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CRS - Q4 2016 Carpenter Technology Corp Earnings Call

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OVERVIEW:

Co. reported 4Q16 net sales of $458m and net income of $14.9m or $0.32 per share.

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PRESENTATION

Operator

Good morning and welcome to the Carpenter Technology Corporation's fourth quarter and FY16 conference call.

(Operator Instructions)

Please note this event is being recorded. I would now like return the call over to Brad Edwards, Investor Relations. Please go ahead.

Brad Edwards - *Carpenter Technology Corporation - Investor Relations*

Thank you, operator. Good morning, everyone, and welcome to Carpenter's earnings call for the fourth quarter and fiscal year ended June 30, 2016. This call is also being broadcast over the Internet along with presentation slides. Please note for those of you listening by phone you may experience a time delay in slide movement.

Speakers on the call today are Tony Thene, President and Chief Executive Officer; and Damon Audia, Senior Vice President and Chief Financial Officer. Statements made by Management during this earnings presentation that are forward-looking statements are based on current expectations. Risk factors that could cause actual results to differ materially from those forward-looking statements can be found in Carpenter's most recent SEC filings including the Company's June 30, 2015, 10K, Form 10-Q for the quarters ended September 30, 2015, December 31, 2015, and March 31, 2016, and the exhibits attached to those filings.

Please also note that in the following discussion unless otherwise noted when a Management discusses sales or revenue that reference excludes surcharge. When discussing operating income, that reference excludes pension, earnings, interest and deferrals or EID and special items. When referring to operating margins that is based on sales excluding surcharge and operating income excluding pension EID and special items.

I will now turn the call over to Tony.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Thank you, Brad. Good morning to everyone on the call. As always, let's start on slide 4 with an update on our safety results. For the fourth quarter of FY16, our total case incident rate or TCIR was 2.2. We finished 2016 with a TCIR of 2.2 which is up compared to the 2.1 for FY15.

Our improvement in the safety culture over the last year has been driven by enhancing our safety system with standards of behavior established and designed to help our employees work injury-free. Effectively we have moved from a reactive state where people try to avoid injuries to a state where adherence to standards in the engagement of the total workforce prevent them from occurring.

Overall while I'm pleased with the improvements we have made, I'm not satisfied. I know there is more we can do and will do to further improve our safety performance. We are continuing on a path to make Carpenter a safe work environment. The actions we have instituted over the last year are creating an environment where individuals take responsibility for their own safety rather then just follow a rule and we'll continue to evolve into we are operating in an interdependent state where everyone is fully engaged and committed to ensuring the safety of not only themselves but all team members.

This is a journey and our focus is on creating a true cultural change on the shop floors and moving towards a model where everyone is responsible for safety, both their own as well as that of others. This coming year we will focus on efforts to further drive a safe injury-free workplace, to the benefit of everyone involved with Carpenter. A safe workforce is a more productive workforce, and we will continue to strive for a zero-injury workplace.

Before discussing our fourth-quarter performance, let me spend a moment reflecting on the FY16 as a whole. As you know, I was appointed CEO of Carpenter a little over a year ago. And since then we have made numerous changes in how we operate as a Company. These strategic initiatives were aimed at enabling our organization to not only weather near-term cyclical challenges, but also to set the stage for accelerated growth in margin improvement as macro and conditions improve and volumes recover.

To provide a little more detail, over the last 12 months we kicked off four major initiatives. Number one, we strengthened our Carpenter team by adding experienced external talent and just as importantly, by promoting internal talent into critical roles. Both have played a major role in our success, weathering some challenging economic conditions while establishing a foundation for our Company to grow from.

Number two, we defined our strategy as a solutions provider, helping our customers solve their most challenging problems and giving them a competitive advantage. As our new slogan states, when performance is everything, Carpenter's products and processes are uniquely suited to support the most demanding applications.

Number three, we launched the Carpenter operating model which already very early in its lifecycle has already made an impact through countless projects by reducing costs, enhancing efficiencies and improving production flow across our organization. More specifically, variable cost per ton in the specialty alloy operation, or SAO segment, was reduced to near FY14 levels driven by a 46% year-over-year improvement in our quality metric to increase yield and efficiency enhancements; a 4% year-over-year improvement in departmental spending driven by labor and production efficiencies; the early retirement initiative in the third quarter that reduced approximately 130 production and maintenance employees at the Reading campus, and an 8% improvement in raw material effectiveness.

These accomplishments are all the more impressive when you factor in that this was accomplished on 13% lower volume. In addition, we locked in our fixed cost savings from the FY15 overhead reduction initiative and continue to look for additional opportunities. All in, we achieved $78 million in costs and other improvements year over year.

In the fourth major initiative, we organized our commercial team to be market focused versus product focus. Carpenter's materials are used in many complex applications from aerospace air freight and engines to oil and gas drilling components to life-changing orthopedic and cardiovascular inserts to lighter and more durable parts within automotive fuel systems and drivetrains.

As our reorganized commercial organization focuses on bringing in a more holistic, systems-oriented approach to serving our customers, we believe we can expand our penetration in key end-use markets. As a result of these efforts, in FY16 we delivered $139 million in free cash flow.

We returned $159 million to our shareholders through our share repurchase program and quarterly dividends. We operated with a focus on improved working capital management. We managed our CapEx spending to align with the market environment and we maintained our solid liquidity positions.

Today Carpenter is much leaner and a more focused organization than a year ago. We've made and continue to make the necessary changes to our organization to ensure that we maximize our potential.

Let's move to slide 6 which is our FY16 operating income bridge to help put some of my comments in perspective. I believe it provides a clear picture of our progress to date on improving our cost structure and controlling what we can given the negative trends impacting certain of our in-use markets.

We entered FY16 knowing we were going to face headwinds in our energy market as well as our industrial and consumer market, given their exposure to oil and gas. Our reported volumes were 13% lower than a year ago and had a $116 million negative impact on operating income in FY16, the majority driven by the downturn in the oil and gas sub market. To give you some perspective, North American directional and horizontal rig count stood at 1,796 in January of 2015.

By the time we reached our FY15 end in June 2015 it had fallen 49% to 880 units. That deterioration continued in the FY16 as rigs fell as far as the low 400 range before leveling recently and increasing to 498 in July 2016, a massive 72% reduction from January 2015.

Given these market challenges, we were laser focused on addressing our cost base, the implementation of the Carpenter operating model produced early wins in terms of productivity, enhanced efficiencies and better production flow across our organization. In addition, we locked in the savings from the FY15 overhead reduction initiative. In total, an impressive $78 million in costs and other improvements year over year.

With that said, there is still work to be done. And we can always be more efficient, further improve the operation and remove additional cost. Although the Carpenter operating model has clearly produced impressive results in the first year, we believe we have only scratched the surface of the potential it holds with deeper application of the principles.

As I've stated, the downturn in oil and gas throughout FY16 had a significant negative impact on our results. However, we took aggressive actions to improve our overall operations, drive profitable growth and strengthen Carpenter's long-term growth potential.

Now let me turn to a review of our fiscal fourth-quarter performance on slide 7. We have delivered another solid quarter with $0.35 per share of adjusted earnings. Our operating results were driven by our focused cost management efforts, the continued implementation of the Carpenter operating model and our product diversification of high-end premium alloys.

Fourth-quarter sales increased by 1% on a sequential basis. The overall sequential increase was muted by the large decrease in the prior generation sub-market due to the sales spike that we noted on the third-quarter earnings call. However, aerospace was up 5% sequentially and our oil and gas sub-market was up sequentially for the first time in six quarters. Both are encouraging market indicators. I'll provide some more detail comments on the markets in the next slide.

In our SAO segment, margins increased 130 basis points versus last year's fourth quarter. Again on significantly lower volume. In all four quarters of FY16, the SAO operating margin was higher than the comparable prior-year quarter. Quite an accomplishment.

In the quarter we continued our efforts on working capital efficiency. We believe working capital management represents a further opportunity for us to unlock additional value, particularly in the area of inventory optimization. In the quarter, we reduced inventory by $20 million on a sequential basis. We also remain committed to disciplined capital spending with expenditures of $29 million in the fourth quarter and just under $100 million for the year.

In the fourth quarter we generated cash from operations of [$120] million and we delivered positive free cash flow of $83 million, a sequential increase of $36 million. This is our sixth straight quarter of positive free cash flow.

Let's move to slide 8. Starting with aerospace and defense, we generated solid sequential aerospace sales growth driven by higher engine material and structural sales. In the engine sub-market, sales were up both sequentially and year over year due to increased sales across the new engine platforms. However, faster sub-market sales were effectively flat sequentially and down year over year, as a result of the tightening in the supply chain over the last year.

Overall, [fastener] activity continues to be impacted by companies in the supply chain managing inventory levels as the industry transitions to the new platforms. Like others in the industry, we continue to be enthusiastic about the aerospace market. The ramp-up of new platforms is a reality. We are well-positioned across all the new platforms and prepared for the market pull.

Turning to our energy market. On a sequential basis, sales were down 29%. This decline was due to the strong power generation sales last quarter which I mentioned earlier. Our oil and gas sub-market sales increased 17% on a sequential basis, albeit on a low base.

On our last several conference calls, I've shared our focus on positioning the organization and extending our service offerings in an effort to build share when the oil and gas sub-markets recover. Sequentially North American directional rig count, a leading indicator for our energy business, has leveled with a modest uptick recently. The leveling is hopefully a sign of the bottom for the industry and potential steady improvement the year ahead as the current oversupply is drawing down.

Moving to transportation. Total revenues both year-over-year and sequentially were down mainly due to the expected reduced demand in heavy-duty truck production. However, sales in the North American light vehicle market remained healthy. Despite the decline in the quarter, our revenues were up 5% for the full year as we continue to see the growing need for advanced solutions that address various challenges facing OEMs today.

Longer term, we continue to believe in the value proposition our products can deliver to this market as increasing emphasis is placed on solutions that run hotter, are more durable, improve corrosion resistance and promote fuel efficiency. Today our products and solutions deliver to critical OEM needs that will continue to be driven by increasingly stricter emission requirements. Our transportation team is hard at work developing various sub-markets within the overall transportation market, including Marine and rail. We believe we have an opportunity to expand our applications and our revenue streams in the transportation sector after some early wins.

Sales to our medical end-use market were flat sequentially, while we realized gains through our participation in several new customer product launches. Those were offset by distributor inventory reductions. We remain encouraged as our premium titanium, nickel and cobalt materials continue to generate strong demand and customer interest.

Lastly, sales in the industrial and consumer end-use market were down year-over-year due mainly to our exposure to the oil and gas sector. On a sequential basis, sales growth was up 9%, driven primarily by stable consumer demand across several of our product groups.

With that, let me turn the call over to Damon for the financial review.

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Thank you, Tony. Good morning, everyone. Turning to slide 10 in the income statement summary, net sales in the fourth quarter were $458 million or $406 million excluding surcharge. Sales excluding surcharge were up almost 1% sequentially as higher volumes in the quarter were offset by weaker mix. On a year-over-year basis, revenue decline $57 million mainly due to the impact the oil and gas market has had on our energy and industrial consumer end-use markets.

Operating income as a percent of sales when excluding pension EID and special items was a 8.9% which is marginally better than the 8.7% reported in the third quarter. The 8.9% is a testament of the strong cost actions taken in the quarter which helped mute the impact of some weaker mix products [hold] in the quarter.

Operating margin was down compared to the 10.4% in the fourth quarter of last year, with the decline due to lower volume in the current period and almost a $10 million change in lower operating income from our PEP year-over-year which I will touch on further in the PEP segment slide.

In the fourth quarter, our effective tax rate was 36.1%, up from the 27.6% in the third quarter. As a reminder, our third quarter tax rate was impacted by the completion of the sale of an equity method investment in India as well as the tax impact of certain special items incurred during the period. For 2016, on an adjusted basis, our full-year tax rate was 32.7%. Net income in the fourth quarter was $14.9 million or $0.32 per share. On an adjusted basis excluding special items, net income would've been $16.3 million or $0.35 per share.

Now turning to slide 11 to review our free cash flow. We generated $83 million in free cash flow during the fourth quarter compared to $47 million in the third quarter driven by inventory reductions and other working capital improvements. As Tony said, this is the sixth consecutive quarter of positive free cash flow and another example of our solid execution.

For the full year, free cash flow was $139 million compared to $74 million in FY15. The $65 million improvement was mainly driven by lower capital expenditures as FY15 had expenditures related to the completion of our Athens facility as well as the improvement in the overall working capital efficiencies. Although inventory was effectively flat for the year, we continued to reduce the levels of work in process inventory as a result of the execution of the Carpenter operating model and remain confident that we will be better positioned to deliver on customer needs as our markets recover.

Capital expenditures in FY16 totaled $95 million, in line with our guidance of $85 million to $95 million. Throughout the year we managed our capital expenditures by balancing maintenance capital needs, market conditions and strategic investments to capitalize on growth opportunities across our end-use markets. Overall our balance sheet remained strong. As of June 30 we had $575 million of liquidity including $82 million of cash and $493 million of borrowings available under our revolving credit facility.

We also have no major debt maturities until FY22, and effectively no pension contributions until FY18. I will also note that we did not execute any share repurchases in the quarter. To date, we have executed $248 million of the $500 million authorized amount, which has resulted in 6.7 million shares being repurchased. The two-year authorization approved by the Board of Directors expires in October 2016. As such, we may elect to repurchase additional shares prior to this expiration.

Looking at FY17, we'll continue to execute with a focus on free cash flow and prudent allocation of capital as we balance maintaining strong liquidity with growth capital expenditures and return to shareholders.

Now let's turn to slide 12 and review our SAO segment results. Overall SAO had a solid fourth quarter. Volume performance was strong in the quarter with a sequential increase of almost 8%. We also reported revenue, including surcharge, of $322 million, an increase of almost 2%.

On a year-over-year basis, volume continues to be challenged by the weakness in oil and gas activity and its corresponding impacts on our energy and industrial consumer end-use markets. Operating margins expanded on both a year-over-year and a sequential basis, in part to our continued improvement in costs from the execution of our Carpenter operating model. Operating margins were 15.1% in the fourth quarter, which was up 70 basis points versus the third quarter and up 130 basis points compared to the fourth quarter of last year. The year-over-year expansion is especially noteworthy as we accomplish this despite a 4% decline in volume.

Our operating margin performance is a testament of the early wins we're seeing in the execution of the Carpenter operating model. It is less than one year into the rollout, as Tony has highlighted. We are making progress in several areas as evidenced by the 10% improvement in fourth [quarter] variable manufacturing costs year over year.

Although these types of improvements will not necessarily be linear and they may be influenced by volume at times, we are very excited about the results we are seeing. We're confident the execution of the Carpenter operating model will help us continue to improve on our efficiency, productivity and customer service over time which will continue to make us a stronger Company.

Looking at the first quarter in SAO, we expect the normal volume seasonality versus the fourth quarter which historically has been down approximately 10% to 15%. We expect the year-over-year decline in energy volumes to mute the increased volumes associated with our other end-use markets. In addition, for comparison purposes you'll recall that the first quarter last year included a $4 million insurance settlement in SAO operating income.

Now let's turn to slide 13 and the PEP overview. Overall, our results were in line with our expectations and largely consistent with Q3. Similar to last quarter, results continued to be impacted by the downturn in oil and gas. On a year-over-year basis, decreased demand in the energy end-use market continued to have a significant impact on our PEP business. In addition, we continue to see demand for aerospace fasteners at lower levels than last year and with more unpredictability given ongoing supply chain tightening.

On a sequential basis, we reported flat sales of $90 million. The relatively flat revenue is the result of the leveling market conditions for Amega West Business. The year-over-year decline in operating income at PEP was driven mainly by lower volumes. This was partially offset by our ongoing efforts to reduce costs in our oil and gas business and align our operations with market demand.

On a sequential basis, the operating loss was $1.3 million and similar to our Q3 performance. Although our Omega West business continues to be challenged and is generating $5 million to $6 million in losses per quarter, we saw stability in the business as rig counts have effectively leveled out over the last few months. Although we're not ready to predict an upturn yet, our team is well-positioned with our customers to capitalize on the upturn when it happens.

For our fiscal year first quarter, we expect oil and gas demand to remain at the current levels. We also anticipate the normal seasonality for certain businesses. Similar to SAO, our PEP team is laser-focused on aligning our cost structure with end-use market conditions while continuing to roll out the Carpenter operating model.

Turning now to slide 14, we wanted to provide a few full-year guidance items to help with modeling. First, looking at depreciation and amortization, we expect it to be relatively flat versus last year at approximately $120 million. Interest expense for the full year is expected be approximately $32 million. The year-over-year increase is due mainly to the gains included in the FY16 as a result of our interest rate swaps that we've used to convert a portion of our fixed-rate debt to floating-rate debt. Any future period impacts from these swaps is difficult to predict and as such we excluded the impact from our FY17 estimate.

Net pension expense is expected to be approximately $69 million. This is up from $54 million in FY16. The increase is being driven by more than a 50 basis point reduction in the discount rate for our largest plan as of June 30, 2016, combined with lower-than-expected asset returns in 2016. As a reminder, only the service cost portion of net pension expense is included in the segment's operating income. The remaining portion, pension earnings, interest and deferrals, or EID as we call it, is excluded from the segment's operating results.

Almost all of the year-over-year increase will be driven by the pension EID component and have minimal impact on our segment operating income. Our required cash pension contributions are only $1 million in FY17.

I would note, however, that the significant decline in our discount rate in [2016] asset returns below our assumption resulted in an increase in our underfunded pension obligation at FY16 end. Based on current estimates, we would expect to have required pension contributions in FY18 of approximately $45 million.

Our effective tax rate for FY17 is expected to be in the range of 28% to 30% versus an effective tax rate of 47% or an adjusted tax rate of 33% in FY16. We currently expect capital expenditures to be approximately $120 million. We will continue to use a balanced approach to investing in strategic growth projects while being prudent in our investments based on our outlook for our different end-use markets and the opportunities we see going forward to position Carpenter for growth over the long term. Now I will turn the call back over to Tony.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Thank you, Damon. Moving to slide 16, Carpenter has a 127-year history of being a leader in the development and production of high-value specialty alloys that serve demanding application needs. Looking at Carpenter today, we provide specialty solutions in value to customers across highly attractive end-use markets. While some of these markets are undergoing transition like aerospace or dealing with unprecedented headwinds like energy, their long-term growth potential is unquestioned.

Our aim is clear: To further strengthen and capitalize on our position as a preferred solutions provider. To do this, we need to ensure we investing in the future and continuing our legacy of helping customers address their needs and challenges. This includes investing in our overall capabilities as a means to not only address the future of our customers and industry, but also to expand our revenue stream by unlocking new growth opportunities in adjacencies across our end-use markets.

With our Athens investment, we have a fully operational state-of-the-art facility, built to primarily serve the aerospace and energy markets. We believe Athens will deliver important incremental earnings to our financial results and value to our shareholders over the next several years the new engine platforms ramp and the oil and gas sector improves.

As we've previously noted, our financial results reflect the full operational costs of the facility, despite it currently running at low utilization levels. This cost is approximately $8 million to $10 million a quarter. We continue to make progress with the required qualifications at Athens. 99% of non-VAP certifications have been completed. Oil and gas qualifications are up to 83%. And our range of products approved for manufacturing continues to increase.

With regard to our pallet of products, we are one of the world's most diverse producers of gas atomized specialty alloy systems. We are a key powder supplier for major applications such as additive manufacturing, metal injection molding and surface enhancement coatings. We operate a super alloy powder facility in Athens, Alabama, that today is producing high purity powders as we ultimately qualify to provide disc quality powder for rotating components in aerospace jet engines.

And we continue to move forward in developing our titanium powder capabilities which will strengthen our ability to produce leading-edge materials for the aerospace, medical and transportation markets. This effort will allow us to develop deeper relationships with the key players in the additive manufacturing space broadening Carpenter's presence and providing us with another long-term growth channel.

Now let's turn to slide 17 and my closing comments. Carpenter delivered another solid quarter to close out FY16. The full year proved to be a challenge for the organization in terms of the significant impact of lower volumes on our operating performance. Despite the markets, we delivered strong operating results, generated meaningful free cash flow and took critical steps to redefine the Company.

As I mentioned earlier, Carpenter is a much leaner and a more focused organization today than it was a year ago. We believe that executing on the Carpenter operating model will be essential to our future success by identifying and realizing future opportunities for efficiencies and process improvements across the whole enterprise. The realignment of the commercial teams will allow us to expand our current view of our customers and our markets while targeting segments which exhibit the greatest potential for value and growth.

Our focus on driving efficiencies and improvements in our operations also extends to identifying areas to improve working capital efficiency. We believe there are opportunities to unlock further value without disrupting our commitment to providing superior service to our customers.

The oil and gas market will recover. And when it does, Carpenter is poised to have a much stronger position. In our oil and gas business inside the performance engineer product segment, the decline in operating income from FY14 to FY16 is approximately $35 million. That will be a significant tailwind when oil and gas returns.

As I said earlier, the aerospace engine ramp-up is a reality and we are well-positioned across all the new platforms to take advantage of the growth. We have installed capacity in our Athens facility that is critical to meet the future demand. As the aerospace market grows and the energy market improves, we believe that this facility's contribution to operating income will be meaningful.

We clearly see the unique position Carpenter holds in the market and the value we can bring to our customers and shareholders. We will continue to do what it takes to position our organization to win over the long-term. Thank you for your attention and I'll turn it back to the operator to field your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session.

(Operator Instructions)

Gautam Khanna with Cowen and Company.

Gautam Khanna - *Cowen and Company - Analyst*

Thank you; good morning. You've given us some color on Q1 and I wanted to calibrate expectations, if you wouldn't mind. Q1 down sequentially consistent with seasonality. I imagine Q2 will be similar to Q1 as it has been historically.

When we look at the second half, are you expecting a pretty substantial increase like you have had historically? Is there anything you can point to in the second half of the fiscal year? Because when look at consensus estimates north of $1.80 in earnings, I'm trying to see what really moves up. Is there some pricing increase or something of that nature that you can point to that would justify such an increase?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Well, I'll answer your question, Gautam, in terms of volume. Yes, in the second half of this upcoming year we expect volumes to be up, all things considered, as they have been in the last couple fiscal years.

Gautam Khanna - *Cowen and Company - Analyst*

Can you comment on pricing? Are there any stepups in pricing that would --?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Nothing specific to comment on that would be significantly different between the two halves.

Gautam Khanna - *Cowen and Company - Analyst*

How much additional content do you have on those programs versus the legacy CFM and B2500?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes, I can say this, Gautam, that on all those new platforms we are incrementally higher than on the legacy programs.

Gautam Khanna - *Cowen and Company - Analyst*

Can you give us a magnitude on how much higher?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes, I would say they are meaningful. I don't have a specific percentage point. As you know, we don't sell directly to those engine manufacturers. I would say it's a meaningful increase across all the new platforms.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. Could you give us come color on what you see, given your order book now, for SAO top-line growth ex surcharge in FY17?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Do you mean what do I think the margins could be in FY17?

Gautam Khanna - *Cowen and Company - Analyst*

Not just margins but also the top line.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes, I mean -- yes. As I said in my comments, we believe that the aerospace ramp-up is a reality. We're going to benefit from that. We believe that in transportation we've just begun to look at other applications that we can benefit from, as you look at -- regardless of whether the build rate for auto increases or not, we're going to see a much broader use of our products as the emission standards get tighter, as engines run hotter, as performance requirements go up. And we believe we have opportunities in energy as we believe that we'll see a recovery.

Now it won't be a V-shape. It's going to be gradual, but (technical difficulty) low point right now. So I think from an SAO standpoint, we believe there's ample opportunity for us to increase the top line. In terms of margins in SAO, well, look what we've done in FY16. I think we've probably moved 3 percentage points, if you look FY15 to FY16. We're not quite at the high that SAO was at probably back in FY13, FY14 range, but that's our goal to get back there.

Gautam Khanna - *Cowen and Company - Analyst*

Do you think you could actually get to a 20% level at some quarter in FY17?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

I think -- yes, I'm not ready to say that. I will tell you that we made a 3 percentage point increase in FY16. We believe we're on track to do better than that, but not ready to tell you exactly what the target margins would be in FY17.

Gautam Khanna - *Cowen and Company - Analyst*

All right. Thank you. I will turn it over to the other guys

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Thanks, Gautam.

Operator

Phil Gibbs, KeyBanc.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Good morning.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Hello, Phil.

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Good morning, Phil.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

In terms of the customer view of the oil and gas market and the existing inventories in the supply chain, assuming that the -- call it the rig count, is only up marginally from here. When do you think you will actually start to see a much stronger pull than what you saw last quarter? Meaning how much inventory is in the channel that we still have to slog through?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

That's a tough question, Phil. I would say that the rig count is the best indicator for us as far as sales. So as you see that rig count go up, you'll see our sales go up accordingly. And I think maybe you will even see a multiplier, because as we've said on the call that we believe that we positioned ourselves to come out of this downturn with better market share. But it's really difficult to say where we think that's going to go over the next couple -- I do believe the recovery will be measured and not abrupt.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Okay. And, Damon, on the side of the pension you gave the minimum contribution this year which were obviously very menial. Is there any thought to putting in a voluntary contribution this year at all?

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

You know, Phil, no final decisions have been made. We're just starting our fiscal year here, so we'll step back, look at our capital allocation plan and for us, as we've said in the past, it's important for us to be balanced here.

We want to make sure we're investing in growth CapEx accordingly. We want to make sure that we're returning an appropriate amount back to the shareholders, but we also -- very important to us to maintain a solid balance sheet and our leverage ratios with the rating agencies are important, so we'll look at the underfunded pension obligations as part of that debt-like obligation and see whether it is prudent for us to be proactive. Tut at this stage we haven't made any final decisions.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Okay. And I think you kind of caught up to your inventory target in Q4. Any thoughts on inventory management in FY17 and what we should expect from you guys in terms of the cadence and potentially (multiple speakers) a bit more, adding a bit more. Just trying to think about that.

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Sure. No problem. So, Phil, I think there's no clear -- we're not giving a specific guidance for 2017. And what I will tell you is it will be dependent upon the markets and how we see our end markets perform throughout the course of the year. But right now what I would say is we expect our inventory to be flat year over year. We'll continue to focus on the management, especially in the work in process. And as you touched on, we did see good performance in that segment or that portion of it in 2016.

Our goal for 2017 is really to hold it flat while we expect sales to increase and at the same time trying to improve our customer service. And that is the theory behind the operating model is to keep the inventory levels effectively where they are as revenue grows and thus taking down our days.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Okay. And then one more and then I'll pop off. The payments from qualified pension plan associated with the restructuring was $9.4 million this year. Is that number going to continue to recur for a bit of time? Or is it something that comes off the rolls here soon?

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

I think that was more -- that is not really expected to recur.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Okay. Thanks so much.

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Thanks, Phil.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Yes.

Operator

Andrew Lane, Morningstar.

Andrew Lane - *Morningstar - Analyst*

Hi, good morning.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Morning.

Andrew Lane - *Morningstar - Analyst*

Boeing's been discussing an earlier entry into service for the 737 MAX. Previously it was maybe the third quarter of 2017, now maybe the first half of 2017. Does this align with your production ramp-up to support the program or have you seen demands to move up here at your ramp?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

We're prepared for that, Andrew, and that aligns with where we're at right now.

Andrew Lane - *Morningstar - Analyst*

Okay. Could you provide some color as to the texture of your order book associated with the industrial and consumer end markets? It's on a nice 9% sequential growth here. Were there any particular areas of strength you would highlight for that particular end market and how important is oil and gas demand to your sales for the industrial and consumer end market?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

The industrial market for us, there's times that we don't necessarily know where our product is going, so we know that inside of industrial there is some oil and gas influence. I will say for that specific quarter that we just finished, the big positive driver was on the consumer side.

Andrew Lane - *Morningstar - Analyst*

Okay. Any particular product lines in particular that are consumer facing that you'd highlight?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes. Electronics.

Andrew Lane - *Morningstar - Analyst*

Okay. Great. And then, finally, for more of a big picture perspective, what does it mean to be market focused versus product focused? And would you point to this strategy as a key driver of the fact that SAO margins were up year on year, even though volumes declined?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

It's still early days of making its move. It's a significant move. It certainly -- it gave support.

But the real issue is instead of just selling a specific product and for the most time that's going into the same application that it's been over the last five or 10 years, we're taking a step back and looking at the market and the solution that Carpenter can provide and saying that that could be applied to many other applications. That's really the focus is looking broad, looking at adjacencies that we can participate in.

Andrew Lane - *Morningstar - Analyst*

Okay. Thanks very much.

Operator

(Operator Instructions)

Chris Dowling, Rosenblatt Securities

Chris Dowling - *Rosenblatt Securities - Analyst*

Hey, good morning.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Good morning, Chris.

Chris Dowling - *Rosenblatt Securities - Analyst*

The commodity nickel market has been showing some strength and pricing has moved up this month. I was just wondering if you've seen a change in your order book to reflect maybe customers coming back in ahead of the surcharge or anything different over the past 30 days or so?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

We have some chatter in the market. We haven't seen that actually show up as material difference in the order patterns, but we would expect if you saw nickel to continue to increase that you'd see some increase in activity, especially on the distribution side.

Chris Dowling - *Rosenblatt Securities - Analyst*

Okay. And just switching gears, curious when you think -- and I apologize if you mentioned it during the presentation, but when you think the titanium fasteners inventory will be balanced and less of a headwind?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Well, that's a tough question. I don't know. We saw some -- quite frankly some upticks in our fastener demand early in the calendar year in January. That has reversed and now we're seeing some of this balancing, if you will. To be honest with you, I can't really tell you over the next couple quarters when that might flesh itself out.

Chris Dowling - *Rosenblatt Securities - Analyst*

Okay. Thank you.

Operator

Phil Gibbs, KeyBanc.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Thanks for taking us. I appreciate it. The mix in SAO, it looks like from a base revenue per pound was down about $0.29 quarter-on-quarter and I think we were anticipating that or you were anticipating that. How should we think about that mix moving through 2017?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes. Listen, one thing, from a mix standpoint, obviously, with the oil and gas business, how it's moved, it's tough to compare quarter over quarter. Right? But I think if you adjust for last quarter the large power generation order that we had, that's a type of run rate you should look for.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Maybe a second-half average or something like that?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Well, I mean for us, one large order there can make a big difference. And also, as you see the [arrow] ramp-up coming the end of this year into the next fiscal year, you'll see an increase on the mix as well.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Right. Okay. And then, Tony, just general question on the backlog. How is the backlog overall end of June versus maybe end of March?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes, we did see a decrease in our backlog, Phil. Some of that, quite frankly, had to do with fastener demand being a little choppy. Some of it had to be that we reduced our lead times in several products and was able to pick up some business. That pulled the backlog down a little bit and I'm okay with that. But we did see a reduction in quarter over quarter in the backlog.

Phil Gibbs - *KeyBanc Capital Markets - Analyst*

Okay. Thanks very much.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes.

Operator

Gautam Khanna, Cowen and Company.

Gautam Khanna - *Cowen and Company - Analyst*

Tony, I was wondering if you could update us on the root cause analysis you've done at every workstation? If you could tell us how far along we are in the turnaround? If it's a baseline game, what inning are we in, if you will? Just to give us a sense for how mature this already is reflected in the margins.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Yes, I would say this. As you know, Gautam, moving to this type of approach is a long process. It's not going to happen in a couple quarters. But you can see in our results over the last FY16, especially over the last couple quarters, that we are -- if you want to put it in a baseball analogy, we're hitting a lot of singles and maybe a double here and there.

We're doing some, as I said on my comments, countless projects that are making their way to the bottom line. So I think the good news is, from my vantage point that I believe we are probably in the second or third inning. That says we have a lot more opportunities out there as we continue to apply these principles. And, quite frankly, not just in SAO, but as we branch out into our PEP businesses as well.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. And can you give us a sense for the first half, second half, free cash profile in FY17 Are you expecting to build inventory again as you normally do in Q1 and Q2 or how should we think about that?

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Yes, Gautam, I don't expect very much change from our normal seasonal pattern. As we would likely see some inventory build, part of our goal with the Carpenter operating model is to reduce the peak to trough in that inventory. You may not see the order of magnitude that you've seen in years past as we build in the first half, but you would still see some sort of a marginal increase here and then coming back down in the second half.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. Have you guys seeing any demand pull yet with a new contracts with Pratt and Whitney UTX? The new nickel alloy contracts? Any of the powder or what have you moving up?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

I will take the second one. We're working out through the quantification on the powder side with our facility in Alabama. We have produced powder and we're shipping that powder now. We have seen pull from the new contracts. We've seen pull across -- to be more generic, across all the new platforms. So the answer is yes.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. And you don't see any evidence of destocking or hesitation in the supply chain, something we saw for a couple years, that is completely abated?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Not overall. We do see the choppiness in the fastener market, Gautam. And I think has been pretty prevalent for other companies that have released prior (inaudible) and [common] to prior sales.

Gautam Khanna - *Cowen and Company - Analyst*

Great. But in the jet engine channel across the OEMs you're not seeing that any longer?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

We have not. No.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. And last question on the buyback. You mentioned you might buy back some stock before the authorization expires. Can you just talk about what you think about the stock these days versus other things that you could fund? CapEx, obviously, is a priority, but you were asked about pension. Doesn't sound like there's any M&A in the pipeline, so why not buy back some stock here?

Damon Audia - *Carpenter Technology Corporation - SVP & CFO*

Gautam, for us, again, we will look at it in totality as we look at our cash that we had at the end of the year plus our Q1 outlook. And, again, from a capital allocation standpoint, our goal is to find that right balance between investing in growth projects for the Company longer term, maintaining or stabilizing the balance sheet and then whatever we feel is appropriate as excess or surplus we would look to redeploy to the shareholders in the form of the normal dividend that we have along with the share repurchase program.

So it is something we consider. We evaluate it in totality versus the other uses of the cash, making sure that we try to find that optimal balance for everybody.

Gautam Khanna - *Cowen and Company - Analyst*

And last one, if you could just -- do you expect any disruption or any share shift from the GE [Alston] deal, you know on the gas turbine side or from the Alcoa separation?

Tony Thene - *Carpenter Technology Corporation - President & CEO*

We don't anticipate any change in either one of those events.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. Thank you, guys. Good luck.

Tony Thene - *Carpenter Technology Corporation - President & CEO*

Thanks, Gautam

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Brad Edwards for any closing remarks.

Brad Edwards - *Carpenter Technology Corporation - Investor Relations*

Thank you. Thanks, everyone, for joining us today. We look forward to speaking with you again on our first-quarter call. Have a great day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.