Company: **Air Industries Group**

Conference Title: **Air Industries Second Quarter of 2022**

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Operator: Good day. And welcome to the Air Industries Conference Call. Today's conference is being recorded. Now for Air Industries' safe harbor statement. 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. See 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, excluding the impact of non-cash depreciation and amortization charges, stock-based compensation expenses, and non-recurring 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.

At this time, I'd like to turn the conference over to Mr. Lou Melluzzo, President and CEO. Please go ahead, sir.

Lou Melluzzo: Thank you, Anna. Good afternoon, everyone. And thank you for joining us today. Air Industries made progress on several fronts in the second quarter of 2022. Let me focus on comparisons to the first quarter of 2022, as the industry and market conditions were most similar.

Our second quarter sales increased by 16.1% from the first quarter of 2022. Gross profit dollars increased 16.7% sequentially and represented a 17.3% of sales versus 17.2% of sales in the first quarter of 2022. Operating income increased nearly 20% from the first quarter of 2022. Adjusted

EBITDA in the second quarter was nearly $1.2 million and increase sequentially by 13.3%. As a percentage of sales, adjusted EBITDA was 8.5% for the 2022 second quarter, versus 8.7% of sales in the first quarter.

Despite this financial progress compared with the first quarter of the year, our results were below the second quarter a year ago as detailed in the press release today. Supply chain disruptions had been a major factor impacting our performance, and that of many other manufacturing businesses throughout 2022 causing significant delays in receiving materials. The supply chain challenges heightened further in the second quarter with raw material delays compounded by delays in outside processing.

For example, there is now a six-month to nine-month lead time to receive shipments of titanium used in many of our products as the war in the Ukraine drags on and Russian sanctions remain in place. Prior to the war, those two countries were the largest suppliers of titanium to the US. While alternative sources are being tapped, the new sources are near capacity. So, we expect titanium issues to be with us for the remainder of the year.

Even with these ongoing challenges, we made important operational progress in the second quarter. That includes the installation of a paint facility at our Sterling Engineering subsidiary in Connecticut, which is now complete, and qualification is underway. I discussed last time that adding a paint capability is one of the key steps in our vertical integration plan. We are proceeding with our strategy to lessen the cost and risk of outsourcing major processes and mitigating the delays we experienced in the second quarter.

Construction of the assembly area at our Sterling facility has also been completed, as we apply the manufacturing advances we have achieved at our complex machining facility on Long Island, while taking advantages of Sterling’s capacity, to accelerate our margin growth and drive our EBITDA.

The new assembly area will facilitate the assembly process for a substantial customer order. As I discussed last time, grinding and non-destructive testing are among the other processes we are targeting to bring inhouse. In fact, in the past three years, our capital investment has totaled $6 million. So far this year, we have written purchase orders for an additional $2.2 million. Our plan is to continually invest in and modernize our equipment enabling Air Industries to manufacture world-class products more efficiently to more profitably.

As many of you know, Air Industries addresses five major platforms, including the Sikorsky Blackhawk Helicopter, the US Navy F-18 Hornet, the Northrop Grumman E2-D naval aircraft, the Lockheed Martin F-35 Lightning II Fighter, and the Pratt & Whitney Geared Turbofan, which is our entry into the commercial aviation market. Since April of 2021, we have won new LTAs and product orders for all these platforms.

In the first half of the year, we achieved especially strong growth in our sales for the E2-D, and the Geared Turbofan.

The E2-D Advanced Hawkeye is the navy's airborne early warning aircraft. The E2-D and its earlier variants have been an important platform for our Long Island subsidiary for decades. We manufacture complete, ready-to-install landing gear as a tier-1 supplier to the original equipment manufacturer. In February, we announced that we received a $12.4 million order to produce complete, main, and nose landing gear, and ancillary components for the E2-D. Deliveries for this order are expected to begin next year and be completed in 2024.

The strength of our Geared Turbofan sales which are mainly for smaller aircraft, including the popular Airbus A220, the Embraer E2 jet reflect the accelerating build rates in commercial aircraft overall. Additionally, you may remember that in January, Sterling Engineering was awarded a Life of Program Extension for an LTA to deliver turbine exhaust case components for the PW-4000 jet engine, which with expected revenue in excess of $6 million over its remaining term. The LTA also met one of our key corporate objectives for Sterling Engineering, which is to transition a larger percentage of the product mix into long-term agreements.

While not listed among our five major platforms, Air Industries is a long-time supplier for the CH-53 helicopter. We saw a strong growth in the half-year sales for our CH-53 platform. In another victory for Sterling Engineering this past October, they were awarded an LTA to deliver chaff pods for the new CH-53K, which is a sea-based, long-range, heavy-lift helicopter providing three times the lift capability of its predecessor and exceeding all other DoD rotary wing platforms. The production of this helicopter is forecasted to increase from four aircraft in 2022 to nine in 2023 and 15 in 2026. It is expected that the CH-53K will remain in production to 2032 and beyond.

Six months sales were lower for the balance of our platforms. It is not unusual to see flow vary through the year, and between years depending on the status of government funding of different programs, and inventory level at our customers.

Turning to the medium and long-term outlook. We attended the Farnborough Airshow this year and found the tone among customers to be upbeat, while realistic about ongoing industry production challenges. Relatedly, I should note that many pandemic-related restrictions have been lifted, and the industry is returning to a more normal cadence of business development, including face-to-face meetings and trade shows.

Air Industries has been taking advantage of this normalized environment to ramp-up our business development activity. This effort has started to gain traction. We have received a number of requests for quotation (RFQs), which represent the first step in sales process. And now we have over 100 active prospects in the pipeline. For example, we have engaged with several new landing gear companies that have already yielded RFQ activity.

As part of our growth strategy, we are also targeting adjacent markets that are a natural fit with our capabilities. For example, we have focused on the nuclear submarine industry, and recently received our first order. We hope for a dramatic growth from this new market over time. We also have received vendor numbers and are seeing RFQ activity from a major space company. It is exciting to be able to meet with clients in-person again and pursue new opportunities for Air Industries Group.

As we look to the balance of the year, we expect our current challenges to continue as well. But, we still anticipate the second half of the year to be better than the first half, with stronger growth shifting into 2023.

That said, we remain highly optimistic about the long-term prospects of Air Industries as we continue to serve major defense and commercial aerospace programs with growing demand, while enhancing our performance by vertically integrating our processes as well as making strategic capital investments to become an even more valuable partner to our customers.

Let me turn the call over to Michael Recca, our CFO for his financial report, which we will follow with questions and answers, and some concluding remarks. Mike?

Michael Recca: Thanks, Lou. Let me provide some additional detail on second quarter 2022 results. Sales in the second quarter increased by $1.9 million compared to the first quarter of the year, but were $1.4 million lower than in Q2 of last year.

For the six months, sales were $26.1 million. This was a reduction of $3.1 million compared to the six months of 2021. Of that $3.1 million decline, about half was related to two products. First was some landing gear for the A380 Aircraft, which as you may know has been taken out of production. And this resulted in a stop work/cancellation order from our customer. The second was a helicopter product that we've made for many years, but was at the end of its contract. Both of these products because of the various reasons were sold at a loss. So, sales were lower, but we also avoided those losses in 2022. I'll have more comments about the decline in sales when I discuss inventory a little bit later on.

Gross profit in the second quarter was a $181,000 lower than last year, on lower sales. However, the six month gross profit was a $100,000 higher in 2022. Keep in mind that, for the most part, we use the gross profit method of calculating gross profit for interim periods of the year. This estimate is then refined following our year-end inventory count and valuation. The gross profit margin percentage that we're using in 2022 is higher than in 2021.

Operating expenses were essentially flat, increasing by just $9,000 in the second quarter and $110,000, or less than a 3% increase, for the six months. And I think in the current environment, a less-than 3% increase for year over year is pretty good news.

Operating income was positive for all periods but declined in Q2 by about $190,000 compared to the prior year. The six month operating income was essentially flat.

Interest expense was essentially flat for both periods, declining slightly by $44,000 in the second quarter compared to last year. For the six months, the decline was slightly smaller, $18,000, but again essentially flat year over year.

For the past several years, our interest rate has been at a floor of 3.5% per year. With the recent actions by the Federal Reserve, it has risen. Our interest expense is calculated at 0.65% below Prime. The Prime is now at 5.5%, thus our interest rate has risen to 4.85% per year. Hopefully, the interest rate increases are now finished.

Net income for the quarter was a loss of $7,000 -- an improvement compared to a loss of $28,000 in the first quarter of the year. For the six months, our loss was $35,000 versus income of $87,000 last year.

Switching to the balance sheet… the balance sheet remains strong with no major changes. Our accounts payables, receivables, all remain within normal limits. There are two items that I would like to discuss though.

First, our term loan. In May, we renegotiated with Webster Bank, where we have both a revolving credit line and a term loan. The term loan is secured by and used to buy equipment. We increased the amount of loan to $5 million, about a $1.0 million increase. Some of that increase is used to reduce the revolver, but it's also used to pay off some capital leases that we had taken out to finance equipment purchases since we got the term loan in the beginning.

In addition, we added a capital equipment line of credit for a total of $2 million. This $2 million can be drawn on to finance 85% of the hard cost of new equipment. All advances on the term loan, including a new line of credit amortized over seven years, that's 84 months. Now we have already made deposits in progress payments of about $750,000 for new equipment. It's being constructed, and some of it's in inbound shipping right now. This amount has been drawn from our revolving line of credit. When the machinery is installed, these funds will be taken from the equipment line of credit and used to pay down the revolver. Second, and I think this is an important point.

Since year-end, our inventory has decreased by $3.5 million. The majority of this increase is WIP, Work-In-Process, and is concentrated on the F-18, the CH-53, and the E2-D platforms. Lou discussed the disruption delays affecting our production. The increased inventory reflects this.

If you add this $3.1 million increased inventory to sales for the six months of $26 million, it then gives you a total of about $29 million. That's essentially equal to sales for the six months of 2021. Our view is that over time, this excess inventory will be completed and result in increased sales.

And that concludes my comments. I'll turn the call back to Lou, and I look forward to your questions.

Lou Melluzzo: Thank you, Mike. Let me close this part of the call by reiterating two central points that I made on our last call, along with a brief summary of today's comments.

We have improved our relationship with customers and suppliers, reduced our debt and established a supportive banking relationship.

We have rationalized and consolidated our operations and are making critical investments in equipment to further drive our opportunity and profitability. Our operational achievements in the second quarter point to our progress.

We also achieved quarter-over-quarter financial growth in the second quarter of 2022, despite heightened supply chain challenges, especially raw material delays that were compounded by delays in outside processing. Unfortunately, those challenges are expected to continue for the rest of the year.

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 program, where demand is growing. We are developing new markets, including nuclear submarines, space programs, as well as other new opportunities.

We are enhancing our performance by vertically integrating our processes. We're making strategic capital investments to become even more valuable partners to our customers. And we remain focused on driving our EBITDA growth.

That concludes our report. At this time, I would like to turn the call over to Anna to open up the lines for question and answers. Anna?

Operator: Thank you. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. A voice prompt on your phoneline will indicate when your line is open. Again, that is star one if you would like to ask a question. And we do have a caller in queue. Your line is open.

John Nobile: Hi, Lou, and Mike. It's John Nobile from Taglich Brothers. You had said in your prepared remarks that you have about a six-month-to-nine-month lag in the time to receive titanium. So, I was just curious. What percentage of your product material cost actually relies on titanium? Total material cost, just to get an idea of how much this is really affecting on getting product out?

Lou Melluzzo: John, that was an example that I gave because titanium is critical. And the war in Ukraine is really impacting that whole section of the globe that's high producing. But we're also having issues with Inconel. The Geared Turbofan product is an Inconel-based product. We didn't see any material for the first three or four months this year. Now, it's starting to trickle in. So, there was a lag in time. And that's one of our best-selling products that we have in house. So, I attended the Farnborough show in England a few weeks back, and we're all singing the blues in that arena.

John Nobile: Okay. And in the first quarter of 2022, I know there were several announcements related to new orders. Since then, I haven't really seen any press releases in that regard. So, I was curious if there were any new orders placed since the first quarter of 2022? And also, if you can comment on what your current backlog is?

Lou Melluzzo: There have been no long-term agreements. In the first quarter this year, we announced some long-term agreements. And that's really a timing issue, that a lot of our long-term agreements were expiring at the end of 2021 and were re-awarded in the beginning of 2022. We have received orders against those. And it will continue for the life of the agreement over the next five years. But we haven't got any really new long-term agreements to announce. We do have a pretty significant pipeline. So, we are expecting to announce some pretty soon. We're relatively conservative about announcing. And we generally do not announce orders, releases as we call them, against LTAs.

John Nobile: Okay. In regard to the LTAs, I believe, Lou, you had mentioned that you expected second half of 2022 to be better than the first half. Is this primarily because of the LTAs in the first half of the year? Or it's just other orders that are helping your second half to be better?

Lou Melluzzo: Well, the materials that we were expecting late last year and early this year are starting to trickle in. So, we're going to do what we can to get them out the door.

John Nobile: Okay. And another question. In regard to 2021, I know that your overdue product has really seen significant reductions, a very good thing. But a question arises with the current supply chain issues that are out there now, I'm curious if you've been able to keep that level still relatively low or has it been creeping back up.

Michael Recca: It remains relatively low. Remember, our past due orders are never zero. It's just the nature of the beast. It has increased in the second quarter, not materially.

A part of the increase in past due was for to the Geared Turbofan, where we had an interruption of raw material shipments.

John Nobile: Okay. Well, thanks for that insight. And you've made significant capital investments. As Lou had mentioned, you could see it in the Capex. And that was all in an effort to alleviate the bottleneck issues that have plagued Air Industries for some time. I was wondering, if you could talk a little about that progress that has been made in this area and compare that to maybe where you were a year ago?

Lou Melluzzo: Well. It's given us numerous options on what machine we can run product on. One of the problems that we had earlier on, when I got to Air Industries, is that there were several bottlenecks, both in turning and milling. And we didn't have options. Now as an example, we've gone from two 5-axis machines to six 5-axis in different sizes. And it can handle different-sized products. So, we have some additional options on where to put this work to eliminate the bottlenecks. And obviously because of that, we have reduce production time substantially over the last couple of years.

John Nobile: Okay. So, with less of a bottleneck concern than say a year ago, would it be safe to say that if there were no supply chain issues currently, that most likely the first-half results and the topline would have shown to be better than last year?

Michael Recca: At least equal to last year, and perhaps a little bit better.

John Nobile: Okay. And the second quarter gross margins, they were up 0.1% from the first quarter. In the meantime, revenue grew by almost $2 million. And I was hoping, you could shed some light on why there was just that minimal change in the gross margins on a pretty significant increase sequentially in revenue.

Michael Recca: I tried to address that. Again, we use the gross profit method at Air Industries Machining for the most part. Our gross profit last year was 18.5%. We use that as a guide. And unless we can discern some change in product mix or some other external factors, we use that during the year.

So, the variance in gross margin is equal to the CMS sales at 18.5% plus Sterling sales at whatever percent because they use a direct measurement approach. And the overwhelming proportion of our sales are at CMS. And so, they are at 18.5%. It will not move until year-end when the inventory is taken and valued. And hopefully, that will only move in one direction, which is up based on that as it did last year.

John Nobile: Okay. Yeah, I noticed last year -- I guess, that really answered my question. Because last year in the fourth quarter, a huge bump in your gross margins. The third quarter was 14%. And then you showed 24.9%, almost a 15% increase in gross margins. So, I guess this year, we should anticipate the same thing basically dictating gross margins for the first three quarters.

And then when inventory is a known factor at the end of the year, we will know what the true gross margin is. And do you feel there's a chance that it's going to be bumped up significantly in that fourth quarter? I don't know if that's too early to tell at this point.

Michael Recca: It is A) too early to tell. And B) I do not expect we're going to get the increase that we got in the fourth quarter of 2021, and that took our gross margin from 14.5% to 18.5%. But that entire 4.5-percentage point increase had to be accounted for the entire year and booked in the fourth quarter.

Now, last year, we had \$3.5 million to \$4 million of the product that was -- about \$3 million of it was zero profit. And in the \$0.5 million in additional sales, we lost about \$250,000. So, we don't have those this year. So, if you think about it, last year, if we hadn't had those particular products, John, our gross profit for the year would not have been 18.5%. It would have been closer to 20%. So, I'm hopeful for an increase in this year. I do not expect it's going to be as significant as it was for last.

John Nobile: Okay, fair enough. All right. Well, Lou and Mike, I appreciate it. Thanks for making the call, and for taking my questions.

Lou Melluzzo: Thank you.

Operator: And once again, that is star one if you would like to ask a question. And we'll pause for just a moment. And we'll now move to our next caller. Your line is open.

Speaker: Hi, yes. My name is Mike Atkins. My phone cut out right before you said something about getting business from a major space company. If you could just repeat that or elaborate a little bit for me, I'd really appreciate it. Thank you.

Lou Melluzzo: So, Mike, what we're saying is things are getting somewhat back to normal in terms of new business development. The Department of Defense, Pratt, Sikorsky, Collins, Boeing, a lot of people are still working remotely. But things are starting to get back to normal. So, we've had an opportunity to get some face-to-face time, and we've really stepped up our business development activity because of it.

So, we've come across a space company, just like SpaceX and Blue Origin, and companies of that nature. And we've gotten some coding activity. Hopefully, we can make something stick because it's the next frontier.

So, we're Air Industries, but the direction of our business development has taken us to the sea, under the sea, and into space. And we are a landing gear company, but we're also a precision manufacturing organization. And there's opportunities in each of those respective categories.

Speaker: Okay. Thank you very much. I appreciate you for filling me in on that. Thank you for taking my call.

Lou Melluzzo: Thank you for the call, Mike.

Operator: And as a final reminder, that is star one if you would like to signal. We'll pause once more. And it appears there are no further telephone questions. I'd like to turn the conference back over to our presenters for any additional or closing remarks.

Lou Melluzzo: Thank you, Anna. So, with that, once again, thank you all for taking the time to be on the call today, and for your attention and questions. We look forward to updating you on the progress of Air Industries Group on our next call.

Operator: Yes, sir. Thank you. And once again, that does conclude today's conference. We thank you all for your participation. You may now disconnect.