# Air Industries Group
# First Quarter 2023 Investor Call
# July 12, 2023

**<u>Presenters</u>**
**Lou Melluzzo - President & Chief Executive Officer**
**Michael Recca - Chief Financial Officer**
**Peter Rettaliata - Chairman**

**<u>Q&A Participants</u>**
**Howard Halpern - Taglich Brothers**

**Operator**
Hello and welcome to the Air Industries Group first quarter 2023 earnings call. At this time, all participants are in listen-only mode. A brief question-and-answer session will follow the formal presentation. If you would like to ask a question, please press * 1 on your telephone keypad. A confirmation tone will indicate your line is in the question queue. If anyone should require operator assistance during the conference, please press * 0 on your telephone keypad. As a reminder, this conference is being recorded.

This call, and the accompanying webcast, may contain forward-looking statements, as defined in Section 27(a) of the Securities Act of 1933, as amended, including statements regarding, among other things, the company's expectations regarding realization of its business strategy and growth strategy. Expressions which include forward-looking statements speak only as of the date of this call. These forward-looking statements are based largely on our company's expectations and are subject to a number of risks and uncertainties, some of which are beyond our control and cannot be predicted or quantified.

Future developments and actual results could differ materially from those set forth and contemplated by or underlying the forward-looking statements. In light of these risks and uncertainties, there can be no assurance that the forward-looking information will prove to be accurate.

This call does not constitute an offer to purchase any securities, nor a solicitation of a proxy consent, authorization, or agent designation, with respect to a meeting of the company's shareholders.

At this time, I would now like to turn the call over to Lou Melluzzo, President and CEO. Please go ahead, sir.

**Lou Melluzzo**
Thank you, Alicia. Good afternoon, everyone, and thank you for joining us today. I would like to review Air Industries' results for the 2023 first quarter, provide some detail on our recently announced contract wins, and outline our growth strategy for the balance of this year and beyond.

First, it is my pleasure to announced that Pete Retalliata has been appointed Chairman of the Board of Air Industries and is joining us on this call today. As Chairman, he succeeds Mike Taglich, who remains on the board. As we noted in a news release issued earlier today, Pete is a highly respected veteran of the aerospace business. He also has served in several leadership roles at Air Industries over a nearly 30-year period, including President of our AIM subsidiary, CEO of the company, and a member of the Board of Directors. His perspective and guidance will benefit Air Industries as we move forward and pursue our exciting growth strategies. Pete will add his comments after our formal review and would be happy to respond to questions during our Q&A session.

Now, looking at our performance for the 2023 first quarter -- consolidated net sales for the quarter ended March 31, 2023, were $12.5 million. That was an increase of $487,000, or 4%, from the first quarter of 2022, but a decrease of $1.3 million, or 9.7%, compared with the fourth quarter of 2022.

As we have noted previously, our shipments have continued to be negatively impacted by supply chain disruption that has affected the entire industry, in particular causing delayed arrival of raw materials. While conditions have continued to improve, the problems are not fully resolved.

Gross profit was 15% of sales for the first quarter of 2023 versus 17.2% for the first quarter of 2022. In the fourth quarter of 2022, by comparison, the gross margin was 5.1%. However, the 2022 fourth quarter included certain adjustments, which Mike Recca will discuss during his remarks.

We incurred an operating loss for the first quarter of 2023 of $158,000, while the net loss for the first quarter was $618,000. This compared with a net loss of $28,000 in the first quarter of 2022 and a net loss of $899,000 in the fourth quarter of 2022.

While we are not satisfied with our recent results, I firmly believe the dynamics of the aerospace industry today, and in the future, will create tremendous opportunities for Air Industries. Demand is being driven by the evolving geo-political landscape, the need to modernize U.S. air and naval resources, and the recovery and growth of the commercial aerospace.

Yesterday, we announced two contract awards that provide a glimpse of the opportunities we see ahead. We received a new award, valued at approximately $2 million, for arresting gear components on the E-2D Hawkeye tactical airborne early warning aircraft. The order originated from a long-time customer of Air Industries Group. The second award announced yesterday comes from a new, non-U.S. customer and is for arresting components for the F-35 Lightning combat aircraft. This second order is valued at $3.2 million and is our first award from a customer located outside the U.S., bringing the total for both orders to $5.2 million.

It is encouraging that the average monthly booking for Q2 of 2023 have increased by over 250% compared Q2 of 2022. During the quarter, we also reduced our past-due delivery to customers by 30%.

In the near-term, we are sharply focused on improving profitability, primarily by scaling up activities at our facilities to better leverage our capacity and our fixed expenses, and secondly, by re-engineering projects so that they can be completed more efficiently and on the newer equipment we have purchased.

Additionally, our Connecticut operation is undergoing a modernization process and being retrofitted with a new roof and solar panels to further cut costs of electricity requirements.

Over the intermediate- to long-term, we are pivoting towards opportunities that we believe have potential to drive profitable growth. Toward that end, we have conducted a strategic analysis of our most compelling market opportunities, with the help of outside consultants. Our process has been focused on identifying markets that are attractive and actionable. Targets include markets that fit our capabilities, where we can compete effectively and where we have significant, near-term to mid-term visibility into the volume and profit potential.

Specifically, our growth strategies are intended to expand our penetration of existing platforms, add new platforms, and capture new markets. For example, we are actively seeking additional business in our traditional served markets of military fixed-wing and rotary aircraft, as well as commercial aircraft engine components. The recent wins of additional E-2D and F-35 business, as I noted earlier, are great examples of our expansion of existing military platforms.

Turning to another important opportunity -- we are making solid progress with our entry into the nuclear submarine market, which aligns well with our core competencies and has the potential to be a significant addition to our business. The nuclear submarine industry is rapidly expanding to meet a projected 50% increase in the number of submarines required by the Navy over the next few years. We see substantial opportunity for suppliers, such as Air Industries, that can deliver to the ultra-high quality standards required. We have already won contracts from two suppliers to Electric Boat, one of the two U.S. submarine builders. We are optimistic that our successful execution of this project will lead to larger and more significant opportunities, as the submarine industry continues to seek new suppliers to support a forecasted ramp-up in the years ahead.

In fact, our Sterling division is also seeing an uptick in submarine, as well as rotorcraft and ground-based turbine engine components.

Our business development team just came back from the Paris Air Show are we are very optimistic about the future outlook of aerospace in general. The show was very well attended by the global community, and we made numerous new connections with companies that we want to work with.

In summary, the first quarter of 2023 continued to reflect the challenging supply chain environment, a situation that may persist for the next one or two quarters. That said, and more importantly, we are encouraged by our inroads in both existing and new platforms.

With that, I'm going to turn it over to Mike Recca, our CFO, for his report. And then, we will conclude with Q&A and remarks. Mike?

**Michael Recca**
Thank you, Lou. I'm going to provide some additional detail, particularly on our gross margin and gross profit for last year and this year. I will agree with Lou that the first quarter was adequate, but kind of lackluster.

As he reported, sales for the first quarter were $12.5 million, and that's an increase of 4% from the first quarter of last year. Profit for the first quarter of 2023 was $1.9 million, and that was down from $2.1 million in 2022.

Gross margin for was 15% of sales for the 2023 first quarter. And that was slightly higher than the annual, gross margin last year, which was 14.3%. At the risk of going deep into the weeds here, I'm going to take a minute to explain gross profit and gross margin for 2022. So at year-end, you have the normal closing and reviewing the books and the annual audit. And during that time, it's normal to have adjustments to inventory and that generates adjustments to gross profit and gross margin.

In 2022, there were two such adjustments and these were:

First, we changed the method of determining our slow-moving or obsolete inventory. Previously, we calculated this amount every year as a percentage of the inventory cost for product that had not "moved" -- that is, it had neither not sold nor returned to work in process over a period of years. Consulting with our auditors, we changed this over-time method to considering 100% of the cost of inventory that had not moved for two years as slow-moving. This increased the reserve to 100% of that inventory for 2022.

Second, during last year, we had a single contract that was consistently losing money. This contract was not yet complete and the losses will continue into 2023, when we will complete the contract. In situations like this, future losses must be estimated and accrued for -- so we've done that. We've estimated the future losses anticipated on the remaining items open in the contracts. This increased cost of sales, reduced gross profit and gross margin for 2022.

As of September last year, our gross margin for the nine months was 17% of sales. After the adjustment for these two items we just discussed, we calculated a gross margin of 14% for the full year 2022. So to get to 14% for the year, after nine months at 17%, we needed to have a margin of just 5% for 2022. (3 X 17 + 5 ÷ 4 = 14.) So our gross margin was 14% for full year 2022, but that really is only because of these two adjustments, which are not recurring.

Going on to operating expenses -- for the first quarter of 2023, we were just over $2 million, and that was an increase of $167,000, or 8.9%, from $1.88 million in the first quarter of 2022. But there are some other points I want to make here. In 2022, operating costs were reduced by a $118,000 recovery of a bad debt. Now, our customers are mostly Fortune 500. Actually, sometimes, they're Fortune 50 companies. So, we really don't have bad debts. But there are times when there is a question about a quantity or some other dispute on a shipment and payment can be delayed. And again, under accounting rules, we must consider a delayed payment to be a "bad debt" until it's resolved. In 2022, some of these disputed invoices were resolved and recovered and we were paid $118,000. This is a negative expense that lowered operating costs in 2022.

In 2023, our audit firm merged. The new firm had basically the same fee, but it was paid in different installments, so we paid about $60,000 more of the audit fee in the 2023 first quarter than we had in the prior year. So considering the bad debt income of 2022, which reduced expenses, and the timing of the audit fees in 2023, which increased expenses, operating expenses for the two years were essentially even.

Our interest expense, on the other hand, increased by over 60%, or $172,000. This is entirely due to the actions of the Federal Reserve.

The net loss for the first quarter of 2023 was $618,000, compared to a net loss of $28,000 in the prior year.

Moving onto the balance sheet -- the balance sheet remains very strong and certainly more than adequate for our needs. Our accounts payable and receivables are very current and strictly in line. Our inventory, which ballooned during the pandemic, is being reduced, slowly, but reduced nonetheless. And our overall debt has remained unchanged.

That ends my comments, so I'll turn the call over to our new Chairman, Pete Retalliata, for his remarks.

**Peter Rettaliata**
Good afternoon, everyone. I'd like to say that I was delighted when Mike Taglich asked me to step up my involvement as Chairman of the Board. I believe that his feeling was that it was time to increase our aerospace experience at a time when we are looking to accelerate our growth program and strategy in a new, changing marketplace, post-COVID. So this is very exciting for me.

I've always been very close to the company. And now, I continue to be close and will increase my role in helping leadership to address this growth program. Once again, I'm delighted and I think the prospects are terrific. The company has done some great things to prepare itself for this new and changing marketplace, in terms of increased capability and talent. So this is very exciting for me and I hope it's all very exciting for you to watch us go through this period. Thanks.

**Lou Melluzzo**
Thank you, Pete. We're excited to have you.

**Peter Rettaliata**
Good to be "back".

**Lou Melluzzo**
With that, Alicia, we would like to open up the call to our Q&A session, if you may?

**Operator**
Thank you. We will now be conducting a question-and-answer session. As reminder, if you would like to ask a question, please press * 1 on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press * 2 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. One moment, please, while we poll for questions.

Thank you. Our first question from Howard Halpern with Taglich Brothers. Please proceed with your question.

**Howard Halpern**
Good afternoon, guys. And welcome back, Pete.

**Lou Melluzzo**
Good afternoon, Howard.

**Howard Halpern**
In terms of -- I guess my focus, and maybe your focus, too, is on what are going to be the primary factors that are going to help improve gross margin, over time?

**Peter Rettaliata**
I think the biggest factor is that we have made some big investments in better equipment. And that allows us to really more efficiently produce those things that we produced in the past, and to do it in a more competitive way for some of the projects we'd like to win in the future.

There has been, over some time, a real concentration on increasing our capability and capacity, which has not really exhibited itself in the way that we'd like to see. That's partly because the COVID period was a very difficult period for decision making with our customers, supply chain issues, all of that clouded, really, some of the operational performance that we're seeing and that we're capable of performing to in the next couple years. Does that make sense?

**Hoard Halpern**
Yes, it does. But, in the near term, will we continually see improvement as the supply chain issues abate? And, could that drive gross margin back to at least that 17% area?

**Lou Melluzzo**
I'm confident that we will be, if not at 17% for this fiscal year, we'll be banging on the door of it, very close to it. We have new contracts, which we have better pricing on. There appears to be prospects for our Sterling Engineering operation, our much improved and better absorption of overhead costs there could have a dramatic effect on gross margin if those are materialized.

**Peter Rettaliata**
And, I think I'm not wrong in saying some of our best products have been slower delivery products, because of slower raw material deliveries.

**Michael Recca**
There's no question about that.

**Howard Halpern**
Right. And as the gross margin improves, that'll drive you towards operational break-even profitability, as the quarters move forward?

**Michael Recca**
There's no magic in this business. Gross profit is everything. We have been, I think, extremely good at managing our operating costs. Gross margin, if you get the operating costs right, as I like to tell the Board, if we can keep operating costs level, we get to keep the increases in our gross margin, although we are giving some of them to the bank, as a result of higher interest rates.

**Howard Halpern**
Yep. Well, with inflation cooling, maybe things will level out, at this point.

**Michael Recca**
Well, they went from 0 to 5. They're not going to go from 5 to 10. So I think we -- if we're not at the top, we're looking at the top.

**Howard Halpern**
Okay. And, just in terms of the perspective on some of the new areas, like the nuclear sub area, is that a higher margin business? Could you describe the type of business we could expect over the next, maybe, two, three, four, five years from that category?

**Lou Melluzzo**
So, in the sub business, Howard, the parts that we are concentrating on are the high-end items. So they're not making 100 submarines a year. They're making two or three. So the pricing for these components is definitely priced, in that respect, where you're not doing high production rates. You're doing a couple of units at much better margins, more sophisticated material, with a lot more content in them.

So we're not shipping parts that are $100 or $200 parts. We're shipping parts that are in the tens of thousands and better. So those kinds of things tend to fare better when we can put more labor into them and the margins will show that. We're doing the cream of the crop work on submarine work right now.

**Peter Rettaliata**
I think one of the things that is happening in the submarine business, is they have more advanced designs. Actually, subs are looking more like airplanes, in terms of close tolerances, and less like battleships – with less welding, more high precision fits and performance. So our hope is that there's going to be more money in that.

**Michael Recca**
And we've looked at a number of companies in that business, both recently and years ago, and historically, they have significantly higher margins than we have experienced.

**Howard Halpern**
Okay. And once you're awarded a contract and you supply parts, like you said, they produce one or two a year. So, it's going to be highly sticky once you get that contract. Right?

**Michael Recca**
It is very sticky, because they are desperate for new suppliers. Electric Boat had an advertisement. They want to hire 10,000 people in southeastern Connecticut. I'm not sure there are 10,000 people in southeastern Connecticut. And so, when you talk about increasing from two to three boats, it's a big deal -- that's from $4 billion to $6 billion a year.

**Lou Melluzzo**
What we were told, Howard, is if you're doing the work now, you're going to do it again. They just don't have the personnel to actually shop this out and then do what needs to be done. So you're kind of guaranteed this work as soon as you're in it.

**Howard Halpern**
Okay. And they will, I assume, be very helpful in getting the supply chain to work, in order for you to produce a certain product?

**Lou Melluzzo**
Absolutely. So we're finding that they're very helpful.

**Howard Halpern**
Okay. Well, thanks. And keep up the good work.

**Lou Melluzzo**
Thank you, Howard. Thank you for the question.

**Peter Rettaliata**
Thank you.

**Operator**
Thank you. As a reminder, press * 1 to ask a question at this time. There are no further questions at this time. I would like to turn the floor back over to Mr. Melluzzo for closing comments.

**Lou Melluzzo**
Thank you, Alicia. So with that, once again, thank you all for taking the time to be on the call today and for your interest in Air Industries Group. We look forward to updating you on the progress on our next call. Alicia, you may close the call.

**Operator**
All right. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.