KAYDON CORP

Moderator: Rick Mosteller
July 29, 2008
10:00 a.m. CT

Operator: Please go ahead.

Rick Mosteller: Welcome to the Kaydon Corporation's second quarter 2008 earnings conference call.

Before the conference begins, the company would like to make the legal disclaimer that certain information in this formal discussion and that may be included in the question and answer session, is forward looking within the meaning of the federal securities laws.

These forward looking statements are only predictions based on the company's current expectations about future events.

While the company believes that any forward looking statements made are reasonable, actual results could differ materially since the statements are based on the company's current expectations and are subject to risks and uncertainties beyond the control of the company.

Listeners are cautioned to refer to the company's 2007 form 10-K for a list of factors that could cause its results to differ from those anticipated in any forward looking statement. The company does not undertake, and expressly disclaims any obligation to update or alter its forward looking statements whether as a result of new information, future events, or otherwise, except as required by applicable law.

During this conference call, Kaydon spokespersons will refer to free cash flow, a non-GAAP measure. To assist you in understanding this non-GAAP measure as well as to comply with SEC requirements, the company has included in its press release, a reconciliation of this non-GAAP measure to the most directly comparable GAAP measure.

Today's conference is being required.

Now, I would like to turn the call over to Mr. James O'Leary, President and Chief Executive Officer of Kaydon Corporation. Mr. O'Leary, please go ahead.

James O'Leary: Thank you, Rick. Good morning and thanks for joining us today. We apologize for a slightly later than expected start. We understand there was a call or two before this, wanted to give people an opportunity to jump off that call and clear the queue here. So, we'll extend Q&A a little bit longer so we don't shortchange anybody.

I'm joined this morning by Ken Crawford, our CFO, and Rick Mosteller, our Assistant Corporate Controller. Peter DeChants is on assignment today.

I am pleased to be reporting on a second quarter in which we achieved second quarter records for operating income and diluted earnings per share and the highest quarterly sales performance in Kaydon's history.

We also had record second quarter orders, setting an all time record for quarter end backlog.

This was all achieved in what I've heard described by many of our peers and investors as one of the most challenging and uncertain macro environments they've seen in some time.

Also during the quarter, we've accelerated and are beginning to realize the benefits from structural changes in our portfolio, undertaken the position for growth, which previously would not have been available to us, namely in the wind energy market and broadening our international profile.

As in prior calls, we'll provide many of the building blocks as practical to help you with our analysis of our results while not departing from our policy of not providing explicit guidance. Through the balance of the year, we'll continue to address these in sufficient detail so you can keep track of them.

During the quarter, diluted EPS equals sixty-four cents, a second quarter record as compared with the sixty-one cents in the prior year second quarter.

Sales increased 23.4 percent through quarterly record of 139.9 million, relative to 113.4 million in the prior year second quarter. We also had record second quarter orders of 144 million, up 12 percent year over year. This leaves us with quarter end backlog of 324 million, an increase of 60.8, almost 61 percent as compared to the second quarter of 2007.

Total wind orders booked in the quarter were 24.6 million, which with the 80.9 million of wind orders in the first quarter, brings year to date wind orders to a total of 105.5 million.

Our record set in quarter sales performance of 113 – 139.9 million was driven by an especially strong performance by our two larger segments, friction controls and velocity controls.

Gross profit for the second quarter was 54.2 million, or 38.7 percent of sales, as compared to 48 million, or 42.3 percent of sales during last year's second quarter. Gross margin was affected by changes in the product mix, the inclusion of Avon whose margins are negatively impacted in the current period by acquisition accounting integration costs and identifiable costs associated with our wind energy ramp up. And by identifiable, we mean easily discrete capturable items, not lost overhead absorption. These totaled about 1.2 million in the quarter.

SG&A was 22 million during the second quarter as compared to 19.6 million in the second quarter of 2007 which, if you'll recall, included some duplicative costs associated with our CEO transition, which impacts the marginal comparisons somewhat.

Operating income was a second quarter record of 32.1 million, as compared to 28.3 million in the prior year second quarter. Operating margin was 23 – was 23 percent versus 25 percent last year and was impacted by product mix shifts, Avon purchase accounting and costs associated with the wind energy ramp up.

In a few minutes, Ken will provide comparable detail on the identifiable acquisition, integration and ramp up costs for the quarter and the balance of the year to help you in modeling margin performance expected in Q3 and four.

We'll discuss the mix issues in detail momentarily, as it relates to a various end markets, but I would like to give you the broader perspective as it really tells the story. We're seeing faster growth, including faster than expected growth in our wind energy business, which has operating margins expected to be in the low 20s, offsetting potentially slower growth in the North American industrial business and in defense where we're seen an order delayed into next year. And defense includes certain legacy defense programs which are discussed in prior quarters. These two segment, general industrial typically at once book and ship orders, and defense have margins well above the company average, which brought the overall company average higher for a period.

So what we're seeing is faster growing, lower but still high margin business replacing a potential slow down in other segments of the company.

Second quarter 2008 interest income of 1.7 million declined 63.4 percent from the 4.8 million earned during the second quarter of 2007. This decline, which we've talked about previously, is due to lower market interest rates achieved on lower investable balance. Rates have declined almost 300 basis points year over year due to lower rates and the impact of steps taken by us to preserve capital in liquidity rather than pursue higher short term market yields in things like auction rate security, subprime investments and many of the things that have plagues other companies with high cash balances. We've managed to avoid them at the expense of lower yields.

More importantly, however, we've put cash to work in the areas such as the wind energy expansion and the Avon acquisition. As we have successfully done that, we've seen the short term impact of turning investment income into operating earnings, which will be meaningfully higher than would otherwise be the case as the capital comes on line in the second half of this year and as the Avon acquisition costs come to an end at the end of this year.

The effective tax rate during the quarter was 35.4 percent compared with 36.1 in the prior year second quarter, primarily due to an increase in foreign earnings in 2008. The expected tax rate for 2008 to be 35.4 percent.

Net income for the second quarter equaled 20.3 million or 14.5 percent of sales, as compared to 19.6 million, or 17.3 percent last year. And again, diluted EPS equals sixty-four cents, a record as compared to sixty-one cents in the prior year second quarter.

Now, let's review our operating performance. Sales of friction control products increased 21.8 million to 86.8 million with 33.6 percent higher than last year. The segment benefited from increased demand for specialty bearings utilized in the wind energy market and the inclusion of Avon bearings. Sales especially turn tables to the wind energy market and split roller bearings globally, in particular, enjoyed robust performance. I'll give a more granular view of end market performance in a couple of minutes.

Second quarter operating income of friction control products increased to 21.5 million, 15.7 percent higher than last year, driven largely by higher volume.

Operating margins were affected by product mix shifts as growth in wind energy and split roller bearing products, both high margin, but lower than the company average lowered the overall blended margin and the inclusion of Avon who's short term results are impacted by acquisition costs and integration.

As the impact of the costs associated with Avon dissipate at the end of this year, as we've discussed previously, Avon's gross margins and contribution margins will approximate those of Kaydon's existing wind business.

Also worth noting are the specifically identifiable costs associated with the wind energy ramp up and collectively Avon in the ramp up costs equal 1.2 million in this quarter.

Operating margin equaled 24.8 percent as compared to 28.6 percent contained in the prior year. Finally second quarter orders for friction controls increased 14.4 million or 18.5 percent as compared to the 92 last year.

In velocity controls, second quarter sales increased 3.8 million to 20 million, or 23.6 percent over the prior quarter with particularly strong sales from our European operations, including the benefit of foreign currency translation and a solid performance in North America.

Operating income for velocity controls increased to 6.1 million or 43.9 percent higher than the second quarter of last year, while operating margin rose to 30.4 percent.

Both sales and operating income benefited from health market demand for our products, improved pricing year over year and the favorable impact of currency translation.

Orders increase 14.1 percent over prior year, leaving us with record backlog at the end of the second quarter.

Sealing product sales were 11.7 million as compared to 11.5 in the second quarter as higher pricing offset modestly lower volumes. Operating income of sealing products declines from two million to one point five, largely due to inefficiencies and redundant costs being incurred during our previously announced facility relocation.

Orders during the second quarter totaled 10.3 million, a decline of 21.7 percent as compared to the second quarter of last year. Orders in this segment have become increasingly program driven and vary significantly on a quarter to quarter basis, very similar to the chunky nature of our wind energy based business. And when you look at orders on an LTM basis to compensate for this factor, comparisons better reflect the order pattern and the general end demand. And when you look at LTM patterns, they're roughly about comparable to sales.

In other, sales of other businesses equal 21.4 million during the second quarter, a year to year increase of 600,000 or three percent. Principally because of higher demand for air filtration products and higher pricing for metal alloy products. Operating income was 3.2 million in both the second quarters of 2008 and 2007.

Let's talk a little bit more granularly about orders and backlog and end markets. Order entry was strong during the second quarter as we achieved a second quarter record of 144 million, 12 percent higher than the second quarter of last year. The strong order activity resulted in record backlog of 324 million, an increase of almost 61 percent as compared to the prior year, second quarter.

Our backlog consists of orders shippable over the next six quarters, and as discussed in previous quarters, our large wind energy orders will ship later than non-wind orders, largely due to capacity. As a result, these large orders have continued to shift the timing of when our overall backlog is expected to ship. We currently expect to ship about 35 percent of backlog during the next quarter, approximately 35 percent over the next two quarters so quarters two and three, and the final 30 percent, over the last three subsequent quarters.

Now, I'll turn it over to Ken to cover some financial items. Ken?

Ken Crawford: Thanks, Jim and good morning everyone. During the second quarter of 2008 we earned 2.4 percent on average investable balances of $288 million. Interest income totaled $1.7 million in this year's second quarter.

During the second quarter last year, we earned 5.1 percent on average investable balances of $372.4 million, which generated 4.8 million in interest income.

As Jim noted earlier, the lower average investable balances compared to the prior second quarter resulted from the effect of capital expenditures to support our capacity expansion projects, the Avon acquisition, our third quarter 2007 pension contribution and our stock repurchase actions.

The lower interest rates were caused by lower rates available in the market and by proactive steps taken by us to protect principal and liquidity.

Sequentially, in the first quarter of 2008, we earned 3.4 percent on average investable balances of $288.8 million.

Just as we had forecasted during our previous conference call, the lower average interest rate and the lower average investable balances reduced second quarter 2008 interest income by $3 million, which is equivalent to six cents per share on a diluted basis, compared to the second quarter of 2007.

At the end of this year’s second quarter our investable balances totaled $280 million, which is $22 million lower than at the beginning of 2008. The lower in interest rates and lower average cash balances will also reduce interest income in our third quarter by at least $3 million compared to the third quarter of last year. And again, that $3 million would be equivalent to six cents per share on a diluted EPS basis. We expect interest income for the full year 2008 to be approximately $7 million, as compared to $18.1 million in 2007.

That said, we believe our financial resources will provide us the flexibility to take advantage of potentially unique opportunities that may arise during a period when liquidity can be a competitive advantage.

Interest expense during both of the second quarters in 2008 and 2007 equaled $2.4 million.

In June of this year, holders of $11.5 million of our contingent convertible notes presented those notes for conversion into 394,375 shares of common stock. This will result in slightly lower interest expense but with no impact on fully diluted EPS due to the accounting treatment of the underlying convertible debt instrument. The effective tax rate during our second quarter this year decreased to 35.4 percent, compared to 36.1 percent in the prior second quarter, primarily because of an increase in foreign earnings and we expect the effective tax rate for full year 2008 to be approximately 35.4 percent.

Net income in the second quarter was 20.3 million, equal to 64 cents per share on a diluted basis, compared to 19.6 million or 61 cents per share on a diluted basis a year ago.

Free cash flow during the second quarter of 2008 was a negative 1.9 million compared to a positive 6.3 million in the prior second quarter. This swing was due to increased capital expenditures to generate long term profitable growth and higher cash usage associated with working capital increase to support our significant sales growth.

During the second quarter of 2008, we invested 15.1 million in capital expenditures compared to 12.8 million invested in the second quarter last year. Capital expenditures will accelerate in the second half of this year and remain at high levels as we expand to take advantage of the outstanding secular growth opportunity in wind energy. Again, free cash flow should be viewed as supplemental data, rather than as a substitute or alternative to the GAAP measure and we've included in our earnings release a reconciliation of this metric to the most comparable GAAP measure for your reference.

Cash and cash equivalents plus short term investment total 268.5 million at the end of the second quarter of 2008 compared to 287 million at the end of the second quarter – at the end of 2007.

Long term debt declined to 188.5 million on the conversion of the 11.5 million of notes during the quarter and is now equal to 26.8 percent of total capitalization.

During the second quarter, we paid dividends of $4.2 million, equivalent to 15 cents per share. We repurchased 81,800 shares of common stock for 4.5 million and we invested 15.1 million in net capital expenditures. And as we talked about during the quarter, we incurred an aggregate $1 million of expenses related to Avon purchase acquisition accounting and integration costs and wind energy ramp up costs totaled an additional $200,000.

These are expected to approximate $1.6 million in the aggregate during the third quarter of this year and another $1.1 million the aggregate during the fourth quarter of this year.

Now, I'd like to turn the call back over to Jim.

James O'Leary: Thank you, Ken. As I said at the top of the call, we're pleased with the results achieved this quarter, but more importantly, we're pleased with the significant progress on our long term growth initiatives, particularly our accelerated and increased expansion in the large diameter bearing market. This should continue to yield considerable benefits as we move into the second half of 2008 and into 2009.

The record bookings achieved in the second quarter leaves us with the highest backlog in Kaydon's history. And our continued penetration in the fast growing wind energy infrastructure market, bolstered by the Avon acquisition positions us well for the balance of 2008, 2009 and beyond.

When we assess end market performance and prospects, I would say our business falls into a few general categories. Number one, the very good, if not excellent. The good, the bad and I'll point out, we only have one market which I categorize as relatively bad. And the uncertain. And let's go through them so I can give you a little bit more color as to how we see the end market shaping up now and for the balance of the year.

The very good, or excellent is clearly the wind energy market. With the strength of that market coupled with our strategic positioning through recent expansions and the Avon acquisition are resulting in meaningful contributions well ahead of last year and consistent with, if not ahead of, our earlier expectations.

This has led us to commence preparation for what may be a further build out, which I'll go into a bit more detail on in a minute, and at least one of our north American facilities and accelerating due diligence on possible international expansions.

The good would cover many of our other markets. In medical, we're performing extremely well as we had picked up qualifications in customer market share over the past few quarters, despite a soft funding environment for some of our customers. In heavy equipment, we have very strong markets, putting us in the fortunate position of having the choice as to whether to allocate that available capacity to wind energy or heavy equipment.

Our international business, particularly our split roller bearing business and our velocity control subsidiary continue to see healthy demand despite concerns about potential slowing in Europe.

The relatively bad, and I use the word relatively, comes in terms of current demand is really unchanged, but the forecast is a bit murkier, and that's with respect to semi conductor. Demand for semiconductor equipment into which our products go continues to suffer. I would not say materially worse in prior years but certainly not better.

That leaves uncertain and uncertain would include our North American general industrial markets, particularly as it relates to recent patterns on book and ship business which occurs intra quarter. so outside of backlog, books – orders where we get an order during a quarter and ship it the same quarter, which often goes to or through distribution and a single specific issue related to a military order for the MRAP program.

With that as backdrop, we expect 2008 to set records in terms of revenues, net income and EPS. Meaningful gains are expected during the latter half of 2008 as additional capacity comes online in our growing wind energy business and our previously announced expansions of our large turntable bearings operations continue to progress as planned as we had sales to the wind energy market of 34.9 million for the first six months of 2008 as compared to 32.8 for all of 2007. So, we've already exceeded last year's total. And we now expect full year's sales to approximate 90 million in 2008.

And while we continue to work towards our historical target of 10 to 12 percent earnings per share growth, attainment in 2008 will be more challenging in light of certain current business conditions. Attainment in 2008 will be predicated on an improved flow of those immediately shippable book and ship businesses to our general industrial markets in North America and upon the funding and release of certain military orders, specifically MRAP, previously expected in the fourth quarter, which may be impacted by delayed funding and therefore, fallen to 2009.

Also, thus far, while much of the increase in material and operating costs sustained over the past year had been more than offset through proactive remediation steps on the part of our operating team, this may get increasingly difficult (asked and relief) and some of the upward pressure of these inputs over the rest of the year.

And finally, while interest income continues to trend lower, as market rates are aimed below – well below levels – we talked so much about interest income, I'm getting tangled up on it now. We expect interest income to be materially lower than last year, particularly as we've turned interest income into operating earnings. We now expect interest income this year to be about seven million as compared to 18 million last year.

Nonetheless, we expect a record year for revenues, net income and earnings as growth in our wind energy business offsets a potential softening in funding delays in our general industrial North America business and the military market.

Our strategic investments in serving the wind energy market, coupled with strong growth internationally highlight our businesses potential overall. Together with the strength of our balance sheet, we're positioned to take full advantage of the organic and acquisition opportunities available to further build out the foundation in place.

In addition, we expect to be able to prudently return capital to our shareholders both in the form of share repurchases and periodically increased dividends while driving profitable organic growth. And as a testament to our confidence, our board of directors declared a more than 13 percent increase in our quarterly dividend to 17 cents per share for the third quarter with the indicated annual dividend now being 68 cents per share.

And more importantly, for long term profitable growth and a result of the continued strength in the demand for specialty bearings utilized by the wind energy industry, our board authorized us to review options to add capacity to serve this fast growing market. We intend to solidify our leadership position and are considering options to expand our North American facilities, principally, our devoted wind energy facility in Monterrey Mexico, during the next 12 to 16 months.

While any expansion decision in the scale, scope and timing will be dependant on finalizing customer commitments. We believe the long term strength of this market and our unique position in it will result in further meaningful investments.

With existing infrastructure, namely the personnel and the geographic footprint already in place, we believe we're extremely well positioned to expand our presence to the benefit of both our customers and our shareholders.

In conclusion, we're pleased with our record second quarter results, our backlog positions us well for the balance of 2008 and beyond as we expand our internal capabilities to service segments enjoying strong secular growth. We believe we are taking all the appropriate measures to maximize shareholder value well into the future and with our strong balance sheet and financial flexibly, you can expect us to continue to drive internal growth while selectively evaluating external opportunities.

Lastly, I'd like to thank each of our employees for their effort this quarter and perceptively for the balance of 2008.

Richelle, that concludes our formal comments, and we would be pleased to take questions.

Operator: Thank you. The question and answer session will be conducted electronically. If you would like to ask a question, please press star followed by the digit one. If you are on a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, star one to ask a question and we'll pause for just a moment.

And our first question we'll hear from Peter Thompson with Coho Partners.

Peter Thompson: Morning, guys.

James O'Leary: Hello, Peter. How are you?

Peter Thompson: Good, thanks. My question is really about your convertible. I understand rates have come down significantly, but just on kind of balance sheet management, why would you not retire that convert and avoid the bondholders essentially from converting over to common stock? It just seems to be you would be picking up earnings doing that.

James O'Leary: Well, no. You wouldn't. The – in the fully diluted EPS calculation the conversion is already fully assumed, so as far as incremental shares on the market or the negative impact of interest expense they're both full eliminated when you do the as if calculation to get the diluted EPS.

Peter Thompson: But your cash is earning two four, and your convert is costing your four.

James O'Leary: Yes, but that would only – if you settled for cash, which would essentially be a share repurchase at – which we have said we are considering and have accelerated. The only way we put the cash to work relative to the shares hitting the market is just to do a straight repurchase. Now, you could retire …

Peter Thompson: Oh, I get it.

James O'Leary: Some of the bonds for cash, but essentially that would be – I kind of look at that as a Dutch auction.

Peter Thompson: OK.

James O'Leary: Now, since you raised it, I do think its worth mentioning, the reason we don't convert is because there are tax benefits which are considerable given we have not debt other than to convert. That's one of the reasons or the arguments for leaving it outstanding, but answer find either acquisition opportunities or expand the capital program, I think we would be considering largely in the interest of balance sheet clean up, potentially converting – we've had a number of people come and convert. But even the 11 million done this quarter, Peter, it's neutral to EPS, because they're fully eliminated when you do the as if calculation.

Peter Thompson: OK, great. That helps me a lot, I appreciate that.

James O'Leary: OK. You're welcome.

Peter Thompson: Thanks.

Operator: And next we'll move to Richard Marshall with Longbow Research.

Richard Marshall: Morning, guys.

James O'Leary: Hi, Richard.

Richard Marshall: You raised the target for 2008 wind sales to 90 million from 80 million, I'm just wondering if there's any change to the out years 2009 or even looking beyond that to 2010. I cant change it today, largely – well, we could do a little bit better than I think the 175 we expected to do in 2009, but remember we're bounded somewhat by the 200 million full run rate capacity, which we expect to have in place. I think the one meaningful potential driver of increasing that will be future capacity expansions, which, as I mentioned during the prepared remarks, we're looking at, our board has approved a number of possible expansions which we're evaluating today relative to customer commitments and logistics. So that would meaningfully change to 200 million.

Now, is it possible we could do better than 175 next year, which I this is what we expect to leave, we said we've expected to leave 2009 at? Sure, but the maximum we could increase is about 15 million, which would get us to full capacity both in Mexico and our Sumter facility.

Richard Marshall: OK. And how much of the increase for 2008 – can you break it down between Mexico capacity and Avon?

James O'Leary: A little bit of it is Avon. Most of it is Mexico.

Richard Marshall: OK.

James O'Leary: Avon – remember Avon was already in the 80 million we talked about I think in prior presentations and commentary.

Richard Marshall: OK. Can you talk a little bit about the geographic breakdown of your wind customers? Has that changed at all and maybe give us a little more color there?

James O'Leary: We have more than a handful of clients now. We have one cornerstone major client. They have a domestic FOB, but I'd be reticent to say that's not an international customer. For the most part, they know the day they ship when their business is being shipped overseas or elsewhere and the market is hot enough and dynamic enough where saying that a domestic FOB meanings our business is domestically bound, it's probably a mistake on our part. We do have a couple of customers that are overseas FOBs and I would say – it would be a guess, but I'd be surprised if the business wasn't more than 25 percent, maybe as much as 55 percent international because again, our customers are shipping all over the world. So they're not necessarily constrained by what our FOB point is.

Richard Marshall: OK. And just one last thing and then I'll get out of the way here. You guys mentioned that the wind – wind bearings are a little bit lower than company average. I thought that they were – I'd assumed they were inline with company average margins. How should we look at that going forward? I mean once supplies cease to be as tight as they are right now. How should we look at those margins for 2009, 2010 timeframe?

James O'Leary: I'm very glad you asked that question, and something we've said consistently over the last year plus in our prepared remarks that where we think the margins for Kaydon overall will end up is low 20s to mid 20s, peak to trough.

Now, interestingly what happened to this quarter, I would say categorizing and if there was a – comment was made, categorizing our – I think we're about 150 to 200, depending on who is looking at the margins below where expectations were. That's a mix issue. That's not a deterioration in our businesses, and it's not a deterioration of the quote unquote legacy Kaydon businesses or margins, it's really a mix issue. Its faster growth, low 20 type business, replaces business that was at least 30 percent and in some cases better in general industrial and legacy military.

Now, if you look at Kaydon's history in 2005 and the 2006 period, the margins were about where they are today. The spike in 2006 and early 2007 was driven by a very heavy mix of military, particularly on a legacy program called (shirkable) races, which we talked about. So where the margins are today and where we expect them to be in the long term, absent big military orders, which absolutely are possible, but I would almost view them as windfalls, is still in the low 20's, which I'd like to point out, is higher than most if not all of the industrial comps out there, and is in line with where Kaydon historically has been over the past 10 years. Once you include about six or seven quarters in the 2006, 2007 range. So, we're happy were the margins are. We will gladly take any orders for higher margin business from the government when they're ready to give them, but unfortunately, we can't time that.

Richard Marshall: OK, great. That's all I have.

James O'Leary: OK, thank you very much, Richard.

Operator: Next we'll move on to Holden Lewis with BB&T.

Holden Lewis: Thank you. Good morning.

James O'Leary: Morning, Holden.

Holden Lewis: I guess I'm getting a little bit confused in my mind about the capacity versus sales argument and so I just wanted to make sure that I kind of understood, because I mean if you're looking at 90 million in revenues this year out of wind, you know, I was under the impression that sort of by the end of the year you're going to have wind capacity of like 100 million. So you're not just existing at 100 million run rate, you're actually recognizing 100 million in 2008 or close to it. I mean does that mean that you're sort of ahead of pace in terms of adding the capacity?

And then, sort of related to that, the 175 million you're referring to – again, I kind of had that as – going out of 2009, having 175 million in capacity on hand, not 175 million in revenues. So I'm trying to make sure I understand what the capacity versus revenue assumptions are.

James O'Leary: Yes, we've said 125 leaving this year, capacity, not sales. We've said 80 million of sales which is now a bit better at 90, this year. Net year the capacity would be about 175 to 200 and I think that what we said is for next year …

Ken Crawford: Yes, they got – that capacity comes on line relatively early. Our last phase is currently underdevelopment, comes on line in February. So the capacity and the sales number – the capacity is slightly higher, but we've talked about $150 to 175 million sales number in '09.

James O'Leary: And if you ask, are we doing better than previously expected, the answer is yes.

Holden Lewis: OK, got it. And then, just trying to understand sort of the guidance's you know as you kind of talk about it. You know you talk about – the language totally went from exceeding 10 to 12 to the hurdles are higher to meeting 10 to 12, but I guess, I look at a quarter where orders are strong, the book to deal was still north of one. It looks like even in the non-wind side the book to bill was around one. I mean, I guess I don't really see in the quarter or in your tone any change that would kind of prompt the language. What am I missing?

James O'Leary: if you look at where we expect the year to come out, in the revenue number will not be materially different and when you look at how various analysts out there have modeled it, I don't think the revenue number is materially different. The margin number, both at the gross and the net operating margin number is probably between 150ish and 175ish basis points high, depending on how mix comes out.

Now, what we're expecting is wind orders to be marginally better, 10 million or so better this year, shipped this year, relative to what was expected to be book and ship, which is general industrial to north American distribution and those are typically much higher margin product shipped intra quarter. That's outside of the 35 percent backlog we've talked about. That pace slowed down a bit at the end of June and it's continued to be a bit slower in July. And defense, defense in particular MRAP, which falls from fourth quarter into next year was about 2.5 plus million of shipments, which could you get that? Absolutely. You know, the MRAP, the forecasts for MRAP have been all over from despair to euphoria. I would not say their despair now, but they're lower than they were earlier in the year. Those two things combined mean the mix, as it impacts profit margin, gross margin and net operating margin will be a bit lower.

Now the other thing and this is purely a cautionary note, but year to date, we have more than offset raw material cost increases. Year to date, we have more than offset operating cost increases of about six million with more than that in terms of price, but notably cost improvements. Whether its sig sigma or other programs we have underway. So we have done better in offsetting cost increases thus far to date. That is getting increasingly challenging so unless we see some relief on some of the inputs of our cost to sales, both on an operating basis and a cost to goods sold basis, I think that's a risk for the balance of the year.

So you're right. Everything is still positive, however, when you look at a huge ramp up in growth – when you look at the growth in operating earnings, when you take out what's almost if not a little bit over $11 million of interest income, which does fall directly to the bottom line, we thought it was appropriate to be a bit more cautionary this quarter than unfortunately some would like us to be.

Holden Lewis: OK. But do you need to see – are conditions exiting the quarter such that unless you see an improvement in those, immanently, you are not going to make the 10 to 12? Right? I mean you putting a caution out there? Or are you saying …

James O'Leary: We specifically – yes, we specifically said we would need to see an improvement in the book and ship rate and potentially higher orders on MRAP for the 10 to 12 to be met.

Holden Lewis: OK, so …

James O'Leary: That is specifically what we said in the press release.

Holden Lewis: OK. So if book to bill is at the same level you saw in June, July, the rest of the year, if MRAP pushes into 2009 instead of 2008, then 10 to 12 is probably not achievable.

James O'Leary: Well, book to bill is out of the equation. We're talking about orders that come (M and out) typically to distribution, typically to smaller customers in North America and typically higher margin. It's the margin in the mix that are the principal drivers.

Holden Lewis: Got it. OK.

James O'Leary: OK?

Holden Lewis: Thank you.

Operator: Take our next question from Eli Lustgarten with Longbow Research.

Eli Lustgarten: Good morning.

James O'Leary: Morning.

Ken Crawford: Good morning.

Eli Lustgarten: A couple of just – some clarifications. One, can you talk about how much pricing is up and for example, going from 80 to 90 million in wind, is that units or is that pricing? Because steel is up that much, it would drive it by itself.

James O'Leary: Well, part – its both. It's partially pricing where we've got raw material price inserts. But we are doing a bit better on units. We found some additional capacity coming online. While it's not Avon, we do expect for the balance of the year to be able to ring a bit more out of Avon than we originally anticipated.

And as far as pricing, its three to five percent. We're doing a bit better than certain of our inputs. If you remember steel, as it relates to our highest raw material intensive product, which is the slewing ring for wind energy, we get price pastures on that, they come about a quarter later. There's a lag on when we present invoices and the balance of our businesses where the cost of sales, raw material intensity is a bit less, say its 50 percent in the slewing ring and its 30 percent everywhere else. We've had success in passing that through or offsetting it with cost increase, but you know, I'm cautious that that can continue with the success we've had to date. That doesn't mean we're not trying and that doesn't mean we don't expect to have some success, but we thought it was appropriate to put some caution over it.

Eli Lustgarten: That, and do you have any quantification of how much currency benefits you had both on the top line and on the bottom line in the quarter.

James O'Leary: We do.

Ken Crawford: Yes, in – about $2 million on the top line and call it $1 million on the bottom line, on the EBIT line.

Eli Lustgarten: OK. Going on and as we look out into 2009, we're going to have more wind, but the economic conditions can remain reasonably difficult and currency is going to go away at this point unless the dollar – radically we can – I mean, do you become as cautious for 2009 in business mix as you are today? I mean is there any reason why business mix has changed radically as you look at it? I mean it looks like we're going to be in the same thing from next quarter, six quarters, or at least two four quarters at this point going into 2009?

James O'Leary: Probably a bit early to comment on that, Eli. I think the recent slow down on the book and ship orders was a very recent – I'd almost say it was like hitting a light switch. The – the thing you got to remember about that and there are some – some good information in the public domain, some of our distributors are public on the AIT, I mean there are some relatively large distributors, I think SKF has some pretty good commentary on what's going on at north America, which they predicted to be flat next quarter. What we saw and what we believe is happening and this is anecdotal is some of our distributors are cutting back a bit on inventory …

Eli Lustgarten: It's an inventory reduction more than anything else?

James O'Leary: Absolutely. And you know what, when you think about the purchasing manager surveys and a lot of the anecdotal – but I think anecdotal drives animal spirit sometimes and whether it out – if it becomes a reality or not depends on the environment you're in. What we think is happened recently is purchasing managers have pulled in their horns a bit. You've seen distributors get a bit more cautious about inventory build, and that has an immediate impact on us as far as book and ship business. You know, if you've got a bunch of good numbers, if people feel better about the world; that could change quickly. So, I think is probably premature to talk about '09.

The reason we thought it was important to put some cautionary working on '08 is we're in the idle of the year, it's a very aggressive ramp up, and we didn't think you guys would be done with service if we didn't.

Eli Lustgarten: Absolutely, one final question, can you talk about whether you're seeing any changes in Europe yet? I mean that's probably the rhetoric that we're hearing more from other companies than anything else. U.S. is sloppy but the Europe has begun to slow down.

James O'Leary: Surprisingly no. But I would not say that we're representative of some of our peers and some of the much bigger companies that have broader European exposure. And our velocity control segment, it's a German value added distributor, we believe we're out executing the competition. We've picked up a fair number of relatively big orders, they're probably skewed towards company specific performance, rather than overall Europe both eastern and western and our split roller bearing business, doing very well, but that's largely in developing nations and that's a heavy industrial product as well. So I don't know if we're broad enough to be a good data point, given that I know part of that is company specific execution. I mean we're just doing very well in that market against a couple of specific customers.

Ken Crawford: Yes, we don't have a general industrial worry in Europe as we do have in the U.S. at this time.

James O'Leary: We have not yet seen it, but I've seen and read and heard a lot of the same conference calls you do and you know some pretty smart guys are talking about that being a possibility. So we check every week, we talk to our guys regularly and we're cautionary about it but we've yet to see it.

Eli Lustgarten: All right. Thank you very much.

James O'Leary: You're welcome. Thank you.

Operator: And next we'll move to Ian Fleischer with FBR Capital Markets.

Ian Fleischer: Yes, hi. Actually on that note, can you touch on some of your organic efforts to grow out some of your product lines in international markets?

James O'Leary: Sure. Eli – the question Eli just asked about how we're doing internationally, our western European business in velocity controls is in the process of expanding, we're moving to a bigger facility to accommodate growth there. And that market services much of the rest of Europe including Eastern Europe and a number of international locales, pretty widespread. The guy who manages that facility for us is taking responsibility for an Indian distributorship which we will be setting up. So, in terms of velocity control, both expansion in western Europe and more than contemplate we've go the paperwork filed and we're in the process of going through all the legal traps and the like to get full y established and certified in India.

We have a – we've recently and its earlier this year set up a Chinese distributorship wholly owned by ourselves within our filtration – our liquid filtration company and you know that started to do well, but that's going to take a couple of quarters I think to fully come on and payback, but thus far, we're very happy with it.

We mentioned in the prepared remarks that we're accelerating distribution – excuse me, accelerating due diligence on potential manufacturing elsewhere in the world for the bearings division. But given that our opportunities to expand around an existing footprint and an existing management team in North America – I wouldn't say low hanging fruit, but they're easier, faster to come to market. I'd say that is not as fast as we'd like but will be faster potentially, and I would have said a few quarters ago because the Chinese and the Indian market are very robust, very strong, with North America and they're mentioned as the three developing nations for alternative energy, notably wind. So we've accelerated our due diligence a bit on overseas expansion and some of the this that could potentially lead to. I wouldn't suggest (JV) but we've considered that. We're looking at opening our own facility. We hope to do it on the backs of some customers, which already do business there and I think that's one to stay tuned on. But that would be the biggest and the most capital intensive and probably the highest impact expansion we could do.

I don't consider Mexican expansion as part of your question, but obviously, that's the one that could happen fastest.

Ian Fleischer: OK and just to circle back on wind. Can you remind us of your – the timeline of your capacity expansion plans? When you brought up the first phase you have two additional phases. When do those come on line?

James O'Leary: They're kind of blended together now.

Ken Crawford: The one will be on line in the third quarter of this year and the other one is expected to be online in February of '09.

Ian Fleischer: OK, and then when you think about additional capacity, I mean then you have almost all of 2009 to continue to invest in that business. I mean how should we think about – are you going to do it incrementally like you've done in the past, you know kind of see where the market is and do you know $20, 25 million you know in increments or would you do a much bigger expansion plan?

James O'Leary: It would be done in increments, but it would be done probably faster and with more of a holistic approach to where this business is going to be in five or 10 years and I think the earlier ones had been done. I'd say the earlier ones were pretty opportunistic. This one is, with a couple of things in mind, we would want to add in a fashion that gets product to market for our customers as fast as possible. So while Mexico is the lowest cost alternative, you know we have a great facility in Sumter South Carolina, we bought a great facility in Avon like Cleveland and you know the possibility in expanding either of those is not off the table. It's just a question of cost effectiveness relative to the price our customers are willing to pay. But those could come to market much faster than a complete Greenfield in Mexico.

That said, the Greenfield in Mexico and Greenfield would be a bit of a misnomer. You know were we to do an existing facility in the industrial park we're in in Mexico, that would be relatively quick, but it wouldn't be as quick as the other and it probably couldn't add to '09, but that's something we're looking at as well. And the key to that is not just customer commitments, but the mix of customers.

We'd like to avail ourselves of broad customer base, but also some different technologies. Whether it's a geared or non-geared facility. The size of the turbine. The composition of where se ship to. All those things go into the mix and again, that I don't think could be done fast enough to impact '09, but probably could be done faster than most of the people in the industry or most of our peers, potential competitors in the industry because we've already got the footprint and we've already got the experience in the management team that have been through the ramp in the past years. That's kind of a valuable and tangible asset that we'd like to leverage.

Ian Fleischer: So I mean, you feel like you've kind of done the heavy lifting there with respect to you understanding, bringing on the capacity and probably would go more smoothly going forward, is that a fair assumption?

James O'Leary: Absolutely. But I would say this has gone pretty smooth relative to a capacity expansion that is more than all the capital this company has done, added up in a decade.

I think you've got to give high marks to the company on that. And you know, obviously there's a bit more water between here and the shore, but we can't be unhappy with how that's gone, but we do have a valuable asset there in terms of the experience to leverage.

Ian Fleischer: Right. And just one final point, you're saying right now that given your current capacity expansion plans, you can do 175 to 200 million – support 175 to 200 million in annual sales, is that the number?

James O'Leary: Yes, leaving '09. By the time we leave '09.

Ian Fleischer: OK, thank you.

James O'Leary: You're welcome. Thank you.

Operator: And next we'll move to Peter Lisnic with Robert W. Baird.

Peter Lisnic: Good morning, everyone. Sorry, if I missed this but we had a fire drill in the building, but I wanted to ask again, on the book and ship business, it sounded like that business tailed off at the end of the quarter and then into July. Was it down for the quarter and then what – I know July's not done, but what does it kind of look like for July's numbers?

James O'Leary: Down, but I don't have those at my fingertip Pete and I probably would be remising giving them out. But down relatively to our expectations and down relative to the ramp that we would have expected in the back half of the year. And again, you may have been out when the gentlemen before asked a question. A lot of this business goes to distribution or to smaller industrial customs in North America and if you look at some of the publicly held distributors, if you look at some of the comments by our peers, North America in particular distribution as seen a bit of an inventory leveling off. I think some of the purchasing managers and certainly AIT would be a good example because their numbers are public and have talked about keeping an eye on inventories, being cautious, and I think pulling in the horns is a good way to describe it.

That's what we think has happened and it's too early to say whether or not that continues and how severe. But that is the biggest driver of margin, as it relates to mix, and kind of the incremental profit it would have gotten us to the target, based on where we were the last time we talked.

Peter Lisnic: OK. All right. Good on that one. And then, if I look at the non-book and ship and non-wind, that order book, I guess, you know in the first quarter may have been mid single digit organic order growth and then that slowest it looks like, maybe flat, maybe down a little, maybe up a little, I don't have the exact number, but can you give us a sense as to what the puts and takes were on the order front for the non-book and ship business and non-wind?

James O'Leary: There's a book and – the book and ship or book and bill?

Peter Lisnic: I'm sorry, the book and bill.

James O'Leary: OK, the book and bill was right around one, a non-wind, at roughly 120 million in sales and 120 million in orders.

Peter Lisnic: OK, and then what I was wondering was what the – were there any incremental negatives relative to your expectations?

James O'Leary: I'd say no. No, we got record backlog, record orders. But the mix of the components with the fence and the book and ship part being down, that's one of the biggest drives of the difference between the 23, 23.5, 24 percent margin and a 25, 25.5, 26 percent margin. It's the mix and the contribution of those two product lines, which would be general industrial, machinery, principally in North America and military.

The mix within the rest of the business is wind but not just wind, medical, heavy equipment, there were no obvious negatives, but those are longer dated in modestly lower margin, but modestly is low 20's so that's a bit lower than what we've done over the past year and a half, but the business is still strong and if you look at the order book and when it unfolds, unfortunately, not enough of it comes next quarter. We're talking about – and with our customers we're not talking about orders for 2010, and 11 and beyond. The way our backlog ships now, however is 35 percent, 35 percent over the next two and 30 over the balance. You've seen a shifting of our book and bill business to the back half of the 18 month period which puts you a little bit more dependant – in fact, I'd say a fair bit more dependant on book and ship business this inter quarter.

Peter Lisnic: OK.

James O'Leary: That make sense?

Peter Lisnic: Yes, it absolutely does. Thank you for your help.

James O'Leary: OK, you're welcome. Thank you.

Operator: Steve Barger with Keybanc Capital Markets. We'll have our next question.

Steve Barger: Good morning.

James O'Leary: Steve.

Ken Crawford: It's afternoon, Steve.

Steve Barger: Oh, sorry.

Ken Crawford: We just officially went over, but we're keeping the questions open because we kept you guys on hold for a bit.

Steve Barger: Appreciate it. And we've talked a little bit about the potential capacity expansions right now, but based on your preliminary customer conversations or commitments and where you think the end market could go, as you look out over two or three years is that business you know 50 percent, or 100 percent, or what magnitude bigger than your implied installed base for 2009?

James O'Leary: Between 50 and 100 million bigger. And that would depend on the mix of what – right now we're looking at as a couple of potential phases and by the way, 50 to a million revenues, not percent. But actually on 200 million, it's about the same.

Steve Barger: Right.

James O'Leary: So about anywhere between 25 and 30 percent and 50 percent bigger than the capacity installed by the end of 2009.

Steve Barger: And given that the additional fabrication machines you know are probably one of the big bottlenecks there, how are you dealing with getting in queue relative to your expectations for being able to that additional capacity on?

James O'Leary: We have a very specific strategy for doing so and I think it would be not doing ourselves a favor to talk about it.

Steve Barger: OK.

James O'Leary: Yes, but you know listen, that is the biggest bottleneck and the relationship with the machine fabricators, the relationship with our customers, who have their own relationships with some of these guys, and you know how you're strategically approaching queuing up deposits and the like have a lot to do with it and you know, we've been forward thinking about it.

Steve Barger: OK. And when you talk about $50 to 100 million, is that excluding the due diligence process that you're going through for potential international opportunities right now?

James O'Leary: Yes.

Steve Barger: So that would be on top of that. Any idea of timing and potential size if you were to pursue something like that? If you were to be able to piggy back that on to an existing customer?

James O'Leary: Probably a late – a late this year, early next year conversation at the earliest, Steve. We're in the process. Again, we're finalizing this one. We're accelerating potential expansions around that footprint and one of the challenges is we have more opportunities than good guys, and we've got a lot of good guys.

Steve Barger: Right. OK. Just talking about the end markets for a second, a couple weeks ago, or recently, the Texas (crez) announcement came out. The increased funding for renewable distribution. Are your customers talking about that and what that means to turbine sales in the U.S. going forward and what conversations have you had about that?

James O'Leary: Not in the level of granularity where people are saying or forecast is X percent or Y percent higher, specifically. But I would point out the recent forecast, EER, has now revised up twice in the last six months. They've been revised up and I think the last one was up over 25 percent and I want to say 29, but I could be wrong. That's just in the past couple of months. I think, what you just referred to continued (enactment), the renewable portfolio standards at the state level. I think the the (Pickens) plan and were you to translate that into hard orders. All these things anecdotally go into forecasts that continue to be revised up and when you drill that down into individual customer forecast and commitments, they continue to be revised up. So, I can't tell you that that specific issue or this specific enactment of renewable portfolio standard or the (Tboo and Pickens) order translates into X relative to the macro forecast, but it's all anecdotally been positive. In the last forecast was revised up, I think, 29 percent globally.

Steve Barger: Right. All right. And one last question then. The stock prices in the low $40 dollar range early in 2Q and I think if I heard the numbers right, you're average price of the buyback was about $54. Can you talk about your buy back philosophy here relative to the current share price and you know potential future dividend considerations and how you're thinking about that.

James O'Leary: Well, I think the 54 was just this quarter. Ken, is that right?

Ken Crawford: Yes.

James O'Leary: The average over the program is materially lower than that.

Steve Barger: Well, sure. I'm just talking about the quarter, yes.

James O'Leary: In fact – and the quarter doesn't contemplate what we had as well as 10B5 in the period when we were a little under 50 and under 55. You know our plans are, we're going to continue to be opportunistic about it when we're down in the low 40's we're more likely to be buyers than when we're in the high 50s. We think it's – you know we think it's an attractive us of proceeds. I think somebody pointed out before the first question was hey, you know a year and a half, two years ago, you could earn eight percent on cash. Who'd know you'd be taking a risk on not being able to ever use it, right?

Steve Barger: Right. Right.

James O'Leary: I mean now we're getting you know two to 300 basis points on cash, we – you know, we recognize that that is not a great use of funds to be sitting on cash balances at that level. But we've accelerated capital a number of times, we're looking at an additional acceleration of capital. We did a $65 million acquisition, we funded our pension plans, we've upped the dividend twice. And specifically to your question, I think we'll continue to be opportunistic repurchasers. If we wake up and the stock's materially lower, as it was earlier this morning, if it stays down there, we're going to be buyers of our shares.

Steve Barger: Very good, thanks for your time.

James O'Leary: OK, than you Steve. Richelle, if we don't have any body this might be a good time to wrap it up, but …

Operator: We do have a few more left, sir. Did you want to continue on?

James O'Leary: OK. Let – yes.

Operator: OK. We'll hear from Mike Hamilton with RBC.

Mike Hamilton: Good morning. Nice quarter.

James O'Leary: Thank you, Mike.

Ken Crawford: Hi, Mike.

Mike Hamilton: Could you repeat where your wind backlog was second quarter end?

James O'Leary: One hundred seventy-three million – the wind was 151 million, I'm sorry. One hundred fifty-one million wind backlog.

Mike Hamilton: Thanks. Was wondering if you could give some general perspective on whether the momentum that we're seeing driving wind and European velocity right now has the potential to offset normal second to third quarter seasonality at the top line? Is there a potential there or do you think that's unlikely just in normal seasonality?

James O'Leary: I think it will be a bit tougher, largely because of the issue we've talked about a couple times in this call, which is the – the more tenuous, certainly relative to the last two years, nature of the book and ship business, so I think the momentum in the wind business, certainly at the top line, may offset that, whether or not it will offset both factors – I think it would be tough for me to way.

Mike Hamilton: Yes, fair enough. Could you give some perspective on your views of economic dynamics and wind at this stage? In other words, we've seen wind require tax credits, domestically to get to where we need to be and we're looking at continued cost pressures how do you think about all of that as you lay in your forecasts?

James O'Leary: Sure, when you look at wind relative to carbon based alternatives, as far as grid parity, it is awful close without tax benefit, obviously the tax benefit helps considerably. When you look at relative to other renewables which I think – one part of the competition within the energy space is with carbon based alternatives. So, we're closer to grid parity, or wind is closer to grid parity than all the other renewables, and I think nuclear you got to put on the side because that's a – it's kind of a completely different conversation in terms of policy and people's feelings about nuclear. But when you look at wind compared to solar, the disparity between wind and solar, as far as grid parity, is pretty considerable. So, wind needs less tax, but tax would still be helpful.

When you listen to people discuss – and this is people on both sides of the aisle, the likelihood and the – you know the feel goodness is the only way I can describe it. But the comfort level that there should be a renewable portfolio, not just renewable portfolio standards, but a PTC and a PTC enacted this year. You almost can't find a person who doesn't think there should be one, but its just amazing that it hasn't been passed yet and its been tied up obviously with other legislature, its been billed with other thins that were less – less favorably inclined to get past in the PTC but we're respectful of the fact that the PTC has not yet been renewed. Everyone we talk to says it will be and no one I've heard says it shouldn't be. But it hasn't.

Now, what our customers tell us and what their customers tell them is they've got a high comfort level and the wind (bats) are up relative to other periods when the PTC didn't get renewed because of number one, the prevalence of renewable portfolio standards, I think its somewhere around 30 states now where there are expectations in part expectations by 2020, or 2030 as to the percentage of electrical generation from renewables. A number of customers – excuse me, a number of companies now are talking specifically about carbon audits and good citizen policies on the part of their supply base.

And while there is a lot of discussion, the PTC does have to get renewed, you know there's a lot of discussion about a national renewable standard at some point and its not tree huggers or people who are all green, green, green who are saying that 20 percent renewable by 2030 is something that, in terms of good corporate citizenship and good global citizenship, we should be thinking about as a country. So, there's nothing anecdotally that doesn't tell me this momentum doesn't stay there. All that said, we really would love to see the portfolio's credit passed and hopefully it will be sometime in the next few months.

Mike Hamilton: Yes, thanks for those insights.

Last one, you ran below my expectation on second quarter CapEx, could you kind of lay in our outlook on the ramp through of CapEx as you roll in phase two and three here?

James O'Leary: I'm betting that's just timing, but let's see if Ken can dig those numbers up for you.

Mike Hamilton: Yes, thanks.

Ken Crawford: Yes, we've – we'll see probably in the $30 to 35 million CapEx total for next quarter and in total, we're looking at 75 to 80 million in '08. And again, that is absent any additional movement we might make to add to our capacity expansion that we've talked a lot about this morning.

Mike Hamilton: All right. Thanks gentlemen.

James O'Leary: Thank you, Mike.

Operator: And next we'll move to Walt Liptak with Barrington.

Walt Liptak: Hi, thanks. Good morning, guys.

James O'Leary: Hello, Walt. How are you?

Walt Liptak: I don't want to beat a dead horse on the book and ship, but – when you went through on your outlook and you talked about the excellent, good, relative and relatively bad, and uncertain. How – what – as a percentages of revenue, how much is the uncertain portion. Or maybe another way to say it is, as a percentage of revenue, how big is distribution? Those AITs of the world?

James O'Leary: I'd say it's – I'd say it's between 10 and 20 percent is the uncertain part. But it's the highest margin and if you look at – we're still talking about a record year and a record year at the EPS line where you've turned a huge amount of interest income into operating earnings. But we're talking about on the margin. And on the margin, that's our most profitable business.

Ken Crawford: Yes.

James O'Leary: And also, unfortunately, the hardest to forecast. And its not just the book and ship, you know every company in the defense industry and every guy who follows companies in the defense industry recognized that there are occasionally over orderings, its volatile, its based on funding – you know, in our case in particular, we're a bit far down in the food chain. So our visibility is not as good as some of our customers who are impacted directly by the funding. So what we're saying is the most profitable portions of a smaller percent, certainly than when the smaller percent and the this that I say were clearly good are unfortunately – well, fortunately on the good times, and unfortunately when they get uncertain are the highest margin pieces.

Walt Liptak: OK, and then the fourth quarter push out of MRAP, did you say that was 2.5 million?

James O'Leary: Yes, about 2.5 million of shipments which could fall into next year.

Walt Liptak: OK. So that's not all that meaningful.

James O'Leary: No, it is but …

Walt Liptak: Did you ship MRAP in the second quarter?

James O'Leary: Yes.

Walt Liptak: Could you tell me how much you shipped?

James O'Leary: Don't have that of the top of my head but we'll come back to you on that.

Walt Liptak: OK. Can you tell us who your MRAP customer is or are you shipping to the government?

James O'Leary: No, we're shipping to BAE and it's principally them.

Walt Liptak: OK. Yes, because they had a push out.

What's the funding tied to, do you think? The supplemental got passed. Where do you think the funding is tied?

James O'Leary: I think its timing of releases within competing vehicle platforms for – a lot of people think MRAP is the answer but there's some who don't.

Walt Liptak: Right. OK>

James O'Leary: And right now, I think there's 15,700 vehicles approved, you know that number had been materially higher at points, but it's also been lower. Like I said, its swung from despair to euphoria and there are competing vehicle platforms which would impact whether that 15.7 becomes more, what we expect is that that will get funded, but it will get funded over a longer period as we go into the election and figure out what the new administration and …

Walt Liptak: Right.

James O'Leary: What's going to happen in Iraq and Afghanistan?

Walt Liptak: Right. OK. OK, great thanks.

James O'Leary: You're welcome.

Richelle, I think its time to wrap it up if everyone's not at lunch already. How many do we have left?

Operator: We do have three questions left.

James O'Leary: OK, take them.

Operator: OK. Do you want to take them?

James O'Leary: Those are the last three. Yes.

Operator: We have Michael Corelli with Barry Vogel and Associates.

James O'Leary: OK.

Michael Corelli: Hi, good afternoon. Just a question. Is there any new competition that's you know been announced as far as new facilities, new production capacity in the wind energy area?

James O'Leary: Not that we're aware of. I think what we've talked about is both SKF and FAG have announced expansions but that's not new. As another domestic competitor who announced a small capacity but that was quarters ago, but nothing new that we're aware of.

Michael Corelli: OK, great. Thank you.

Operator: And next we'll move to Nigel Coe with Deutsche Bank.

Nigel Coe: Oh, thanks. Good afternoon. Obviously covered a lot of ground here but you haven't talked about acquisition. I mean what are you seeing Jim in terms of the opportunities out there and how has that changed from maybe last quarter?

James O'Leary: I think there's a little bit more volume in terms of people trying to get thins to market, there is – I would say there is – not that different than the IPO market, you know, more people are filing prospectuses, more people are registering for potential IPOs, but you haven't gotten into hard price discussions yet, which is kind of where the rubber hits the road. We're starting to see more volume on what I call midsize to fairly large sponsors looking at harvesting some things in their portfolio. But I think we're at the early stages. They say volume has picked up a bit relative to last quarter. But it's still not quite at the phase where you see whether or not people are willing to sell at prices than what they might have entered properties at. And basically what happened if there's not a bank market to support larger deals.

Nigel Coe: True. And then I thought the you know, the small conversion on the note was interested. The (bumpty) dividends quite meaningfully and usually CD holders hate that sort of thing. So have you seen any more conversations in July?

Ken Crawford: No, but we've had some inquires.

Nigel Coe: OK.

James O'Leary: We've had some inquiries and as we ramp up the capacity expansion and we think about acquisitions, that's the nature – I think the math answer is, you always leave the convert outstanding both qualitative, you know as we start to put more capital potentially into wind or the acquisition market heats up a bit, cleaning up the balance sheet maybe something we consider because that would give you the ability to go to the agencies and go to the banks with an optically clean balance sheet but I think that's all trimming around the edges.

Nigel Coe: OK, and then just one final one. Thanks for the disclosure on the wind revenues. How does that phase between 1Q and 2Q.

James O'Leary: How does that phase between Q3 and four?

Nigel Coe: No, 1Q and 2Q, the $34 million of revenues in the first half of the year.

Ken Crawford: They're 15.5 in Q1.

Nigel Coe: Yes.

Ken Crawford: And 19.5 in – 19.3 in Q2.

Nigel Coe: Great. That's very helpful. Thanks a lot.

James O'Leary: You're welcome.

Operator: And our final question, we'll hear from Holden Lewis with BB&T.

Holden Lewis: Thank you again, two quick things …

James O'Leary: You're back?

Holden Lewis: I'm back, I'm back.

James O'Leary: All right.

Holden Lewis: I don't want to waste all your time at once. I figure I'd just phone.

James O'Leary: You've got to do what the (wong book) guy said, which is send another guy in first for reconnaissance and you come in with the second question.

Don't you have an associate?

Holden Lewis: I suppose I can line up any number of people to get any number of questions in that way.

James O'Leary: Not now, you can't. All right, Holden.

Holden Lewis: What was the acquired – what was the acquired revenue from Avon in the quarter?

James O'Leary: Ken, can you get that?

Ken Crawford: Little north of seven million.

Holden Lewis: Little north of seven million. And you also had a divestiture, I think, that …

Ken Crawford: Less than a million.

Holden Lewis: Less than a million and a little more than seven million.

Ken Crawford: Right.

Holden Lewis: OK and on the working capital. I know you said that you know you're seeing increases in terms of your receivables and inventories which is certainly true, but it looks like the rate of growth this quarter and last, in both receivables and inventories have been faster than your rate of growth on cogs and sales. So it seems like you're adding working capital assets at a rate faster than your growth. Can you give some color as to what's behind that?

James O'Leary: Well, we look at things like DSOs and the – on the receivable side, we're not too concerned, we look at agings and we always have and this quarter is no exception. Ninety percent of our receivable balance is less than 60 days and 96 percent is les than 90 days. So the quality of the receivables is still good.

On inventory, you have added Avon since a year ago and our operation in Mexico is at – is buying a lot of forgings in anticipation of making these wind turbine bearings. So, we're not concerned – it's obviously something we'd like to turn into cash as soon as possible, but we're not concerned with the quality of our inventory and our receivables.

Ken Crawford: But all the qualitatively, if you think about the way the material passed throughs work, you know you'll be taking in forgings at today's cost, you just compared that to last year's – excuse me, last quarter's cost and you're not going to get the reset in what you paid, the higher price until next quarter. So I think the rate of your inventories which you're taking at a current cost, relative to sales in the DSOs where you don't get a reset until you pas that through next quarter, I think is a bit of mismatch between what we take on our books as inventory and how that relates to the various working capital ratios. But we watch that stuff like hawks.

Holden Lewis: And when you talked about the reset, you know and the lag for – the quarter lag. I mean if in the first half you've offset raw material costs so far, you know, presumably you're behind by a quarter. You know why would be be concerned about Q3?

James O'Leary: Well, I think where we've – I said we've offset – we've more than offset based on two components, price pass throughs and efficiencies. Well more than half of that thus far has been efficiencies and quite frankly, proactive steps on the part of our management to reduce costs.

You know, we look at it in two baskets, cost reductions and pricing increases and most of it – more than half of it have been cost reductions. So it's not just a pass through, its efforts we're taking that unfortunately, eventually do have diminishing returns. And that's why we gave you the cautionary note about that.

Holden Lewis: OK. Great, thank you, guys.

James O'Leary: You're welcome. Thank you.

Operator: And there are no further questions.

James O'Leary: Richelle, thank you very much and if there is anyone still on the line, thank you for your time this afternoon and we will talk to you next quarter.

Operator: And that will conclude today's call. We thank you for your participation.

James O'Leary: Thanks.

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