KAYDON CORP

First Quarter 2009 Earnings Conference Call
May 1, 2009
10:00 am CT

Operator: Good day and welcome to today's Kaydon Corporation conference call. Please go ahead.

Rick Mosteller: Welcome to the Kaydon Corporation First Quarter 2009 Earnings Conference Call.

Before the conference begins, the Company would like to make the legal disclaimer that certain information, in this formal discussion and 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 2008 Form 10-K for a list of factors that could cause such 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 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 certain non-GAAP measures. To assist you in understanding non-GAAP measures, as well as, to comply with SEC requirements, the company has included, in its press release, a reconciliation of non-GAAP measures to the most directly comparable GAAP measures.

Today's conference is being recorded.

Now, I would like to turn the call over to Mr. Jim O'Leary, Chairman and Chief Executive Officer of Kaydon Corporation.

Jim O'Leary: Thank you, Rick. Good morning and thank you all for joining us today. I'm joined by Peter DeChants; Ken Crawford and Rick Mosteller, as always. And Peter and I will briefly our first quarter release, at which, we'll be responding to questions. And when I say briefly, explicitly we will try to be short because much of what is in the press release, which we'll go over on the conference call, is consistent with the general environment and consistent with many of the themes and trends we talked about on our prior quarter.

Also, again, in the last quarter, I said we'll be short but unfortunately, we can't be sweet. And this quarter, again, we'll be short but we can only be as sweet as the current environments allow us.

As expected, the year's first quarter, saw global recessionary conditions negatively affect each of our businesses. The general economic environment had a significant impact on sales volumes, across the board. Operating income was, in turn, adversely impacted by the lower sales volumes; higher depreciation associated with the recently increased levels of cap ex, all which came into service or most of which came into service, during at the end of the first quarter.

Higher pension costs, incidental, to the financial side effects of the financial crisis on pension assets and liabilities. Adverse changes in product mix, particularly, as higher-margined industrial orders received and shipped within the same quarter, which we term book-and-ship orders, declined within each segment. And finally, the stronger dollar, which negatively impacted not just export sales but also, the translated foreign results.

Interest income also declined to negligible levels due to the global (flight) to safety, impacting EPS comparisons by about 3 cents year-over-year. Sales, in the first quarter, were $110.3 million, as compared to $123.3 million, in the first quarter of 2008. Operating income was $15.5 million, in the first quarter, compared to $26.2 million, in the first quarter of 2008.

Margins were negatively impacted and somewhat disproportionately affected, by increased depreciation associated with new capital expenditures. Increased pension costs; changes in (meds) and the loss absorption of facilities now operating at less than full capacity due to the drop offs in volume.

SG&A was $20.3 million, during the first quarter, down about a million compared to the $21.2 million, in the first quarter of 2008. SG&A were low, primarily, because of steps taken, by the company, last year, to reduce costs as the global economy waned. And the $1 million absolute drop is probably a fair bit bigger than that when you look at the fact that we're offsetting our cost cuts; the impact of depreciation and higher financial costs, such as pension.

EBITDA, a non-GAAP measure was $22.6 million for the first quarter of 2009, as compared to $32.5 million in the prior year's first quarter. Net income, for the first quarter, was $10.1 million or 30 cents per share on a fully diluted basis, as compared to the first quarter of 2008, $15.3 million or 52 cents per share on a diluted basis.

Turning to the operating segment, our largest segment, friction control had sales of $72.2 million, as compared with $74.1 million, in the first quarter of 2008. While sales to customers in the strategically important wind energy business, increased almost 33% to $20.8 million and increases in sales to the medical and the military markets were realized, as well, during the first quarter, this growth was offset by declines in other end markets, principally, those servicing general industrial customers. Also, during the 2009 quarter, those businesses servicing international markets, principally Europe, experienced declines similar to the declines experienced in the Company's North American end markets, during the latter half of 2008.

With respect to the wind energy market, while the near-term has been impacted by issues associated with credit and finance availability, recent steps taken to repair the health of the financial markets, should eventually improve visibility and end-user confidence to proceed with previously planned projects. More importantly for the long-term, however, recent actions and policy statements providing a sustained, committed policy towards increasing renewable energy usage, in the United States, supports our confidence in our investments in this long-term growing market.

First quarter 2009 operating income, in this segment, totaled $12.5 million, compared to $71.6 million in the 2008 first quarter. Operating margins were affected by adverse changes in mix, principally the drop off in book-and-ship orders; higher depreciation associating with capital expenditures put into service this quarter and pension costs. And the unfavorable effects of exchange rates, both on export sales and on translated results.

Turning to velocity control, first quarter 2009 sales totaled $12.2 million, as compared to $18.8 million in the prior year's first quarter, due to reduced demand, in all regions and the adverse effects of exchange rate changes. Remember in velocity control, our largest international segment, is based in Germany, so the foreign exchange also have the heaviest impact on our velocity control segment. Operating income declined to $2.2 million due to the effects of lower sales and the unfavorable trends and exchange rates.

Within sealing products, sales were $10.6 million compared to $11.5 million, in the first quarter of 2008, largely, due to the drop offs in volume and market conditions. Operating income declined $600,000 due to the lower volume and additional pension costs.

And finally, sales of the Company’s remaining businesses, our other segment, equaled $15.4 million, during the quarter, compared to $18.9 million in 2008, primarily, due to lower demand for liquid filtration; air filtration and metal alloy products. Operating income decreased to $0.8 million, $800,000 in the first quarter, due to the lower sales and higher pension costs.

Backlog, at quarter-end, $273.3 million, as compared to $319.9 million at March 29, 2008 and $312.6 at year-end; wind backlog was $137.8, at the end of the quarter. The 14.6% drop in backlog is attributable to shipments in excess of gross orders; cancellations and deferrals or push outs, in certain longer cycle markets and to a lesser extent, gross sales price adjustments associated with raw material price pass-throughs and foreign currency translation.

Backlog, as you remember, is comprised of orders for products expected to be shipped during the next 18 months. So, when we have push outs or deferrals that go outside the 18 months that falls out of backlog as we report it.

During the first quarter of 2009, net non-wind orders decreased approximately 39% from the prior year’s historical record, as customers deferred placing orders for immediate shipment, again, book-and-ship orders and generally reduced inventories. The aggregate impact of cancellations, order deferrals and other backlog adjustments was $15.2 million during the quarter. Gross non-wind orders, prior to the impact of these items, decreased approximately 33%.

Within the wind energy business, customers have deferred placing new orders until near-term visibility improves but current shipments continue to be made based on existing (PO’s) and longer-term agreements.

Now, I'll turn it over to Peter to cover some additional final items, after which, I'll wrap up and then we'll take questions.

Peter DeChants: Thanks, Jim and good morning everyone. During the first quarter of 2009, interest income totaled $130,000 on our average investment balances of $219.3 million. This compares to $1.9 million of interest income in last year's first quarter when we earned approximately 3.4% on average investment balances of $288.8 million and in that recorded a $500,000 charge to recognize the loss in value of a previously disclosed restricted investment.

The lower average investment balances resulted from our capital expenditure program; increased working capital; our stock purchase actions and an enhanced dividend. The reduction of $1.8 million in first quarter interest income, compared to the prior first quarter, was equivalent to 3 cents per share on a diluted basis. While our investment balances continue to provide us with significant liquidity, when liquidity is at a premium, we're currently earning very little interest on the balances due to global market conditions. We expect that interest income, in the second quarter of 2009, will continue at the level achieved during the first quarter.

At the end of first quarter 2009, our net position held in the restricted investment totaled $3.6 million. This enhanced cash investment is being liquidated by the issuer and during the first quarter of 2009, received distributions of $1.4 million, at approximately book value.

Our current cash and cash equivalent investments, today, are principally in money market funds that invest in short-term Treasury securities. This provides the highest level of safety available, although, the returns currently are negligible.

Interest expense, during the first quarter of 2009, totaled $62,000 representing the amortization of fees on our line of credit, as we completed the conversion of our long-term debt into equity, during the third quarter of 2008. Interest expense, in the first quarter 2008, adjusted to reflect the required retrospective applications of the Financial Accounting Standards Board's Staff Position was $4.4 million. The conversion of debt last year and the related reduction in interest expense had no impact on diluted EPS due to the accounting treatment of the underlying convertible debt instrument.

The effective tax rate, during first quarter 2009 equaled 35.1% compared with 35.3% in the prior first quarter. The first quarter tax rate was favorably impacted by lower state taxes.

Net income for the first quarter was $10.1 million or 30 cents per share on a diluted basis, as compared to adjusted first quarter 2008 net income of $15.3 million or 52 cents per share on a diluted basis. First quarter 2008 results have been adjusted to reflect the required retrospective application of two Financial Accounting Standards Board's Staff Positions, which were effective January 1, 2009 and resulted in the recording of additional non-cash interest expense of $2 million or $1.3 million net of tax. These required adjustments reduce previously recorded first quarter 2008 basic earnings per share by 6 cents and diluted earnings per share of 1 cent.

Turning to cash flow items, EBITDA a non-GAAP liquidity measure, an important indicator of financial health, during the first quarter was $22.6 million compared to first quarter 2008 EBITDA of $32.5 million. Free cash flow, another non-GAAP liquidity measure, is an important indicator of the Company's health, reflecting our ability to generate cash in excess of growth and maintenance capital investment, equaled $1.3 million in the first quarter of this year, after $5.4 million of capital expenditures.

We currently expect 2009 capital expenditures to be well below our earlier estimate of $30 million, as we continue to adjust our spending to the current business environment. Again, EBITDA and free cash flow should be viewed as supplemental data rather than substitutes or alternatives to the comparable GAAP measures. We've included, in our earnings release, a reconciliation of these metrics to the most comparable GAAP measure for your reference.

On the balance sheet, cash and cash equivalence totaled $220 million, at the end of the first quarter 2009, compared to $233 million, at the end of fiscal 2008. The Company has no outstanding debt.

During the first quarter, we paid dividends of $5.8 million or 17 cents per share; repurchased 314,047 shares of common stock for $8.9 million and invested $5.4 million in net capital expenditures.

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

Jim O'Leary: Thanks Peter. Well, the current economic environment remains challenging. We've taken several steps to improve our results and position ourselves for the long-term.

These actions will allow us to take maximum benefits of the eventual improvement of business conditions. Notably, we froze salaries; eliminated across-the-board increases; closed or eliminated a number of benefit programs; curtailed temporary labor and overtime and have implemented targeted staff cuts at many locations. All of these actions are positioning us for the long-term but if you remember, we saw some of this weakness earlier in the cycle than most, so we began taking these steps a little bit sooner than many. So we believe we're very well-positioned when eventually the recovery comes.

Having taken these difficult but necessary steps, our strong balance sheet; leadership position; fundamentally sound growing end markets, should allow us to emerge from the current period stronger. With unrestricted cash totaling $220 million; $295 million in available credit and no debt outstanding, at quarter-end, we're exceptionally well-positioned for the long-term.

Before I turn it over to questions, I'd like to thank each of our Kaydon employees for their efforts, thus far and prospectively, in what is most likely to be a very challenging 2009 but longer-term, a very promising future.

With that, Jennifer, we'd turn it over to you to moderate questions.

Operator: Thank you. The question-and-answer session will be conducted electronically. If you'd like to ask a question, please do so by pressing the star key followed by the digit 1 on your touch-tone telephone. If you are using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Once again, press star 1 on your touch-tone telephone to ask a question.

And we'll take our first question from Eli Lustgarten with Longbow.

Eli Lustgarten: Good morning.

Jim O'Leary: Good morning, Eli, how are you?

Eli Lustgarten: Fine. One clarification, the $1.4 million distribution from the liquidation of the investment, does that show up income statement at all?

Peter DeChants: No, it doesn't.

Eli Lustgarten: OK that's just so. I just wanted to make sure of that. Probably the most impressive thing, in the quarter, was that you know friction was down 2.5% and down 10% if you just accept the wind business, so you know the wind gains you know held that the wind gains you know probably safe at 10.

Can you talk to us about what's going on in that business? That's somewhat you know the first quarter was a very impressive you know performance but as you know we have to live in the future and without any guidance or even talk about the second quarter and beyond, can you give us some help with what's going on and how to think about that sector for the rest of the year?

Jim O'Leary: It'll be – I'll make it a Kaydon-specific end-market review because I'm not sure changing our policy of not giving guidance is a wise thing to do, when everyone else is pulling their guidance, so – the wind business you know at one point you know we had high hopes, expectations and firm (PO's) that would've said we filled up our capacity you know a year ago. And the year before last we're talking about 140 to 160, with full capacity of 180. Last year we did about 80.

We expect to exceed last year's wind energy volume but exactly by how much you know I'd say a most likely case is we exceed or marginally beat last year's volume, in that space or take market share within a key customer. And beating that or doing much better, is really predicated on the improvement of finance conditions and how that would impact what we have termed, within Kaydon, as kind of secondary customer base. And find companies – other companies that aren't one of the top two or three wind energy producers.

And it's largely because we only have the capacity to accommodate either General Electric or one or two others of the largest. And we've, obviously, chosen and ((inaudible)) to be partnered with the largest in North America, right now.

The improvement beyond that Eli is almost exclusively based on financing market conditions and when projects come back to the floor. All the things the new Administration's been doing and whether you agree with or not are the steps the EPA has recently taken, you have to be pretty confident that long-term virtually everything that's gone into or being talked about, as far as, legislature are you know longer-term, progressive steps in the wind energy market are positive.

But we still need a financial market, in the Wall Street Journal, in the A section, there's a very good article on a pretty large player, in the turbine market, about the challenges they're having, again, almost exclusively to the financing conditions, again, in getting projects going.

Our ability to exceed last year's total will almost exclusively be driven by that. The other part, we talked about a few markets outperforming last year. Most handily outperforming is wind energy but defense did better, as did medical technology.

Medical, we expect it to be up year-over-year and so, do pretty well. And again that's not because the medical markets are doing well. Its because we're positioned to take market share within existing customers you know on a go forward basis, based on known (PO's) and products that we've got shipped and expected (PO's). So, medical technology will continue to do well that drove a part of the performance in the first quarter.

And defense, also, did well. They always caution you about defense is that's based on the culmination of what has been a very, very good program for us and many others, which is (MRAP). We will continue to do well on that for the back half of the year but the comparisons get tougher because last year was much more of a ramp-up and fill the pipeline. This year, there'll be a transition to (MRAP) light, which we would expect to be on but towards you know we're a secondary producer through to the OEM.

When that comes online and how much would be this year. It's a question of timing between this year and the beginning of next year, is open to some debate. And a lot of it will depend on funding releases and the like. Longer-term, in the military business, where the Administration goes with our efforts around the globe will have a lot to do with that.

So, I don't know of defense, necessarily but my guess is defense will not be able to outperform the way it has but that'll obviously be based on timing. And then, longer-term what the

Administration does. And then everything else on how we perform, again, is going to depend on either crucial one the one that we saw a lot first, was early back in June of last year and which had the highest impact on our margins, was the book-and-ship business and the traditional Kaydon bearings.

And that's the one where if you believe and you know our visibility will probably corroborate with some of the government data suggested earlier this week and last, which is inventories have been run down too low. When that business comes back; as soon as that market demand is there, we should see the benefit of it. And the question is when does end market demand come back?

You know our sense inventories have been run pretty low and the transmission mechanism between people feeling good enough to embark on a higher level of cap ex, than the past 2 quarters, to our order book should be pretty quick based on end market demand.

Eli Lustgarten: Yes. And I guess what I'm driving at and you had an easy comparison in wind, in the first quarter, the second quarter contraction will be minimal. And you had a big quarter, so the expectation would be that that decline in the friction group will be much greater in the second quarter than we saw in the first quarter. And if that's true, can margins still hold at the current levels because – I mean, unless you're seeing something different than everybody else, we're not seeing a lot of very different business condition in April, or I can view April than you saw in the last couple months.

Jim O'Leary: Yes, I think unless you have end market demand improvements we probably have a little bit of downside, in the margins. It would not be better pick up in book-and-ship orders. So, it's had a hundred-ish or so basis points, possibly.

But when you compare us and we've spent a lot of time going through this in anticipation of this call and in part, of our business planning but when you look at how our margins have held up, thus far, compared to previous downturns, most notably, the recent in 2002, early 2001 – 2001 and 2002, our margins right now at 14.1 are about what the second worst quarter in that period was on an EBIT basis. On an EBITDA basis when you factor in the depreciation, we're still about 200 basis points above that point. And the thing that that doesn't consider, which I do think at some point will turn, it just can't be this year, is the impact to pension.

If we take pension, which is a non-cash charge but does, in fact, go into the margin comparisons you know accounts for another 50 to 100 basis points and it's largely driven by, not just the asset gap, which we can do something about. But the fact that interest rates are so low, the biggest impact to pension calculation is the liabilities.

At some point these things will turn and that'll go – that big gap will go away. But right now that does go into the margin issues and as you pointed out, we've got a big pick up – not a big pick up, we've got some bounce back in book-and-ship orders you probably have some downside to the margins for the next quarter.

Eli Lustgarten: Yes. Can you give us what the pension and depreciation impacts are for the quarter and for the year?

Peter DeChants: Three million and you could pretty much annualize that. I'm pretty sure that's the number in the press release, $3 million between pension and depreciation.

Eli Lustgarten: That's for the year?

Peter DeChants: Yes, for the quarter and you'd annualize that times four for the year.

Eli Lustgarten: So, assuming for the quarter and how was it divided? Is it divided, principally, the way sales are divided in the sectors?

Peter DeChants: Well, the pension would be a little more heavily in the friction control and sealing products. So, it's not equal among the sectors.

Jim O'Leary: The only place there's no impact would be velocity control.

Eli Lustgarten: OK. I'll let somebody else ask some questions. Thank you.

Jim O'Leary: OK, this was turning into a conversation.

Eli Lustgarten: I know that's what I figured. Shut up for a minute.

Jim O'Leary: Thank you.

Operator: And we'll take our next question from Holden Lewis with BB&T.

Holden Lewis: Good morning, thank you. In the wind business, can you talk a little bit about you know when you talk about the, you know, there's a backlog and that sort of thing coming down. You talk about things, such as, currency and you know price cost through – price pass-throughs and things like that impacting the value, can you talk about it from a unit standpoint?

Are you seeing you know actual units you know being cancelled or deferred? Do you just sort of split it between the – just the mass and actual unit behavior?

Peter DeChants: Well, we'll give you the raw dollars because we give that in the press release. We're not going to talk about units because that could be backing into pricing but of the $15 million or so of backlog adjustments, about 13 was cancellations. Of the, what we would term cancellations, more than half of that was in heavy equipment, which I would say are pure you know true unit cancellations.

And you know for those of you who covers guys in the crane or the heavy equipment business, if you're on their call and they're talking about their backlog going down and adjusting their order books that's the impact of it, which is cancellations within heavy equipment. The balance of the, what I would term (definitionally), would be cancellations, would include push outs; the deferrals, meaning, we've got things flowing outside of the 18-month window.

Some of the smaller wind energy customers have cancelled but you know there're cancellations where we're being told that orders will be replaced again. We have some legal rights that we could assert but right now, we're working with people on their own internal challenges. And you know again, within the secondary and tertiary wind energy customers, I think that's in our best interest.

And the balance, which is less than $2 million, is price adjustments, foreign currency and a hodgepodge of other things. About 80% to 90% of the $15 million is cancellations, more than half of which is heavy equipment.

Holden Lewis: OK, so you had – and on the wind side, just a few smaller players and they deferred it. But they're saying it'll come back when they can finance.

Peter DeChants: Oh yes and again, I'd take a look at that article in the Journal and you know outside of the big three or four guys, whether its because of acquisitions; their own cap ex ramp-up, there are a lot of very important players for the long-term, of this industry that we're committed to; that we think are great companies and are great customers but they need a financing market. They need a financing market for their internal health reasons and to just get business jump started, so that's one where we, the supply chain, their other partners are working with them because to fulfill the Administration's long-term initiatives here, you need more than two or three players. But again, you got to have a credit market.

Holden Lewis: Right. And then, just to make sure that my numbers are working out, sort of backing into the implied orders using your backlog and revenues, I mean, you are looking at sort of a negative three in wind, right? So that kind of represents zero new orders and about $3 million in cancellations, is that right?

Jim O'Leary: Yes, marginally negative. I think it's – it was wrong, something more than a million, yes.

Peter DeChants: Yes.

Jim O'Leary: … editorialized a little bit. A big part of the decline in orders, we've always been anticipating. I mean right now most of that backlog is stuff that we're working off of LTAs, with our principal customer that were in place. And the scenario where we could have had big positive orders, this quarter, could only have come from secondary and tertiary guys for apps orders or big orders for 5 and 6 quarters out, which I don't know why anyone in their right mind would place big orders for 5 or 6 quarters out today.

Holden Lewis: Right and so, when you talk about cancellations, you're including in cancellations anything which gets pushed out of your 18-month window?

Jim O'Leary: Yes and even for some of the guys that you know we're terming secondary or third tertiary in terms of volume for us, they have a push out that goes into cancellation.

Holden Lewis: OK. And then, now that you've brought Mexico sort of fully up online and you're producing – even though you're not producing to full capacity, where does that put your annualized you know potential capacity for wind if you were running full out now?

Peter DeChants: One sixty to 180.

Holden Lewis: One sixty to 180 is where you're at now?

Peter DeChants: Yes.

Jim O'Leary: Yes. That's the great thing about that is it hasn't changed a bit. It's just the whole world changes around it.

Holden Lewis: OK. And you really – I think there was an article on you know on one of the wind competitors where they had talked about how they've seen their backlogs beginning to sort of come back. I didn't really get it. That ((inaudible)) April comment or what-have-you but have you seen any movement, any wiggle towards the positive sort of in the activity levels that suggest that we are beginning to get our footing and the financing is stabilizing or is that still something that feels like its on the ((inaudible)) to you.

Jim O'Leary: You know I pretty much don't believe thing I hear from anybody these days. But now that said, anecdotally, I've heard some positive remarks. The reason why we wanted to have this call today, which you know I don't love doing Friday calls and it's a little bit – a week or so, probably than we usually do, is next week is the American Wind Energy Show, in Chicago.

And it's an important meeting for us to meet with customers. You know we're meeting with some other people, as well and you know the next call I'll have a lot better information. And if you're out there or you know people on the call are in Chicago and that's a great snapshot of the industry.

It’s going to be extremely well attended. And we’ll have a much better view on you know anecdotally good things that are going to turn into real good things by the end of the year.

Holden Lewis: OK. And do you feel like, as you go into Q2, you’ve got a month sort of booked in, do you feel like there’s still some of that cancellation activity taking place or has that stopped? And I guess, the question is, do you kind of feel like you’re net orders will be positive in Q2 or how do you see that trending?

Jim O’Leary: You know a first month is never representative of anything, unfortunately. I’d say – I mean there’s no major cancellation activity. Just because the world health’s so bad, especially, in the heavy equipment space and the finance issues were so bad, for the wind energy guys, a lot of the cancellations we, obviously, saw in the first half of the first quarter, I don’t know if that necessarily is the way it would play out every single quarter. Business conditions didn’t improve, so anything I’d say about the first month is probably not representative but so far, OK. They’re not as bad as last quarter.

Holden Lewis: OK. All right, thanks.

Jim O’Leary: You’re welcome.

Operator: And Steve Barger, with Keybanc Capital Markets, has our next question.

(Joe Box): Hey, good morning guys. This is actually, (Joe Box), filling for Steve.

Jim O’Leary: Hello, (Joe).

(Joe Box): Can you guys just put some color around the inventory build, in the quarter? And maybe just comment on how we should think about working capital performance over the next few quarters?

Peter DeChants: Sure. Inventory grew again, in the quarter. Turns are down below three times; working capital, in general, was the use of the cash during 2008. And we're sort of in an inflection point as the substantial part of that inventory build is supporting our large wind customer and supporting their growth as we've been – that business, still, if you look back the number of quarters is still ramping up, although, its now plateaued.

There's you know we're working on a plan, over the course of this year, to reduce inventories and have working capital be a source of cash for the year.

(Joe Box): OK and can you just talk a little bit about wind bearing capacity? Specifically, the recent slowdown in wind has probably allowed some of your competitors to bring some capacity online. And overall, how should we think about the pricing environment for the business?

Jim O'Leary: Well, there is more capacity because of the demand size. I don't think supply has changed. I don't think supply's changed a lick from the last 2 or 3 quarters when we knew you know a foreign – a foreign company that does business in the U.S. would bring on capacity. We have a very fine U.S. competitor that's bringing on capacity, I believe, in Houston around a departed company and I'm pretty sure all those things have been the same for the last 2 or 3 quarters.

The only real change has been on the demand side. Demand's dropped below ((inaudible)), where before it was tight as a drum, to now, there's some slack capacity. And in terms of pricing you know a lot of pricing was based on LTAs, a little bit to changing and renegotiating to accommodate an important relationship. But you really see the drop incrementally, is on again, secondary and tertiary guys.

Well, we do have (PO's) that had pricing in place, it would be those next couple of orders when the business starts again where I'd expect the pricing environment, then, to be a bit softer than it was you know 3 quarters ago. And then, if business returns, we, I think it will in you know a year or 2 years, you'd obviously have some price power but you're going to have a gap in-between where you just don't have the supply-demand balance in our favor that we did, a while ((inaudible)) but you know ((inaudible)) cyclical and you know right now we'll work our work through it and expect ((inaudible)) long-term potential of the industry to be back to a more favorable place in 2 years or so.

(Joe Box): Great, thanks for the color. Can you, also, just comment – I mean it looks non-wind order activity was down about 33% if you X out the cancellations and push outs. Can you just talk directionally about what might have been from inventory de-stocking in some of your customers versus what your sense would be for an actual decline in demand?

Jim O'Leary: This is entirely anecdotally, (Joe) but I'd say most of it, this quarter, is ((inaudible)) in market demand because a lot of the drop off we've seen in orders is you know a direct relation to drop off in sales ((inaudible)) specific plans. There are book-and-ship industrial users (because) I'd say most of its end market demand now.

I do still think that there's de-stocking but de-stocking, especially, as we've gotten into the last 2 quarters. Remember, we saw ((inaudible)) fees, as early as June of last year and our products, except for velocity controls, is not a real shelf – not a real SKU catalog different products. Within velocity control, especially, in Europe, I would say that is where we saw not only de-stocking and it was demand driven but heavy de-stocking, both United States and Europe, because the industrial shock absorber business is a catalog product. And while we do, do specials, I do think that was the business, in particular, because of Europe this quarter that still ((inaudible)) heaviest de-stocking, in the bearings business probably much less so.

(Joe Box): Great, thanks for the time, guys.

Jim O'Leary: You're welcome; thank you.

Operator: And we'll take our next question from Richard Marshall with Longbow Research.

Richard Marshall: Hi, good morning.

Jim O'Leary: Hello, Richard.

Richard Marshall: Hi, just wanted to switch gears a little bit. You touched briefly on what you're seeing in Europe. Could you, maybe, elaborate on that a little bit more and maybe, how we should be looking at that for the remainder of the year?

Jim O'Leary: I think Germany saw in – we have two businesses, one in Germany and one in the United Kingdom. Germany and England in terms of end market demand, I think saw very similar things, this quarter, than we had seen in the last 2 quarters of – and we, I mean, general industrials, ourselves included, particularly, in the last quarter of last year, so, they seem to be lagging.

And I know there was a kind of a prevalent view that maybe, Europe and some Asian markets would be insulated from what the U.S. saw or maybe a bit more of a safe haven. That has turned out not to be the case. Germany fell off pretty steeply.

Although ((inaudible)) play out exactly the way the U.S. did because we export to a number of Eastern Europe and Asian markets for both Germany and England. But I would say, also that both Asia and Eastern Europe have gone off ((inaudible)) as well. So, right now, I think in the first quarter of '09 you saw internationally very similar order behavior in end markets – end market declines that we saw in North America in fourth and third quarter of last year.

And right now, I see nothing that tells me that's changed you know rebounding any time quickly. And most of the things that I read on – again, the same things you read in the press, says that Europe is every bit as challenged, if not more so, than the United States fiscally, coupled with the challenges of how do you balance different policies, in different countries, around the E.U., so …

Richard Marshall: Got you; all right, thanks for color on that. Did you guys – maybe I missed it, do you guys quantify the currency impact for the quarter, for the top line and I guess, on profitability, as well?

Jim O'Leary: No, we didn't – go ahead.

Male: We didn't. The currency impact …

Ken Crawford: The currency impact on the top line, in the quarter, would've been about $5 million, it's a little bit late. It's a little short of $5 million. And on the EBIT line about 3/4-of-a-million.

Richard Marshall: Got you. All right and just …

Peter DeChants: And the problem is that a year ago, first quarter '08 versus '07, those obviously are positive comparisons, so …

Richard Marshall: OK and just one last thing, can you, maybe, talk a little bit about the raw material environment and what you're seeing there?

Jim O'Leary: You know we're starting to see some relief coming through. We're – unfortunately, in our case and this is, fortunately, on the upside and unfortunately, on the downside if you're expecting big improvements, where we talked before about raw material adjustments and the impact on backlog. As purchase price adjustments that we pass through, when prices are rising to customers, apply to the long-term contracts and give (back) when prices decline.

And you know most raw material-sensitive products, which is the wind energy bearings where you've got you know a couple thousand pound bushing that we're buying in a way pre-machine basis, we are seeing declines there. But much of that gets given back.

And as far as the leverage and the impact on cost of sales, only products where we have a raw material component that is you know well in excess of former company average, which is about 30% of cost of sales being raw material that's a wind energy product. So, even if prices come down, see some benefit but the – it won't be as large as you might think, partially, because of the long-term contracts.

They're protected on the way up but they minimize the benefit on the way down, as well.

Richard Marshall: Got you. That's all I got, thanks very much.

Jim O'Leary: Thank you.

Operator: And Peter Lisnic with Robert W Baird has our next question.

Peter Lisnic: Good morning everyone.

Jim O'Leary: Hi, Pete.

Peter Lisnic: Hey, Jim, can you talk a little bit – I think I heard the mention of getting some market share in the wind energy business and I'm just wondering if you'd give us a little bit of color on that and how that's occurring? And what the prospects for that going forward are?

Jim O'Leary: Well, when you take market share you know there's a – there are, at least – there's one European here who is formerly the largest in North America, which I think we've – we have gained that position with our expansion. There's another domestic producer, which you know has been talking about and is opening capacity now.

And then there's a lot of non-traditional producers, formerly guys like (Avon) that are still out there. We expect market share to still be gravitating ourselves and other two guys ((inaudible)) recent capacity expansion ((inaudible)) European.

Other market share is, obviously serviced by people like (SKF) and (FAG), in Europe. I'd expect market share to continue to go towards guys like them and ourselves. In terms of our ability to pick up market share because a lot of our capacity's already committed to you know to our principal customer you know once the demand is there – once that market demand is there you know beyond filling up the existing capacity, which takes us you know to full basis, at base pricing to about 160 to 180. A year ago that was 180 to 200.

You know we can't pick up a lot of market share until we open a new facility, which we'd expect you know based on long-term forecasts and the things the Administration is saying and doing, it'd be something that's going to be viable. I hope to think it's in a year or two. It'll probably be a bit later than that.

But it'd be an opportunity to pick up market share from others, particularly, in North America. But it's going to be predicated on capacity expansion, if you believe the long-term demand side of the equation, which we do.

Peter Lisnic: OK. All right and that'll actually lead into my next question. But before I get to that one, just in terms of the – in terms of the balance sheet and what you're thinking about. You've got this longer-term, secular growth outlook for wind, where you are in terms of the deploying the balance sheet relative to acquisitions versus organic opportunities like wind. And how are you considering that now given the environment?

Jim O'Leary: Nine months ago, I'd a said you know a year to two, I'd hoped to be considering expansions. It's probably 2 years or so. Remember it was only 9 months ago we were talking about opening new capacity for customers who were ready to sign up and commit to long-term contracts, what we would need to support hard capital.

And that went away in the space of 6 months because the world changed so dramatically. So, right now, organic capital and the need to increase our cap ex, I think, Peter said we're less than 30. Our internal forecast would probably say its 25.

And business conditions like it is now, there's no way we're going to spend $25 million of capital ((inaudible)). But we're going to have more free cash flow than we did last year you know on a like-to-like basis just because the cap ex goes down by so much.

We would expect to take money out of working capital. You know that's the one that I would say is a bit more challenging but our target needs to be much lower than where we are now. And the only caveat there is some of that working capital is tied up with guys that you know we're working with, not the major customer that we know we're going to be shipping to but the guys that are getting push outs and obviously, have more challenging financial market conditions than somebody like a General Electric. But we still expect to harvest some cash out of there.

And without a big – another big wind energy expansion, acquisitions and to a lesser extent, share repurchases, are where we're spending most of our time and efforts. And on the acquisition side you know I think reality is setting in, in terms of the seasoning of pricing, as a cash buyer for many of the properties we would look at, cash buyer, meaning cash on hand plus available liquidity, I would say we're preferentially positioned.

One of the problems is I can't remember a time, in my career, when there have been so few auctions; so few properties, on the market. And you know even – we're not looking at other public companies, exactly this moment but you and other public companies, it's the seasoning of 52-week highs, I still think has a couple quarters to go. So, even though we're in a great shape that's where we're spending a lot of our time.

The time is being spent laying down seeds; talking to people. You know the old saying of you've got to kiss a lot of frogs to find a prince. We're kissing a lot of frogs now but there's not a lot of actionable properties in the market because sellers just don't want to go out there.

There was a little bit of a flurry, at the end of last year, which I think we've talked about before because people were worried about capital gains. People wanted to get properties done before you know with the belief that pricing could come back. That didn't happen and you know right now, I think, sellers are sitting on the sidelines waiting to see what happens.

Peter Lisnic: OK. That is very good. Thank you for your help.

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

Operator: And as a reminder, that is star 1 to ask a question. And we'll take our next question from Mike Hamilton with RBC.

Mike Hamilton: Good morning everyone.

Jim O'Leary: Hello, Mike.

Mike Hamilton: Just a follow-up on some of the raw material questions. Intuitively, it seems to me that in the pass through world, contractually that your best relative gains, probably, occurred in this last quarter in terms of pricing coming down. Am I right in timing or are we still looking more second quarter phenomena?

Peter DeChants: I think the effect won't be quite as pronounced in any one quarter. Because of different arrangements with different customers it'll be a bit more smooth than I think you're assuming it might be.

Mike Hamilton: OK. What – can you give a picture of kind of what the blended average is on timing? Is it a 90-day pass; 60-day pass?

Peter DeChants: It varies and there's a little bit of negotiation that goes into it. And no doubt, given the terms of our contracts, we probably won't give that to you.

Mike Hamilton: Fair enough, thank you.

Peter DeChants: You're welcome.

Operator: And we have a follow-up question from Holden Lewis with BB&C.

Holden Lewis: Thank you. I guess I'm still trying to understand the increase in inventory, primarily, from the standpoint that – I mean your wind revenues, if that's where some of these increases are coming from, your wind revenues over the last 4 quarters are, largely, flat kind of in that you know call it low 20 area. And yet, over that same 4-quarter period, the inventories have gone from 86 to 115, which I mean, does that suggest that you know the wind revenues are about to pop back up again? I guess I'm just having a hard time really understanding why those continue to scale-up when the revenue area has been flat for the past 4 quarters.

Peter DeChants: Especially in the wind business, it is based on some improvements with a possible ramp with existing customer. But some of it is based on you know we have customer inventory that we're working through and there's been a back up in the supply chain. So, some of it is just stuff that hasn't turned as quickly as we expected.

Some of it is in anticipation of a ramp-up for ((inaudible)) few quarters. Not much more than last year but that's a conservative forecast we believe.

Holden Lewis: And does the fact that you know you'd probably like to work that down a little bit and again, it does tend to be more in wind, does that suggest that over the next quarter or two, you might cut your production of wind products to sort of bring that inventory down? And does that have any margin implication in the near-term?

Peter DeChants: We have already cut production. And we've you know we have a – we've got a rolling layoff because at one point, remember, we were talking about a 160 to a 180 ramp-up in the new facility and we just said it's a (flat-ish) year, as kind of the base case. And we would bring people back as the opportunity to do better than that is.

And I think at the top of the call, we said that you know there is some downside in the margins. We expect them to a bit softer than this quarter but when you look at EBITDA margins, it's really not inconsistent with our historical performance. In fact, EBITDA margins are still a fair bit better than the trough in the prior cycle.

Holden Lewis: Sure, OK. But the feeling is – so when you look at the gross margin in Q1, at (324), the feeling is that was you know that probably had higher production in it, on the wind side than you anticipate having in Q2 or maybe Q3?

Peter DeChants: No, I think it'll probably be stable.

Holden Lewis: OK. So, you feel production in Q1 had already adjusted from Q4 levels?

Peter DeChants: Yes.

Holden Lewis: OK. All right, thanks.

Jim O'Leary: ((inaudible)).

Operator: And we have a question from Mike Hamilton with RBC.

Mike Hamilton: Yes, thanks. Just a follow-up, on the last few quarters you've given a picture of how you thought the backlog was going to flow, is there anything changing in terms of timing on the basis of what's in there now?

Peter DeChants: Well, we talked about the change in the orders related to cancellations and push outs and that's going to have some little – couple basis – or a couple of percentage points effect on what we talked about before but other than that its not material. Its, perhaps, maybe a little less than the first quarter but over the next three its still pretty close to what we said.

Mike Hamilton: Yes. Thanks for the insight.

Jim O'Leary: Is that it, Mike?

Mike Hamilton: That's it for me, yes, thanks.

Jim O'Leary: OK, thank you.

Operator: And once again that is star 1 to ask a question. And there are no further questions at this time. I'd like to turn the conference back over to our speakers for any additional or closing remarks.

Jim O'Leary: Operator, thank you and everyone who joined us for the last hour, I appreciate your time and attention. We are always available to talk with you. Obviously, we recognize this is a challenging time but we think with our balance sheet strength; with what is a great collection of healthy, long-term bolt-in markets, particularly, wind which despite incredibly hateful news environment, if you look at the things that are being done and the actions being taken by the new Administration on sustainable, long-term renewable energy policy, I feel pretty good about where we are. I feel better about the next 2 or 3 years and you can't about the next 2 or 3 quarters but for a long-term – for the long-term proposition, we feel very happy where are and like to thank you for your time and with that operator, we're done.

Operator: That does conclude today's presentation. We appreciate your participation.

Jim O'Leary: And thank you.

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