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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Modine Manufacturing Company's fourth-quarter fiscal 2018 conference call. (Operator Instructions). As a reminder, this conference call 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. You may begin.

Kathy Powers *Modine Manufacturing Company - VP, Treasurer, IR & Tax*

Good morning and thank you for joining us for today's call. I am here with Modine's President and CEO, Tom Burke, and Mick Lucareli, our Vice President Finance and Chief Financial Officer. We will be using slides with today's presentation which can be accessed either through the webcast link or by accessing the PDF file posted on the Investor Relations section of our website, Modine.com.

On slide 2 of the presentation is an outline for today's call. Tom and Mick will present our fourth-quarter and full-year results and provide our revenue and earnings guidance for fiscal 2019. At the end of the call there will be a question-and-answer session.

On slide 3 is our notice regarding forward-looking statements. This call may contain forward-looking statements as outlined in our earnings release, as well in our Company's filings with the Securities and Exchange Commission. With that it is my pleasure to turn the call over to Tom Burke.

Tom Burke *Modine Manufacturing Company - President & CEO*

Thank you, Kathy, and good morning, everyone. On today's call, I will discuss our fourth quarter and full-year 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 provide our revenue and earnings guidance for fiscal 2019. I will then provide a few closing remarks prior to opening up the call for your questions.

Fiscal 2018 was a very successful year for Modine, continuing the positive momentum from the prior year. Looking back over the past two years, we have increased our revenues by over 50% from $1.4 billion in fiscal 2016 to $2.1 billion today. This increase was jointly due to the addition of the CIS business in fiscal 2017 and meaningful sales growth in our vehicular and Building HVAC segments.

Of particular note is our Asia segment where our local team has executed very well and more than doubled revenues over the past two years, increased operating earnings by almost $17 million. In total we reported full-year adjusted operating income of $120.1 million, an increase of 66%, and adjusted EPS of $1.54, which is nearly double the prior year.

Moving to our fourth-quarter results, I am pleased to report another strong quarter with significant sales and earnings improvements. Overall sales increased 16% with the largest contributions from the Europe, Asia and CIS segments. Our fourth-quarter adjusted operating income was $34.7 million, up $4.8 million or 16% from the prior year. And our adjusted earnings per share were $0.44 for the quarter, a $0.09 improvement from the prior year.

Now I'd like to briefly review the segment results for the fourth quarter. Turning to page 6, sales for the Americas segment increased 4% on a constant currency basis to $150 million driven primarily by higher sales to off-highway and automotive customers. Gross margin declined 420 basis points to 14.8% as compared to the prior year.

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We anticipated we would have a tough comparison particularly due to the extremely strong fourth-quarter last year. This decrease was driven by several factors including higher material cost, which had a $2.6 million negative impact during the quarter. Material pass-through provisions in many of our customer contracts should alleviate this negative impact in subsequent quarters as long as metal prices stabilize.

In addition, we had higher labor and benefit expense in our Nuevo Laredo, Mexico plant as we prepare for new business launches that will lead to future sales growth. Lastly, we had a negative currency impact from the stronger Mexican peso.

While we are subject to labor cost increases in addition to having to offset customer price downs, we are continually working to offset these impacts by controlling our supply chain cost and improving efficiency and productivity. We expect margins in the Americas to improve in the next one to two quarters.

As a result of these factors, and the tough comparables, adjusted operating income for the Americas segment was $9.7 million; $4.9 million lower than the prior year primarily related to the decrease in gross profit partially offset by lower SG&A expense.

Our markets in the Americas segment continue to be strong with growth expected in all of our end markets. We are still working through some of the wind down of commercial vehicle programs, but are launching new business in automotive, off-highway, specialty vehicle and new commercial vehicle customer programs.

Higher material prices continue to be a concern and will impact our margins in the short-term, but the pricing mechanisms in our contracts will allow us to recover much of this cost increase over time, as I mentioned earlier.

Please turn to page 7. Sales for Europe segment increased 5% on a constant currency basis to $162.9 million with improvements across all markets. Gross margin increased 70 basis points to 16.6%. The increase in margin is primarily due to higher sales volume, procurement cost savings and plant production efficiencies.

Adjusted operating income increased $4 million to $14.8 million due to higher sales and improved gross margin along with favorable foreign currency exchange rates. Our European team, as is the case in each region, is managing a high level of quote activity for electric vehicles, leveraging our strong product portfolio and manufacturing footprint.

As you know we have completed construction of our plant expansion in Hungary, allowing us to expand our low-cost country footprint for automotive oil coolers and charge air coolers. We have seen the benefit of this investment in our income tax expense this year as we are able to take advantage of development credits in Hungary.

We are also transferring production of certain product lines from our Austrian plant to our Hungary -- to our facility in Hungary and those transfers have been going smoothly.

Please turn to page 8. Our Asia segment continues to report significant sales and earnings growth. Overall Asia segment sales grew 35% compared to the prior year on a constant currency basis. We increased sales in China, India and Korea with the most significant increases in automotive and off-highway sales in China.

Higher sales volume led to a 70 basis point improvement in gross margin to 17.6%. This resulted in a $2.8 million increase in our gross profit from $5.6 million last year to $8.4 million this year. Operating income for the Asia segment increased $2.2 million or 79% to $5 million due to higher sales volume.

As I mentioned last quarter, higher sales volumes have continued to stretch our capacity in China. To allow for further growth in the region we announced our intention to construct a second building at our Changzhou site and have finalized design for a facility and have broken ground on construction. We anticipate that construction of the building will be complete by the end of calendar 2018.

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Turning to page 9, sales for our CIS segment increased 10% on a constant currency basis to $168.4 million, primarily due to higher sales of precision cooling, mobile air-conditioning and coatings products. Gross profit was $25.7 million, which resulted in a gross margin of 15.3%, up 20 basis points on the higher sales volume.

The segment reported adjusted operating income of $11.6 million, a $3.8 million or 49% improvement over the prior year. This improvement evidences the synergy savings we have been able to attain this year as we work towards our goal of attaining $15 million in synergy savings over the first two years of operation, which is on track.

We've done a great job this year achieving the procurement synergy cost savings outlined in our plans and now we will turn to manufacturing cost savings to further reach our goals. As a first step we closed a plant in Austria and expanding our footprint in Serbia; second, we will add an additional lease capacity to our facility in Juarez, Mexico to allow for production increases. Our goal over time is to enhance production capabilities at the Juarez plant to continue its development to a scale coils manufacturing facility.

Please turn to page 10. Sales for our Building HVAC segment increased 7% on a constant currency basis compared to the prior year to $43.3 million. The increase in sales was driven by a strong North American heating season.

Gross profit increased 21% and gross margin improved by 250 basis points to 30% driven by solid conversion due to a favorable sales mix and improved pricing. This resulted in adjusted operating income of $3.3 million, up 18% from the prior year driven by higher gross profit on higher sales.

As part of our broader strategic portfolio analysis, we discontinued our geothermal product line during the fourth quarter. Sales growth in this product line was continually below our expectations and we were not able to reach the critical size to be competitive in this market with annual sales of less than $1 million.

In addition, we have decided to sell our South African business to a local entity which will allow the business to have greater opportunities for success. Fiscal year 2018 sales for this business were less than $2 million.

And finally, just as a reminder, this will be the last quarter that we report on five business segments. Starting with the first quarter of fiscal 2019 we will report on one vehicular segment called Vehicular Thermal Solutions, or VTS, that will include the current Americas, Europe and Asia segments. So our three segments going forward will then be VTS, CIS and the Building HVAC segments.

With that I'd like to turn it over to Mick for an overview of our consolidated financial results as well as our outlook for guidance in fiscal 2019.

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

Thanks, Tom. Please turn to slide 12. Reported sales increased $78 million, or 16%, which includes a positive FX impact. On a constant currency basis sales increased $42 million or 9%. Our top-line benefitted again this quarter from favorable markets, foreign exchange rates and pricing tied to metals pass-throughs. Gross profit of $96.5 million was up 13%.

Our results were positively impacted by the higher sales volume, FX rates and ongoing purchasing initiatives. Gross profit and gross margin improved in our Europe, Asia, CIS and Building HVAC segments. Total Company gross margin was down slightly to 17%, mainly due to the temporary challenges in the Americas as Tom just reviewed.

SG&A of $63.6 million was up $3.5 million primarily due to the change in foreign exchange rates. Unfavorable exchange rates accounted for $2.9 million of the increase and, on a constant currency basis, SG&A increased just 1%.

Please note at the bottom of the page we've included a table with adjustments to operating income which totaled $7.5 million for the quarter. The largest item represents our restructuring expenses which primarily relates to severance in Europe. We also adjusted $600,000 for acquisition and integration costs along with $900,000 for strategy consulting fees.

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The $1.2 million impairment charge relates to the Building HVAC segment which discontinued its geothermal product line during the quarter. The remaining adjustments relate to environmental expenses in the Americas for a plant that was previously closed.

Fourth-quarter adjusted operating income of $34.7 million was up 16%. Our adjusted earnings per share was $0.44, an improvement of 26%.

Note that our US GAAP earnings per share of $0.34 was impacted again this quarter by tax reform legislation enacted in December. We recorded $2.3 million of provisional charges to income tax expense in the quarter. This included a US deferred tax benefit of $1.7 million as a result of higher US taxable 2018 earnings compared to our forecast.

Also, a $4 million charge for the transition tax on foreign earnings that have not been previously taxed in the US was recorded in the quarter. The US tax environment is quite fluid and additional legislative guidance is expected which we will be monitoring closely.

As a reminder, we benefited during fiscal 2018 from $9 million in development tax credits related to our Hungary expansion. This is a one-time benefit that will not carry over into fiscal 2019.

In addition, we reversed a portion of the valuation allowance on our deferred tax assets in China resulting in a $2.8 million benefit in income tax expense. In our adjusted EPS we made income tax adjustments related to tax reform and the reversal of the valuation allowance in China.

Last, please note that our US GAAP income statement is included in this presentation and in our earnings release, including a full reconciliation.

Turning to slide 13, fiscal 2018 operating cash flow was $123.8 million, or $82.2 million higher than the prior year. Full-year capital expenditures were higher than the prior year by $6.6 million. This is primarily due to capital spending in our new CIS segment and unfavorable foreign exchange rate changes.

In addition, we made equipment purchases to expand manufacturing capacity in Hungary and China to support new product launches. We reported free cash flow of $52.8 million in fiscal 2018. Please note that this includes a negative $26.1 million impact of cash payments for restructuring activities, strategy costs, acquisition and integration costs and environmental-related expenses.

Finally, our net debt declined by $37 million during the year and our leverage ratio was at 2.4, down from 2.9 at the end of fiscal 2017.

Now let's turn to our fiscal 2019 guidance on slide 14. I'm pleased to report that we are expecting another year of good earnings growth driven by improving margins and continued market growth. To summarize our guidance, we project sales to be up 3% to 8%. We expect ongoing vehicular market growth, as Tom described earlier, partially offset by the wind down of multiple truck programs. For our industrial and HVAC markets we expect low to mid-single-digit market growth.

In addition to the revenue growth, we are planning to drive earnings through margin improvements across all business segments. We expect adjusted operating income to be in the range of $135 million to $145 million. This equates to year-over-year growth of 12% to 21%.

As usual, I want to briefly review some of our key assumptions. First, metals prices have continued to increase and we anticipate that this will be an ongoing headwind. Second, we expect annual interest expense of approximately $23 million. Third, we are using current foreign exchange rates which will result in a slight benefit year-over-year.

Also I want to spend a moment reviewing our very complicated and fluid tax environment. To start, we had a significant benefit in fiscal 2018 related to the Hungarian development tax credit that will not repeat in 2019. Next we have impacts from the change of our expected mix of earnings particularly related to those jurisdictions where we have valuation allowances.

And last we have the impact of the US tax reform legislation which is causing a significant increase to our tax rate in fiscal 2019. We

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previously expected our US tax rate to drop due to the lowering of the federal rate. However, we are now expecting to have additional US tax related to a specific provision in the new law. We estimate this to be about $6 million in fiscal 2019.

Given all these factors, we expect our adjusted tax rate to be approximately 27% to 28% in fiscal 2019 versus 12% in fiscal 2018. Based on the expected tax rate we anticipate our adjusted EPS to be between $1.50 to $1.65.

So to wrap up, we finished a strong year, closed out one of our best years in terms of financial results and increased shareholder value. I look forward to reporting back on our continued momentum throughout fiscal 2019. Tom?

Tom Burke ***Modine Manufacturing Company - President & CEO***

Thanks, Mick. Please turn to slide 15. As I mentioned last quarter, we have focused significant resources this year on performing a strategic review of our product portfolio. And as we assessed our strategic progress over this time, we kept coming back to strengthen, diversify and grow, or what we refer to as SDG, the strategy that has successfully guided our decisions over the past 2.5 years.

Although we will define new targets and new actions for reaching our long-term goals, the overall strategy will remain consistent. As we strive to become a more diversified global thermal management leader I look forward to sharing details on the next phase of SDG in the near future.

But to be clear, we will continue to strengthen our business by optimizing our global manufacturing and operational capabilities, working hard to continually improve our global business processes. Today I outlined many examples of how we are expanding our low-cost country footprint around the world in order to continue to competitively meet demand for our advantaged products.

Our global operations team recently coined the phrase One Modine to describe their approach on developing Modine operating system discipline deeply and consistently around the world. This has proven to be a powerful competitive advantage along with our growing size and scale.

Secondly, we will continue to diversify the business following on the success of our acquisition of the CIS business. We proved we can deliver on our promises by completing the biggest acquisition in the Company's history, having it be accretive to earnings in the first year, and allowing us to generate sufficient free cash flow to bring our leverage ratio back down into our targeted range.

This success will allow us to look for other opportunities for acquisitions that will add to our industrial portfolio, increasing our diversification and decreasing our customer concentration and reducing our exposure to market cyclicality.

And finally, we will continue to grow by seeking those investments where we have the right to win and making wise choices with our capital. Whether the growth comes from new inorganic opportunities, or from our proven organic growth capability, we will continually seek high returns on our invested capital.

In some cases we may choose to deemphasize certain products or end markets, as I described earlier in the Building HVAC segment. But we've been making these types of decisions for the past several years. But this is a special time as we embrace technological advancement and societal changes that will be disruptive to our markets. This is where Modine will thrive.

As a technology leader we will be able to deliver the products that our customers need to meet higher energy and fuel efficiency requirements, enable the introduction of advanced refrigerants and provide thermal solutions for electric vehicles. This is Modine at its best. And with that we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ryan Amberger, Seaport Global.

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Ryan Amberger ***Seaport Global Securities - Analyst***

Hi, good morning. This is Ryan Amberger on for Mike Shlisky. Just two quick ones. So looking at the segments, Asia was your leader for fiscal 2018. Margins were up nearly 4 points for the year and were above 10%. Do you still think there's more expansion ahead for margins in Asia, or is the 10% to 11% range a reasonable number going forward?

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

That's the range we'd expect going forward. I'm the first to say they've surpassed our expectations. But I think at this point we've leveraged the existing scale and now, as you know, we are starting to put in some additional capacity. So we'll reach a natural level here and I think it's probably in that 10%-11% operating range.

Ryan Amberger ***Seaport Global Securities - Analyst***

Okay, great. Appreciate it. And then one other one quick. In looking at your guidance, the incremental margins look like they are high teens for fiscal 2019. That's an improvement over the last year or two but still maybe could be a little better.

Is it just a matter of raw material costs at this point? And if we were to see raw materials come back to more normalized levels, could we get a sense of where operating profits could be for fiscal 2019?

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

Yes, great question and a lot going on there with regards to our guidance this year and then next year. From a gross profit standpoint, if you look at our outlook for next year, at a gross profit line we're really planning to convert pretty nicely in a 25% plus range. And then I think you're representing the operating income.

One of the headwinds we do have next year, and that's part of it, is metals. We are not as concerned about all the discussion on the tariffs and trade wars; but it's really on the LME and the raw material price. For most of this year we talked about a $10 million to $15 million headwind and we are passing that through in the new year.

Really around the spring here we saw another run-up in raw material, especially copper and aluminum prices. And there we are looking at another $30 million to $40 million increase in costs in fiscal 2019. And we will start passing that through, but there will be a lag on that. So that would pull down the margin a little bit this year until we pass through the balance of the material change. Does that make sense?

Ryan Amberger ***Seaport Global Securities - Analyst***

Yes, yes, no, that's perfect. I appreciate the color. Thank you.

Operator

David Leiker, Baird.

David Leiker ***Robert W. Baird & Company - Analyst***

Good morning, everyone. First of all, great finish to the year. These numbers are great; the returns are great and look for more to go forward. On China, is there a way to break apart the revenue growth of how much of that is what's going on in the market as opposed to new contract awards, content, market share? Is there a way to separate those two?

Tom Burke ***Modine Manufacturing Company - President & CEO***

Yes, I can kind of qualify it. Clearly our big markets have -- were the traditional off-highway construction markets where we are really benefiting from a bounce back of construction sales, namely heavy excavators. So that is market driven, but also inside there are new awards. And again, when we talk about that it's China that's driving the bulk of that, but also seeing strong performance out of India and some out of Korea.

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The real growth side as far as new wins is really around the automotive engine products, specifically supplying engine content as the lower displacement boosted engine phenomenon takes place in China that has given us great opportunity for content and increase in business wins. So that's really how that breaks down. I'd quantify that -- Mick, do you have any way of --?

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

Yes, I would say, David, it's -- less than half is market, maybe a third. So out of 35% or 40% growth we look across the end markets in India, the construction market in Asia and auto in China. The excavator market, by our external data, was up 10% to 20% in Asia. Most of the markets in India in the quarter were 10% to 15% and just a pretty low growth rate by our data on auto in China.

And across all of our -- so then Modine sales, up 40%, it was pretty across the board. Our auto sales were up 30% to 40%. Our off-highway sales, our construction sales were 20% to 40%. And then India sales were up another 20% to 40% depending on off-highway or commercial vehicles. So I would say about a third of the growth would be market and then the balance is us winning new programs and launching new programs.

David Leiker ***Robert W. Baird & Company - Analyst***

That's great. If we look at that, it seems like you are bumping up against some capacity constraints. Is that incremental growth opportunities slow down a little bit before it ratchets up again? How would you look at that?

Tom Burke ***Modine Manufacturing Company - President & CEO***

Well, it clearly is driven -- the growth acceleration has forced us to look ahead and we looked at many options on how to solve that. We decided to build right on the same campus where our Changzhou facility is so we can leverage the management structure and other infrastructure there. But yes, that's completely driven by this growth that Mick said.

The participation, the business wins that we are taking on there are really looking positive. Obviously those markets, and also truck market in China as well, that we are looking for opportunities. So, I'd say the continued growth -- the percentage of growth may not be like it has been the last year or two, but it's still going to be growing double digit.

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

And David, it's not prohibiting or limiting our quote activity or our win rate; that's for sure. I think in the last six months and probably the next six months the challenge is just as volumes ramp up in the existing facility, the conversion and the productivity to keep up with it.

Tom Burke ***Modine Manufacturing Company - President & CEO***

And it's kind of success breeds success. If we have success with certain customers they can open the door for more opportunities. So we are getting more share of wallet as well, which is really encouraging.

David Leiker ***Robert W. Baird & Company - Analyst***

That sounds great. Thanks for the time.

Operator

(Operator Instructions). Matthew Paige, Gabelli.

Matthew Paige ***Gabelli & Company - Analyst***

Good morning. You had strong cash flow in the quarter. Does this change your thoughts on your leverage target? Does that go up at all?

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

No. We're going to stay disciplined on the leverage. But I think what -- I think what it does is it builds our confidence in two things. We will continue to look at acquisitions, and now we're getting the balance sheet back in a position where we have, I'd say, the right to go look at acquisitions.

And then secondly, Tom commented on his comments that the Luvata integration has gone quite well. With anything, you always know where your tough points are and your opportunities, but everything we really set out to do we achieved.

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So I think it's a combination of we're building the cash flow, the balance sheet is in a reasonable position, and we've had good success with Luvata. So, we don't want to go -- again, we are going to stay long-term to the 1.5 to 2.5 leverage ratio. But if the right opportunity came, I think we would look at it again, like we did Luvata, for a temporary spike with a strong commitment to get it quickly back under our target ratio.

Matthew Paige ***Gabelli & Company - Analyst***

Okay. And then I guess maybe along those lines could you provide a little color into your M&A pipeline? What areas are you looking to expand? And have you seen reasonable valuation multiples? Kind of along those lines.

Tom Burke ***Modine Manufacturing Company - President & CEO***

Yes, so we set up an office -- a new function strategy and business development office and manned that up on a search that's looking through key markets. As I mentioned in my comments that our focus is on diversification is to keep that momentum going. Right now we've got a 60/40 split between vehicular and what we call industrial.

We see the benefits of that and we think that improving that ratio to more parity between the two is a way to go because of, again, diversification with a solid focus on our core technical strength of thermal management gives us lots of advantages both on earnings, quality of earnings, capital -- intensity being less and, again, more diversification across markets and customers.

So, look for us to be spending a lot of time in the industrial space which could -- and we are seeing opportunities and clearly we're going to be shopping wisely.

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

It took us -- we talked quite a few quarters about -- maybe a year or more about -- before we announced Luvata. And valuations are really -- depends on each opportunity and there are some that are going to be quite reasonable and fit well with our competencies and then there will be ones like we had before Luvata that we won't participate or we will pass. Either the multiple goes up or we don't see the synergy benefits to justify the cost. So, really the answer will be it really depends on the particular company we're talking about.

Matthew Paige ***Gabelli & Company - Analyst***

All right. And then one more question from me. Through the presentation it seems like you are forecasting continued end market improvements, and you noted some expected margin expansion. How much conservatism is baked into your EPS guidance?

Mick Lucareli ***Modine Manufacturing Company - VP Finance & CFO***

This will be the CFO talking here (laughter). We stretch the team really hard and we always try to go forward with the shareholders and we always try to deliver guidance that is right in line with what we are pushing the teams for. With the metals headwinds this year and all of the volume launches we really have pushed the teams hard.

So I will leave it at I don't think you ever have any management -- no management team is ever going to say we can't hit the numbers so they are sandbagged. But I think we're trying to build an expectation with all of you that we are coming right down the middle and this year we really pushed hard to deliver another year of strong growth and there's a lot of work to do to hit those numbers.

Matthew Paige ***Gabelli & Company - Analyst***

Okay, well I appreciate the color and good luck in the next quarter.

Operator

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

Kathy Powers ***Modine Manufacturing Company - VP, Treasurer, IR & Tax***

Thank you. Thank you for joining us this morning. A replay of this call will be available through our website in about two hours. We hope you have a great day.

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Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude our presentation and you may all disconnect. Everyone have a great day.

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