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MOD - Q2 2018 Modine Manufacturing Co Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Modine Manufacturing Company's Second Quarter Fiscal 2018 Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session, and information will follow at that time. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Ms. Kathy Powers, Vice President, Treasurer, Investor Relations and Tax.

Kathleen T. Powers - *Modine Manufacturing Company - VP of IR & Tax and Treasurer*

Thank you. Thank you for joining us today for Modine Second Quarter Fiscal 2018 Earnings Call. With me today are Modine's President and CEO, Tom Burke; and Mick Lucareli, our Vice President of Finance and Chief Financial Officer. We will be using slides with today's presentation. Those links are available through both the webcast link as well as the PDF file posted on the Investor Relations section of our company website, modine.com.

Also should you need to exit the call prior to its conclusion, a replay will be available through our website beginning approximately two hours after the call concludes. On Slide 2 is an outline for today's call, Tom and Mick will provide comments on our fourth quarter and full year results, and provide our revenue and earnings guidance for fiscal '18. At the end of the call, there will be a question-and-answer session.

On Slide 3 is our notice regarding forward-looking statements. I want to remind you that this call may contain forward-looking statements as outlined in our earnings release as well as in our company's filings with the Securities and Exchange Commission.

With that, it's my pleasure to turn the call over to Tom Burke.

Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

Thank you, Kathy and good morning everyone. On today's call, I will discuss our second quarter results including an update on our business segments and strategic initiatives. After that, Mick will provide a more detailed review of our consolidated financial results and will update our revenue and earnings guidance for fiscal 2018. I will then provide a few closing remarks prior to opening up the call for questions.

I'm pleased to report another strong quarter with significant sales and earnings improvements driven by growth across all of our business segments including a significant contribution from the CIS segment that we acquired last year. In addition to significant sales growth, each business segment observed gross margin expansion in the second quarter led by higher volumes and operating performance.

Overall, sales increased 60% including $149 million of sales from our CIS business in the quarter. Our non-CIS business grew 11% on a constant currency basis with increases reported in each of our segments. This growth was fueled by improvements in many of our key end markets along

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with continued launch activity for automotive programs in the Americas and Asia segments. Our adjusted operating income was $26.8 million, up $22.4 million from the prior year. Each segment reported year over year improvements in earnings, and the CIS business contributed $8.1 million of operating income during the quarter.

Our adjusted earnings per share were $0.36 for the quarter, a $0.37 improvement from the prior year primarily due to higher operating earnings partially offset by higher interest expense from the debt taken on to finance the Luvata acquisition.

Now I would like to briefly review the segment results for the second quarter. Turning to Page 6, sales for the Americas segment increased 12% on a constant currency basis to $141.9 million driven by end market improvements in both North America and Brazil. In North America we saw sales increases across all end markets with substantial increases in off-highway and specialty vehicle sales.

We are also benefiting from ramp-up volumes on new automotive programs. In Brazil, we are seeing continued improvements in our markets with the recovery in our after-market business and higher commercial vehicle sales.

Gross margin improved 260 basis point to 15.2%. This is driven by the higher sales volumes and improved performance partially offset by the impact of higher material costs. Adjusted operating income for the Americas segment was $8.6 million, an increase of $6.5 million from the prior year driven by the higher sales volume and lower SG&A expense. We continue to be very encouraged by the improving markets in North America and Brazil.

In addition, I am particularly pleased with our strong sales conversion this quarter as higher volume and production efficiency improvements led to a considerable gross margin expansion. However, as I mentioned last quarter the global commercial vehicle power train cooling business has become increasingly competitive. And in some cases the investment required to launch these programs did not meet our return on capital expectations.

Our capital allocation discipline, which has been further honed by our Strengthen, Diversify, and Grow Strategic Initiatives is driving our focus for improved returns in our new business pursuits. As a result, we do expect to see some lower volumes in our North America commercial vehicle business during the second half of the fiscal year as certain power train cooling and service programs begin to wind down.

With our new diversified business structure, we will continue to be selective with our choices supporting programs and markets to provide an acceptable return on the use of our capital. This improved discipline in our capital allocation strategy is aimed directly at yielding the highest possible return for our shareholders.

Please turn to Page 7, sales for our Europe segment increased to 3% on a constant currency basis to $134.5 million. Primarily driven by higher sales to automotive and off-highway customers. This was partially offset by lower sales to commercial vehicle customers as certain programs continue to wind down as we've announced in prior calls.

Gross margin increased 130 basis point to 14.5%. The increase in margin is due to improved plant performance, procurement savings, and a higher sales volume. Higher gross profit led to a $3.1 million increase in adjusted operating income which was $8.9 million in the quarter. Additionally, the construction of our new production facility in Hungary is nearly complete.

We've begun equipment installation and will commence process validation and production next month. The additional capacity in Hungary is an important step in our growth strategy and will further enhance our already competitive global footprint. We continue to see a great deal of quote activity for electric vehicle programs in Europe with a significant number of RFQs in process with several European manufacturers.

Please turn to Page 8. Our Asia segment continued to lead our vehicular segments in both sales growth and gross margin. Overall, Asia sales grew 60% compared to the prior year. This significant improvement was driven by stronger sales to off-highway customers in China, India, and Korea along with higher automotive and commercial vehicle sales in China and India.

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Higher sales volume led to a 400 basis point improvement in gross margin which at 18.9% leads our vehicular segments. This resulted in a doubling of our gross profit from $3.7 million last year to $7.4 million this year.

Operating income for the Asia segment increased $3.4 million to $4.2 million due to the higher sales volume. As I mentioned in the past, our strong growth in Asia over the past year has challenged our capacity in the region. This has been a direct result of the growth of our automotive oil cooler business which has seen growing market share as well as recovery of excavator market sales across Asia. We will need additional capacity in China to meet the demands of our current order book and the needs of our incremental business and growth strategies. We are planning a fourth manufacturing facility to support our vehicular segment in China. This is a great example of how we are strategically allocating our capital to where we expect to deliver the highest return for our shareholders.

Turning to Page 9, the CIS segment reported $149.2 million in sales. Gross profit was $22.5 million which resulted in a gross margin of 15.1%. The segment reporting operating income of $8.1 million. As a reminder, this includes $3.2 million in depreciation and amortization expense recorded as a result of purchase accounting split equally between cost of sales and SG&A.

We are confident that our synergy savings will offset these costs and bring this segment back to its historical operating margins. The markets we serve in our CIS segment are generally stable with positive growth projected for the rest of the fiscal year. There are some opportunities for additional growth in the precision cooling market as demand for new data center capacity in the U.S. continues to grow with one of our major customers. In addition, the recent major weather events in the south have increased demand for mobile air conditioning and dehumidification which could drive additional demand for our products.

In China, the transformer oil cooler growth market remains robust driven by increased infrastructure investment. In addition, we are well on our way to achieving our synergy goals ahead of our initial timeline. Our current focus is on our global manufacturing footprint where we are evaluating expansion from our current low-cost country presence.

Please turn to Page 10. Sales for our building HVAC segment increased 7% compared with the prior year. With improvements in heating and ventilation partially offset by lower air conditioning sales. We continue to see strong sales of school products which nearly doubled from the prior year.

Gross profit increased 26% and gross margin improved by 470 basis points to 30.5%. This along with a slight decrease in SG&A resulted in adjusted operating income of $6.3 million, more than double that of the prior year. This improvement is largely due to improved pricing and better performance in the U.K. As you may recall, our U.K. business struggled last year with sales mix issues and operational inefficiencies. We took several actions to correct these issues, and are now seeing positive results. This is the second consecutive quarter where operating earnings have more than doubled resulting from the cost saving and operational improvements made last year.

In addition, our order book remains strong. We have seen good demand for our ventilation products in North America and are encouraged to see pre-season stocking orders for the heating products up over the prior year. In the U.K., we are seeing solid demand for precision air conditioning and air handlers. And expect growth in these markets in the second half of this year.

Please turn to Page 11, it has been two years since we first announced our Strengthen, Diversify, and Grow strategy along with our initial objectives, and I am very pleased with the results. Modine is now a more diversified business that has seen significant topline growth along with improved earnings and cash flow. Although the initial goals of that program have largely been met, our strategic focus has not changed. We are continuing to look for ways to strengthen, diversify, and grow now and in the future.

As I've shared in the past, our main operational focus of this year is to resolve the remaining operational inefficiencies in North America and the U.K., complete the integration of the CIS business, meet or exceed our synergy targets and to generate cash to repay the acquisition debt. I am pleased to report that we are well on our way to achieving all of these goals.

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In addition to these operational goals, we have also set some strategic goals for ourselves to make sure that we are thinking ahead to determine how we can best continue to provide profitable growth. This review is focused on creating a disciplined framework to analyze our business portfolio and to better understand how to prioritize our capital resources in order to continue to create value for our shareholders.

Some examples of this strategy include the investments in additional capacity in China and our focus on electric vehicles. We know that our customers are making electric vehicles a development priority. We understand these vehicles have different thermal management needs than internal combustion engines. Some of these needs can be met with products that are very similar to those we've already produced particularly with our plate type or engine-based products.

In addition, there is also the opportunity for us to add adjacencies to our product offering such as battery plate cooling. This would be a new product platform for Modine, and we're going to take a balanced prudent approach to our investments around this technology as the market continues to develop.

We consider this our next phase of our Strengthen, Diversify, and Grow Strategic Initiative which will guide our actions over the coming years. This is a great opportunity for Modine as our stronger profitability and market diversification makes us truly a diversified industrial company.

With that, I'd like to turn it over to Mick for an overview of our consolidated financial results. Mick will also update our revenue and earnings guidance for fiscal 2018.

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Thanks, Tom. Good morning everyone. Please turn to Slide 13. We are extremely pleased with the results this quarter with year over year sales and earnings improvement in each segment. In particular, we benefited from favorable volumes on the vehicular side and strong margin improvement in building HVAC.

Beginning with the top line, sales increased $183 million or 58% on a constant currency basis. Sales in our new CIS segment totaled $149 million. Excluding CIS, constant currency sales were up $34 million or 11% year over year. Gross profit of $86.1 million was up $38 million or nearly 80%. This includes $22.5 million from CIS. Excluding CIS, gross profit was up $15.6 million or 32%.

As Tom mentioned, this improvement was driven by all of our segments from higher sales volume and operational improvements. SG&A of $62.2 million was up $14 million, the year over year increase is primarily due to the addition of CIS.

Please note that at the bottom of the page we've included a table with adjustments to operating income. In total, adjustments were $3.3 million for the quarter. We added back $2.2 million of acquisition-related items. The remaining $1.1 million is for restructuring and environmental expenses relating to plant closures.

Second quarter adjusted operating income of $26.8 million was up $22.4 million. And our adjusted earnings per share was $0.36, an improvement of $0.37 compared to last year. As discussed last quarter, EPS was positively impacted by the tax benefit from the development credit in Hungary.

As a reminder, our U.S. GAAP income statement is included in the appendix of this presentation and in our earnings release. In addition, we provide a full reconciliation between our reported results and our adjusted operating results.

So let's turn to Slide 14. Year to date operating cash flow was $71.1 million, which is $57.5 million higher than the prior year. The year over year increase was due to the combination of several items including favorable changes in working capital, the inclusion of CIS this year, and higher earnings in all our segments.

Capital expenditures were above the prior year by $4.8 million and we expect CapEx for the full year to be $65 million to $70 million. This is slightly higher than the last year, and primarily due to foreign exchange rate changes and capital spending in our new CIS segment.

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We reported year to date free cash flow of $34.3 million, which was better than the prior year by $52.7 million. Please note that this does include $15.5 million of cash payments for restructuring activities, legal and environmental charges, along with acquisition and integration costs.

For the second quarter, free cash flow was $37.2 million, an increase of $42.7 million over the prior year. And this includes $3.6 million of cash payments for the areas I just described.

Finally, our debt leverage ratio is currently 2.6. Down from 2.9 at the end of fiscal 2017. This is well below our current covenant ratio requirement of 3.75.

With the addition of CIS and the strong first half performance, we continue to anticipate much improved cash flow in fiscal 2018. We remain focused on paying down our debt and getting our leverage ratio below 2.5 by the end of this fiscal year.

Now let's turn to fiscal 2018 guidance on Slide 15. We are happy with our second quarter results, and excited to report we are raising our fiscal 2018 sales and earnings guidance. To summarize, we project sales to be up 32% to 36% from the prior year. An increase from the previous range of 25% to 30%. We expect our topline will continue to benefit from automotive growth in Asia and improvements in the global off-highway markets.

We also anticipate more favorable exchange rates than last quarter, as the euro and British pound is strengthened against the U.S. dollar. We expect adjusted operating income to be in the range of $107 million to $117 million, an increase from the previous guidance of $100 million to $110 million. We currently expect an increase of 48% to 62% compared to the prior year.

We anticipate adjusted EBITDA to be in the range of $182 million to $192 million, up from $175 million to $185 million. Our current expectation equates to an increase of more than 46% over the prior year.

As usual I want to briefly review some of our key assumptions. First our guidance includes planned wind downs of certain commercial vehicle programs in Europe and North America. As a result, forecasted sales may not fully align with the overall commercial vehicle market growth.

Next, we anticipate that copper and aluminum will hold at current levels, which are about 20% and 25% higher than last year. With the additional increases over the last few months, we are watching and managing this area closely. Third, we expect the U.S. dollar will hold at current levels versus most major currencies. Lastly, we assume annual interest expense of approximately $26 million.

Moving on, we expect our adjusted EPS to be between $1.30 and $1.45 which is up from $1.20 to $1.35. And up significantly from $0.78 in fiscal 2017. This includes the impact of the Hungarian Development Tax Credit, and a resulting adjusted tax rate of approximately 12% to 14% in fiscal 2018.

Finally, I would like to cover several important factors with regards to our increase in guidance and the second half run rate. First, a significant portion of our additional revenue relates to currency translation and materials pricing adjustments which have minimal conversion. The volume portion of our revenue increase does include normal profit conversion, and we have increased our outlook accordingly.

Offsetting a portion of the volume is the additional increase in metals up approximately 15% since last quarter, and a significant mix effect relating to the loss of some commercial vehicles service business. In addition, given the strengthening of our business, we expect some limited SG&A increases. Consistent with last quarter's comments, we expect the next two quarters to proceed at a similar run rate to our second quarter. And lastly, our year over year comparables will become more normalized in the fourth quarter as CIS results will be included in both years.

So just to summarize, we have adjusted for the positive impact of exchange rates and volume in certain markets. While also factoring the additional metals increase and reduction of commercial vehicle service business. Our employees have made excellent progress during the first six months while taking advantage of some market tailwinds. And we're excited about the opportunities ahead and look forward to further improvements in our business.

Tom?

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Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

Thanks, Mick. As Mick outlined, our performance this year is clearly exceeding our initial expectations. This is in large part due to improving markets, but is equally the result of the actions taken in the past to ensure our future success. As we near the one year anniversary of the Luvata acquisition I would like to look back on some of the actions we have taken that positively impacted our quarter and fiscal year so far.

Clearly, the addition of the CIS business has been an incredible success with significant accretion to our bottom line. In our vehicular business the investments made in China have led to tremendous growth. So much so, that we're running out of capacity and eyeing opportunities for expansion.

In our building HVAC segment, I am pleased that we have returned to growth and are seeing margins that are closer to historical levels. This is a direct result of the actions taken to improve this business, particularly in the U.K.

Over the past few years, Mick and I have often discussed the earnings potential of this business if only we'd see some improvements across our markets. We are now seeing the strength of that potential in our results while positioning ourselves as a more diversified industrial company. This is truly an exciting time to be a shareholder of Modine. And I'm thankful for your ongoing support and excited for our future.

And with that, we'll take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mike Shlisky from Seaport Global. Mike, your line is now open.

Michael Shlisky - *JP Morgan Chase & Co, Research Division - Analyst*

Want to start off with questions about Asia. An interesting quarter here. It looks like that's really gone from kind of last place to first place over the last 12 to 18 months. I guess I'm kind of curious about the potential for expansion or capacity in Asia and the new business that could be on the way for you guys.

I guess I'm curious to see kind of what's your benchmark operating margin rate for that business or gross margin rate? Are you looking at trying to keep the EBIT at double digits here going forward? And what's the timeframe for any kind of CapEx or spending that you might have to take in Asia over the next couple of years here?

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Yes, Mike it's Mick. I'll go first and then Tom can add his comments. But yes we're very, very pleased with both the gross profit margin and operating margin in Asia. I think as we go forward what we're modeling and we would hold ourselves to is holding at similar margins somewhere between gross between the 18% and 20% gross margin range. And we'd be quite happy with a 10% operating margin.

And with regards to capital spending and CapEx, the majority of that will just continue to be on equipment and tooling to support the new business. The expansion that Tom referenced is really we're looking to be within an existing campus and looking at more leasing of square footage than a major greenfield plant expansion.

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Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

Mike, I just came back from China. I was there last week, and visited each of our VTS businesses and one of our new CIS businesses. And I can tell you I'm very excited with what's happening there. The team has matured extremely well. This has been well groomed over the years to get to this position of getting the right not only products there but talent in place, leadership in place, and it's clicking on all cylinders right now. With the expansion for growth both with multinationals, the multinationals, and domestic OEs looking very strong.

And on the CIS business, which is kind of new to us as far as China, I'm very pleased with what we have down there as far as really supporting infrastructure gains that are focused on China specifically and elsewhere. So I expect the Asia segment in both the VTS and the CIS business to be very big contributors going forward.

Michael Shlisky - *JP Morgan Chase & Co, Research Division - Analyst*

I wanted to turn quickly to building HVAC as well. Again, also a very strong margin growth there obviously year over year. And I'm kind of curious can you keep the double digit range going over the next couple of quarters here? Or can you give us some sense with all the cost reductions and changes in strategy, changes in facility kind of is there a different seasonality now than you've had in the past? And kind of your near to midterm outlook there as well. Thanks.

Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

Well first off, it starts with the leadership changes we made in the U.K. Specifically really getting to understand that the market connection as far as channels in the market and getting the order book set up the right way which is strong. Inside the business they made all the right decisions on streamlining as necessary to get the cost in line and that's starting to pay off as well.

Looking forward to growth, they're all great segments that we're participating in whether it's precision, ventilation, heating, air conditioning, and the added ventilation product line that we're adding to North America with the Atherion product line. We're launching the new D-cabinet as we speak this month which will really kind of broaden that out. So I see again the opportunity for growth in this segment and making sure that this segment gets its fair share of capital to take advantage of that in the market. Something I'm really excited about as well.

Michael Shlisky - *JP Morgan Chase & Co, Research Division - Analyst*

Great. And finally, I wanted to turn to the Americas segment and your changes you've made in your portfolio business and I guess at the truck market. It looks like you walked away from some business and that's in line with what you've been talking about for a couple of years now. It just doesn't meet. Your goal is just to kind of walk away here.

I'm curious about two things. One, did somebody else win this business that is quite a bit smaller than you that just wanted to kind of get the bookings? And do you stand ready to kind of step in if they can't deliver? And then kind of secondly, is this one of the first of what could be several different program wind downs? But there are other market share gains as other new platforms kind of ramp up in 2018, 2019?

Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

Well, first let me say we are not walking away from the commercial vehicle business, okay? One element of that business being the power train cooling segment is in the heavy duty section or market, sub segment is kind of the challenging moment. And I just want to say the VTS growth opportunities across all of our products and markets I'm very pleased with. This happens to be the one challenging element in the heavy-duty PTC area. I'll remind you that it's about 7% of our total sales, and if I take the engine product out of that that's about half of that, okay? And again we have about a 30% global market share on the engine product inside of the commercial vehicle program. So again commercial vehicle very important to Modine.

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Specifically on PTC, with diversification and growth plans that we laid with the acquisition of CIS and with the focus we've had on VTS and building HVAC we have lots of options as far as making sure we invest our capital in a disciplined manner to return rates that meet our expectations. And that's kind of the key point. We aren't going to chase market share for the sake of market share. Let me just be clear about that. We're going to make sure that business, that investment is growing to accrete our business according to our expectations. So again, we're not walking away from commercial vehicles we are reprioritizing our portfolio inside of that specifically heavy-duty PTC.

As far as new entrance or whatever, I don't really have a comment on that. I think that clearly there's competitors we know well that are focused on that area, and quite frankly we made decisions on where we're going to stop at our quoting thresholds and we're going to hold that discipline for the benefit of our shareholders.

Operator

Your next question comes from the line of Matthew Paige from Gabelli. Matthew, your line is now open.

Matthew T. Paige - *G. Research, LLC - Research Analyst*

We had spoken in the past about your view on leverage and you mentioned it today. I guess just given the strong stock performance of late, I just wanted to ask for your thoughts on alternative sources to finance what you had perceived to be a lack of margin of safety in your finances.

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Yes, could you repeat the first part of your question you said V1?

Matthew T. Paige - *G. Research, LLC - Research Analyst*

No, I just thought given where we had been in the stock price and the strong movement lately I was just curious what your thoughts were on financing options.

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

It's Mick. So we are quite pleased to see the stock moving up and reflecting, as Tom said, all the hard work we did. We've been so focused on since the Luvata acquisition about driving cash flow and ensuring we get our leverage ratio back to that 2.5 times range. So the strong cash flow this quarter, the strong results in the raise in the guidance and the current ratio is sitting about 2.6. We feel really good about our capital structure.

I think especially on the debt side, we've got favorable borrowing rates and we feel really good about the leverage ratio and cash flow. With regards to any type of equity raise, Tom and I've talked a lot about that. I think that would have to be tied to something very specific and a very large project before we would think about any type of equity raise.

Operator

(Operator Instructions) Our next question comes from the line of David Leiker from Baird. David, your line is no open.

Joe Vruwink

Hi, good morning this is Joe Vruwink for David. One, just can you maybe size the magnitude of the program exits in North America in the second half? And then if you could, maybe the profit implication?

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Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

So, Joe, it's Mick. I'll kind of ballpark the volume sides. But we'll prefer not to comment. I'll give you some color potentially on margins. So we've said through the year on European just to be clear on that we've been talking about somewhere between 25 million and 30 million euros of that commercial vehicle related there to the Origami radiator business.

And the North America side we're looking at approximately $10 million this year. That's a combination of heavy duty OE business and service. And there's a mix in there. As Tom mentioned, on the OE production business clearly more challenge from a returns standpoint. Service business historically has always been across the market, across the distribution channel a relatively higher margin less capital intensive profile.

Joe Vruwink

Okay, and it sounds like $10 million beginning in the second half. So presumably focusing on North America for now, so probably first half of next fiscal year you probably grandfather that?

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Yes, it's still a little bit early. But looking into next year, it's probably a similar level for fiscal 2019.

Joe Vruwink

Okay, on the materials side, what is the headwind now contemplated in guidance? And can you maybe just update us on where that number stood in June when you first issued guidance for the fiscal year?

Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Yes, when we talked earlier in the year and last quarter we were estimating $15 million to $20 million of material cost increases. I think that range still holds, but we've moved from that low end to the high end. Incrementally, Joe, I think from last quarter to this quarter we're looking at least a $3 million to $4 million, I would say, of increased metals. And that's really due to the timing with the spike in the last quarter. Again we'll catch it up, but we'll start to catch that next fiscal year or late in our Q4.

Joe Vruwink

So where I'm going with this, I think at the midpoint revenue guidance moved up round numbers about $100 million at the midpoint. EBIT moved up I think about $7 million. Maybe I can add back material headwinds, it sounds like maybe that's $5 million. There's obviously some volume implications to consider.

But when Modine thinks about quote unquote normal contribution margins for the organic piece of the business, is that more like 15% to 20% number at this point at the EBIT line? And as you think into next year given you have some plan actions in place, SGG continues to contribute savings. Is 15% to 20% kind of the new status quo going forward? Or could you actually operate above that when thinking about Luvata synergies and things like that?

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Michael B. Lucareli - *Modine Manufacturing Company - VP of Finance, CFO & CAO*

Yes, a great question, Joe. A lot of questions in there. When we target volume conversions we still stand behind a 25% gross margin conversion is what we expect to see all else equal. One of the challenges we see -- and again if you just do the midpoint clearly we try to give you guys ranges at any one point. All numbers don't line up right down the midpoint, but I get your question.

If you take the increase in revenue and the operating income of $7 million at the midpoint, at least 40% or so of that revenue increase is as you mentioned FX and metals that isn't volume. So we're not going to convert on that. But even taking a 25% conversion then on a smaller number, we would expect and we did see the gross profit come through.

The offsets to that are the metals and the service business on the commercial vehicle side which both of those were second half impacts to us. So that took a significant negative impact on the volume. Then your second question or your bigger question is is there a different conversion rate running for Modine going forward? And I would say no. On volume we still see 25% plus conversions, and you've seen a lot of quarters like that. This quarter or this half we have some of those headwinds, and we've had quarters where our conversion is 60%. The positive as we look to next year is we will start to recoup the metals increases.

And you also mentioned synergies. So not to get too far out in front of us, but we're not setting a new low conversion rate for Modine. There's some unique factors here on the second half, but more importantly as we start those become recoveries or tail winds and synergies. You can see a conversion rate that looks by the time you get to EBIT more favorable. Hopefully I'm making sense to you Joe. I'll just pause.

Joe Vruwink

Yes, that's exactly what I was looking for. That's great detail. I wanted to finish up on just recalibrating around Luvata. One more quarter in, so maybe just an update on how the business continues to operate relative to your expectations. And I want to be sure I'm thinking about the business correctly and into the December quarter obviously we got a one month look at a year ago of what Luvata can do in the month of December and it's seasonally weak. And so with the expectation into the December quarter this year probably a sequential step down in EBIT margin just given seasonality. And then Q4 kind of jumps back up and potentially the strongest margin quarter of the year?

Thomas A. Burke - *Modine Manufacturing Company - President, CEO & Director*

You answered your question very well, Joe. No, that's exactly right. First off, I'm very pleased with the performance of CIS obviously on how they're contributing and more importantly really excited about the synergy opportunities that are developing. U.S. last quarter about how we've seen the synergies between CIS and building HVAC and those are coming together well through procurement, through some other make versus buy things that we're looking at. And so again, very positive with that outlook. So a great performing business, brings the diversification we wanted and obviously cash flow.

But fiscal Q3 is its weak quarter, going into December. Obviously there's short order lead time. It falls into the holiday period so things kind of shut down, if you will, for a couple weeks in there so we'll see that. But it comes back strong in the fourth quarter next year which we anticipate.

I did mention that we see the precision air condition business that they have a very significant position in specifically with one customer that we see that outlook brightening. We think that can have some additional impact potentially in Q4 this fiscal year and going forward. So again they really bring exactly what we want into the company and very pleased with what they're contributing. And again, some major steps we're considering forward on synergy when we add to that. So that's my quick summary on that.

Operator

I am showing no further questions at this time. I would now like to turn the conference back to Kathy Powers.

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Kathleen T. Powers - *Modine Manufacturing Company - VP of IR & Tax and Treasurer*

Thank you. And that concludes today's call. Thank you for joining us this morning, and thank you for your continued interest in Modine.

Operator

And that concludes today's teleconference. You may now disconnect.

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