuing our strategic capital investment with a focus on expanding our capabilities, enhancing our efficiencies through vertical integration, and further tapping the substantial opportunity of our Sterling Engineering subsidiary.

Let me also, emphasize that we remain highly optimistic about the long-term prospects of Air Industries. We continue to serve major defense and commercial aerospace programs where demand is growing. Additionally, we are highly encouraged by our initial success in the adjacent nuclear submarine market.

Air Industries Group remains committed to manufacturing products that meet or exceed the exacting safety and performance demands of the industries we address and to becoming an even more valuable partner to our customers. That concludes our report. And I would like to open the call to questions from participants. Josh, can you open up the lines, please?

Operator: Thank you very much. If you would like to ask a question or make a contribution on the call today, please press star one on your telephone keypad now, please. Please ensure your line is unmuted locally. I will then speak to you individually, take your full name and then introduce you into the call. So, star one for any questions. Thank you very much. Our first question comes from the line of Howard Halpern. Please go ahead.

Howard Halpern: Hi. I'm with Taglich Brothers, and I'm pinch-hitting for John today. He's out. Congratulations on navigating a tough quarter and still producing operating profit. That was nice to see. But in terms of… You talked about some of the headwinds with supply chain and materials and components. Has that begun to ease? And if so, should we begin to see you increase shipments throughout the fourth quarter?

Lou Melluzzo: Well, we are seeing some improvements in our supply chain. Materials earlier this year actually had started about third quarter of last year, were very difficult to get. And we started some product late because of it. We had a pretty good size order that we expected material before the end of December of last year that we didn't we didn't get until June of this year. So, we lost six months on that order. So, we're starting to see some better flow of materials into our shop.

There's still some disruption, particularly in engineered springs and other items, sensors, that are a little bit more challenging to get. But we are starting to see some easing in that. Largely because some of the OEMs are ordering a lot in advance, where material to see more just in time. Now we're starting to see Collins and Boeing and Pratt place orders for material a year or sometimes two years in advance to try to ease some of this. So, we're seeing some improvements. And hopefully, like I said, that trend continues.

Mike Recca: Can I add one thing to that? Our products take a long time to make, six months, nine months, sometimes longer than a year. If you have a shortage of material in the middle of that, on a product that we've worked on for three months in the six-month cycle, and we have a product shortage or a material shortage for another three months, when that shortage is lifted, we still have three months to go. So, if all the supply chain issues evaporated tomorrow, that doesn't mean that all the problems are solved for the fourth quarter. But we do expect fourth quarter to be much stronger than the third.

Howard Halpern: Okay. And all things being equal, as we go into 2023, the new machinery, the testing, and once everything gets fully up and running, do you expect that you'll be able to really increase productivity, increase gross and operating margin for all the different programmes and even the new nuclear product shipments? Are you really encouraged that that is going to kick in next fiscal year?

Lou Melluzzo: Well, what drives some of that is the type of orders that you get in. Obviously, on the platforms that we already deliver on, we know the quantities, we know what next year will bring if you follow the forecast that the OEM puts out. Some of these new opportunities that we're seeing, we're not well versed so, far with the submarine business. It's lower quantities, higher value type products, a lot of valve work. So, we know that Electric Boat is looking to hire 571 employees as of two weeks ago, the last report we got. So, there are opportunities to be able to position ourselves in those type of industries.

It's a little early to tell what piece of the pie we can get, but they like some of the capacity that we're offering. The machine tools that we've added in the last call it eight months to 12 months, we put them in place to fill that capacity. And they're starting to recognize that we could be a place to go to. We will see a gradual increase as time progresses.

And would you do us a favor and tell John we said hello.

Howard Halpern: I will.

Operator: Thank you very much. There are no further questions in the queue. So, just as a reminder, if you would like to ask a question on the call today, please press star one on your telephone keypad now, please. Okay. It looks like there are no further questions coming through. So, I'll hand back over to Lou Melluzzo?

Lou Melluzzo: Thank you, Josh. So, with that, once again, thank you all for taking the time to be on the call today and for your interest in the Air Industries Group. We look forward to updating you on our progress on our next call. And in the meantime, we would like to extend our best wishes for the holiday season. With that, Josh, you may conclude the call.

Operator: Thank you very much for joining the call today. You may now disconnect your handsets.

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