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BWX Technologies, Inc. (BWXT)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, welcome to BWX Technologies Third Quarter 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. Following the company's prepared remarks, we will conduct a question-and-answer session and instructions will be given at that time.

I would now like to pass the call over to your host, Mark Kratz, BMXT's Vice President of Investor Relations. Please go ahead.

Mark A. Kratz
Vice President-Investor Relations, BWX Technologies, Inc.

Thank you, Tia. Good evening and welcome to BWXT's third quarter 2022 earnings call. Joining me today are Rex Geveden, President and CEO; and Robb LeMasters, Senior Vice President and CFO. On today's call, we will reference the third quarter earnings presentation that is available on the Investors section of the BWXT website. We will also discuss certain matters that constitute forward-looking statements. These statements involve risks and uncertainties, including those described in the Safe Harbor provision found in the investor materials and the company's SEC filings. We will frequently discuss non-GAAP financial measures which are reconciled to GAAP measures in a separate presentation that can also be found on the Investors' section of the BWXT website.

I would now like to turn the call over to Rex.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

Thank you, Mark, and good evening to everyone. Earlier today, we reported third quarter earnings of $0.69 a share, in line with our forecast and consistent with our framing in the last earnings call. Revenue was up 5%. Free cash flow was up $25 million. Adjusted EBITDA was down 5%. And strong performance in commercial operations and company-wide cost controls nearly offset labor challenges and government operations. Despite macro market volatility this year, the company has exhibited solid underlying financial performance from its core operations. The labor challenges that have emerged have been largely offset by cost controls and outperformance from our commercial-facing businesses, resulting in high-single-digit EBITDA growth on an ex-pension basis.

Given our performance to date and the impacts of macro headwinds, we have narrowed 2022 earnings per share guidance to just below the original midpoint issued about a year ago in a very different overall economic environment. Revenue and EBITDA have both moved favorably from our initial 2022 outlook in February.

Before I turn the call over to Rob to go through the financial details, let me give you an update on the business and the optimistic long-term outlook we have on BWXT's nuclear end markets. In our Government business, we're continuing to see strong demand for our naval products, including components, reactors and nuclear fuel. The Columbia submarine program continues to ramp, and we recently shipped some of the first components for the lead boat. The reactor components and fuel for the Virginia program are progressing at a regular cadence, and we are continuing to work on multiple Ford class carrier propulsion chipsets. And although we are starting the government fiscal year with a continuing resolution, we don't anticipate any disruption to these critical and well-supported national security programs.

We recently kicked off the next multi-year pricing negotiation with our Navy customer and anticipate getting that next set of orders negotiated and under contract in the first half of 2023. This agreement is for reactor components and fuel for the next two fiscal years and supports the Navy's 30-year shipbuilding plan which includes stable production of Virginia fast attack submarines and additional content on the Columbia program as we approach an annual ordering tempo for reactor components and fuel for the new ballistic missile submarines. We also continue to support the US Navy and the government as they negotiate the details of the AUKUS trilateral security agreement. If called upon, BWXT stands ready to utilize our unique capabilities, facilities and licenses to help enable this important global security effort.

As I noted, and not unlike our market peers, we are experiencing some difficulties in our core business in this post-pandemic, dislocated labor market. Finding and retaining skilled manufacturing labor is our most acute problem. At some of our nuclear manufacturing sites, we are tracking almost 10% below our net head count plan. Said another way, we are simply struggling to sufficiently hire to satisfy our growth needs as we stretch to meet demand from our customers. This has a twofold effect of limiting progress against the backlog and reducing planned overhead absorption.

To address these labor shortages, we have implemented a set of comprehensive actions. For recruiting, we've expanded our employee referral programs and conducted a detailed Kaizen exercise to streamline the talent acquisition process. The recruiting battle rhythm includes daily tracking and reporting to ensure constancy of purpose and process visibility. We've also hired more site level recruiting resources to more effectively market our unique career offerings to top candidates. For retaining and onboarding new team members, we are expanding and accelerating our training programs to improve their skill sets and create a foundation for competency and success. Beyond the labor impacts, this year, we are doubling down on operational excellence to drive efficiency to offset increasing cost and improve schedule and quality.

Having made significant capital investments in the Navy business, we are in the process of optimizing throughput to reduce span times and drive efficiency as we execute the backlog. While we've always had a continuous improvement culture and formal operational excellence functions, we are taking a fresh look at improving the business by getting back to the basics, deploying lean manufacturing tools including visual flow boards, process mapping and key performance indicators to name a few and standardizing their usage across the enterprise. We are firmly invested in the belief that our new leaders, third-party assessment and continuous commitment to rigor and discipline will create additional capacity for the business, drive efficiency and position us to exceed customer expectations.

In any case, the outlook for this business is superb despite this near-term labor and financial pressure and these efforts better position us for the future and serve as an accelerator of our naval performance as macro headwinds abate. On microreactors, Project Pele is ramping albeit at a slower pace than we had planned given the challenge finding engineering talent needed for this special project. That said, we have begun procurements for long lead items, base-lined our schedule and configured the supply chain for this prototype reactor. Our interactions with the DoD, Strategic Capabilities Office and future potential customers have been very positive.

On a related topic, we anticipate a contract option award in the near term for TRISO fuel to be used in this mobile reactor which is separate from and incremental to our existing $300 million contract to build the prototype reactor. We remain optimistic about the microreactor market and continue to see strong government demand for nuclear space, power and propulsion manifesting in multiple opportunities including the DRACO program at DARPA, fission surface power and space nuclear propulsion for NASA. And as we have noted on multiple calls before, the ideal instate for this market is continuous production of microreactors and fuel, and we remain bullish about those possibilities over the long term.

The services business continues to track upward. The new Savannah River Site remediation contract is executing well, and outside of that, performance scores have been trending favorably. Our strategy to leverage BWXT's unique nuclear knowledge and site management and complex nuclear environmental restoration is working, and we are building back our portfolio through market share gains, enabling us to reach historical levels of operating profit.

The next stair-step opportunity for growth in the pipeline is the Hanford Integrated Tank Disposition Contract which we anticipate to be awarded by early next year. Beyond that, there are smaller scale but fairly near-term opportunities at the decommissioned enrichment plants in Portsmouth, Ohio and Paducah, Kentucky. And the longer term, there remain large opportunities to manage and operate the Pantex and Y-12 sites, the scopes of which are clearly in our sweet spot.

Lastly, on the government side, we see near-term growth in processing special nuclear materials. In March of last year, BWXT was awarded a contract from the National Nuclear Security Administration to design and pilot a process for uranium purification and conversion services. This first phase is tracking ahead of schedule, and we anticipate a larger second phase award next summer.

Now, switching gears to BWXT's commercial-facing markets. Momentum is building in our nuclear medicine business. In September, we submitted a new drug application to the FDA for BWXT's Tc-99m generator. In that same timeframe, we hosted investors, customers and others at BWXT Medical's headquarters and major production facility in Kanata, Ontario. Last week, the FDA requested dates to conduct a pre-approval inspection of our Tc-99m generator line and accepted our application for priority review.

In a related matter, we have begun installation of the Target Delivery System or TDS at the Darlington site near Toronto. The TDS is a first-of-a-kind system used to irradiate target material for the Tc-99m generator. The system, which we expect to be fully operational next year, will have the highest production capacity of any radioisotope irradiation system globally. It bears mention that beyond our Tc-99m application, the target delivery system can be utilized for multiple other neutron capture isotopes and will be a major industry accelerant. For instance, the system can irradiate targets to produce yttrium-90, the active pharmaceutical ingredient in the TheraSphere product that we manufacture. It also has the potential to deliver an unprecedented scale of irradiated lutetium-177, an isotope of growing demand for radio-therapeutic applications.

On that topic, we are making substantial progress on important therapeutic isotopes, including the development of our lutetium-177 product and related preparation of a drug – master drug file for sale of that product as an active pharmaceutical ingredient. In addition, the business recently completed and shipped the first trial batch of actinium-225 to Bayer for use in their therapeutic clinical trials.

In summary, we see tangible progress in positioning the nuclear medicine business for accelerating growth.

Finally, we continue to see positive sentiment around commercial nuclear power particularly in light of the current geopolitical environment wherein energy security is increasingly viewed as a component of broader national and economic security considerations. This coupled with net zero emissions target has created an intense focus on new commercial nuclear power solutions globally. To that end, we are pleased to announce receipt of a new contract from GE Hitachi for engineering design of the BWRX-300 small module reactor pressure vessel which we expect will lead to material procurement and manufacturing.

Not only do we see serious interest in the GE Hitachi design for potential customers in Canada, the US and Poland to name a few, but other small modular reactor designers and integrators are also gaining traction for potential orders. BWXT occupies a premium position in the commercial nuclear supply chain in North America and can support multiple technologies and designs given our capacity which includes the largest nuclear cleanroom manufacturing facility in North America.

In summary, all of our markets are growing and BWXT maintains enviable, competitive positioning across its entire portfolio amid a strengthening macro demand signal for nuclear. Having a highly differentiated and diverse nuclear portfolio is advantageous as we navigate the near-term macro challenges in the broader context of steady, long-term growth in markets characterized by growing demand and high-entry barriers.

Robb?

Robb A. LeMasters

Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

Thanks, Rex, and good evening, everyone. Let's start with total company results on slide 4 of the earnings presentation. Third quarter revenue was up 5% to $524 million, driven by growth in both operating segments, but most notably in Commercial Operations. Third quarter adjusted EBITDA was down as anticipated by 5% to $100 million, which was driven by higher revenues and solid cost controls in Commercial Operations, which were more than offset by Government Operations headwinds, including the hiring and labor challenges that Rex mentioned, as well as lower recoverable CAS pension income. As a result, non-GAAP earnings were down $0.07 per share, as we outlined on our previous earnings call. A more detailed quarterly bridge can be found on slide 5 of the earnings presentation.

Net operational headwinds were about $0.03 per share, which was further reduced by $0.03 per share from lower recoverable CAS pension income. Higher interest rates, some foreign exchange losses and a higher tax rate contributed another $0.03 per share headwind. These were all partially offset by a lower share count from last year's share repurchases, which contributed $0.02 to EPS. Lastly, free cash flow was up $25 million, primarily driven by a decrease in CapEx as we continue to wind down the two major capital campaigns in the Navy and medical businesses.

Moving now to segment results on slide 6, in Government Operations, third quarter revenue was up 1% to $423 million, driven by higher naval production and microreactor volume, that was partially offset by lower long lead material. Third quarter adjusted EBITDA was down 8% year-over-year to $90.4 million as decreased efficiencies from a challenging hiring dynamic resulting in fewer favorable contract adjustments. Year-over-year results were also down, given lower recoverable CAS pension costs, which were partially offset by higher income from our technical services joint ventures.

In Commercial Operations, revenue was up 22%, driven by higher field service activity and fuel handling. BWXT Medical revenue was also up year-over-year. Third quarter Commercial Operations adjusted EBITDA was up 12% through a combination of higher revenue, a more favorable business mix and segment cost controls.

Turning now to guidance on slide 7, as we noted in the earnings release, we are narrowing 2022 guidance for revenue, EBITDA and EPS. We now expect consolidated revenue growth of 6.5% to 7% this year with Government Operations expected to come in at the low-end of the prior range at around 6%. Commercial Operations is expected to land at the higher end of the prior range at around 8.5%.

Consolidated adjusted EBITDA, which includes the $17 million pension headwind, is now expected to grow about 5%, with Government Operations now anticipated to be lower than previously expected at $395 million due to labor issues. Commercial Operations is expected to be slightly better than prior guidance at about $50 million. We also anticipate lower corporate unallocated costs for the year. This overall outcome was enabled by a diverse set of businesses and end markets, all pulling together to achieve a great operating result. Many companies in our industry have sought to hold or end up at the lower end of their operational guidance, whereas we are proud to be able to drive all year to the upper end of our initial operating range. We started 2022 with mid to high single-digit EBITDA growth guidance on ex-tax pension basis.

And today we are affirming that we're – we will be squarely in the upper end of that guidance range, growing nearly double-digits on that metric. However, we anticipate some modest non-operational headwinds, including a higher tax rate as well as a little less income from other income from minor foreign exchange losses that will dampen overall EPS performance. The summation of these operational and non-operational factors is keeping non-GAAP EPS relatively stable from prior guidance. We now see earnings in a tight range of $3.10 to $3.15 per share. The EPS guidance bridge is on slide 8.

From an operating cash flow standpoint, we still anticipate a broader range of $260 million to $290 million as working capital items can fluctuate at the end of the year. Given the R&D tax amortization legislation has not changed as well as overall net income performance to-date, we expect to land in the low end of that range. I will note that currency hedging activity to neutralize key balance sheet items expresses its benefit in the financing section of the cash flow statement under settlement of forward contracts. Those hedges provided over $10 million of cash settlement proceeds in the third quarter and we are tracking well to have an equivalent cash inflow from financing in the fourth quarter this year. On the CapEx side, we have revised our expectation to less than $200 million this year. This change was driven by a combination of a slower ramp in spending on some of our investments, primarily Project Pele as well as some modest savings from rationalizing and reprioritizing spend.

Before turning to our preliminary 2023 outlook, I did want to make a few comments on our recent balance sheet enhancements through an improved capital structure. Last month, we amended and extended our credit agreement, resulting in $250 million of additional liquidity at generally the same or more favorable terms, including an enhanced interest rate pricing grid and generally better flexibility. While we don't currently anticipate a need to utilize this expanded liquidity, we did want to take advantage of the favorable environment for companies like

BWXT that lenders see as stable credits in this unique financing environment. BWXT now has no debt maturities until 2027.

Turning now to preliminary 2023 outlook that we have summarized on slide 9 of the earnings presentation. Overall, we expect to see another strong year of operational growth that is likely to be more than offset by below the line headwinds, namely lower non-cash pension income and higher interest expense. Operationally, we anticipate mid-single digit revenue growth driven by the Government Operations segment with the main driver being the ramp up of the Project Pele microreactor as well as some modest anticipated growth in our uranium processing activities. Our naval nuclear reactors business is expected to remain roughly flat next year.

In Commercial Operations, we anticipate that the growth in BWXT Medical will be offset by a downshift in field services after strong volumes in 2022 from that business line. Margins should expand, given various dynamics in both segments.

In Government Operations, not only do we anticipate better margin contribution for more technical services work, but we expect to claw back labor volume and associated efficiencies as the year progresses. Initially, the benefits from creating [ph] non-cap (00:20:43) CapEx long-term capacity and efficiency won't bleed through until we move past the shorter term headwinds of having a newer workforce. Next year, we are seeking to simply maintain margins in our core Navy business, but should begin to build on that over the medium term. Finally, in this segment and as we have highlighted in our last 10-Q filing, we continue to explore opportunities for recovery of contract changes and associated cost growth related to non-nuclear components. We help stand up the American manufacturing of some of these key components and have absorbed unforeseen costs related to changing work scopes and design instability in the execution phase. We intend to seek adjustments for the past few years of grappling with this situation and bearing the costs through our bottom line.

In Commercial, margins are anticipated to expand as a lower mix of field services relative to a growing medical business will serve as a tailwind. All of these factors will enable consolidated adjusted EBITDA growth to outpace revenue growth next year.

As we highlighted on our last earnings call 2023 is setting up to potentially experience some meaningful non-operational and non-cash headwinds which are expected to dampen our earnings outlook. We will finalize estimates for pension asset and liability balances as part of our standard year end process and we'll specifically guide to these non-cash and macro driven items on our fourth quarter earnings call in February.

As a preview, we are using the latest September 2022 asset performance and forward interest rate curves to provide an initial outlook. We currently anticipate about $55 million of headwinds for both non-cash pension income and interest expense. Similar to the relative magnitude seen by several of our defense peers. The most significant component of next year's non-operational headwinds is the accounting treatment for pension expense and income, which is presented in the other income line of the P&L.

Last quarter, we provided the sensitivities related to pension accounting's impact on the income statement, and we are enhancing that by providing a table in the appendix of the presentation that depicts our pension estimates for next year against asset returns and discount rates. Currently, return to discount rates suggest a $40 million non-cash FAS pension headwind given year-to-date asset returns down about 25% and a discount rate that has moved up almost 300 basis points from the start of the year. So simply put, standing here today, that other income line to which we just guided a $48 million number to you in 2022, could be under $10 million in 2023. As a reminder, non-cash pension income is an add back in operating cash flow. So there's no cash impact from this reduction to income, nor does it affect the strategic and operational condition of the business. Higher discount rates also enhance the funded status of the pension, which will likely finish the year at a nearly fully funded position. We continue to anticipate no material non – no material cash contributions to the pension in the years ahead.

For interest expense, we anticipate a headwind of about $15 million, driven by significant increases in interest rates applied to our floating rate debt, which currently stands just above $500 million. Broadly, projected interest rates are up about 275 basis points compared with this year's weighted average. Lastly, for 2023, we continue to focus on achievement of another important aspect of our medium-term guidance, the inflection in free cash flow and conversion of earnings into cash. Next year, we anticipate about $200 million of free cash flow, which will be driven by improvements in operating cash flow management across the business and a significant moderation of CapEx. There has been no change to our view that after several years of significant investment and too large capital campaigns, that we will be able to return to the maintenance levels of CapEx of roughly $100 million, with the need for only tens of millions of dollars for any top up strategic investments. A prime example of incremental strategic investment is the Pele micro reactor project, which can be supported by bite sized amounts of capital. That project in particular only requires $30 million or less of incremental CapEx, most of which we expect to place throughout 2023. With years of solid investment across the company's facilities, we believe we can sustain and accelerate the strong adjusted EBITDA growth rates we are delivering this year and that we anticipate for next year. And with that, I'll turn the call back to Rex for some closing remarks.

Rex D. Geveden

President, Chief Executive Officer & Director, BWX Technologies, Inc.

Thanks, Robb. We remain excited about the underlying growth of the business this year and next that is largely masked by exogenous factors and are committed to navigating near-term operating and macro market challenges which do not change the long term trajectory of the business. BWXT's growth verticals across multiple defense and commercial markets are building rapidly, and the backdrop for nuclear solution remains extremely positive. This gives us continued confidence in our plans to accelerate growth over the medium term, and we thank our shareholders for embracing the value of the core businesses and our growth aspirations. We now look forward to taking your questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question comes from the line of Bob Labick with CJS Securities. Please go ahead.

Robert Labick
Analyst, CJS Securities, Inc.

Q

Good afternoon. Congratulations on the priority review.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. Thank you, Bob. Big, big day for us.

Robert Labick
Analyst, CJS Securities, Inc.

Q

Yeah. No, it's great. So I just wanted to, kind of following up on that a little bit, could you give us an update now on next milestones timing and if there may be, in fact, an opportunity for initial sales late 2023 or what your timeline for that is, given that you have the priority review in hand now?

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah, sure, Bob. So the way that looks is send you a letter with a priority review designation, along with a bunch of questions that we need to answer. And then they perform a – in the next – over the next month or two month, a sort of a facility inspection of our product line, our manufacturing line in Kanata. The timeline that they commit to on a priority review is six months. But there's some discussion around that point. When the FDA gets to a place where it requires more information from the producer of the product, BWXT in this case, they kind of hit the snooze button on the clock, and so it pauses for a period of time.

And so we've always hedged that by saying that the timeline is something like six to nine months. And I think that's still that's still consistent with our view. So great to get the priority review and so I'd say the timeline is six to nine months. As to any product sales in 2023, we do expect those to be modest because recall that we're using the research reactor at Missouri, the MURR reactor, to irradiate our target material in the beginning and that means we can only offer a limited suite of products to the radio pharmacies. The real growth comes from when we're irradiate our target materials on the Darlington reactor that belongs to OPG. And so I'd see that business building nicely into 2024 and 2025. So I'd say modest expectations for 2023 as we see the market and create demand and start entering into long-term supply agreements.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Yeah Bob. I'll just remind you that as we laid out that page for BWXT Medical that built on those couple different businesses, we were really not expecting much of anything from – in 2023 to hit those statistics that we outlined. The underlying business is actually doing quite well. We're really scratching as we had outlined to you up in Kanata that business is go – is getting to about a $60 million run rate business that we expect a teens growth rate next year as well. So it's building quite nicely. We hope to get some sales possibly in 2023, but that really won't impact ultimately delivering on the financials that we've laid out for you at the Investor Day and we've [ph] affirmed (00:29:53) recently.

Robert Labick
Analyst, CJS Securities, Inc.

Q

Okay. Great. And then as it relates to the Target Delivery System, TDS timeline, how does that work as it relates to the review for the current generator? And so I guess first we have that installed this year early next and then what's the timeline on that product coming to market? I think you just said obviously 2024 and 2025 and beyond, but just maybe give us the steps that we should look forward to on the TDS installation.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. So the way that works, so I'll talk about the implications for the FDA application and then talk about the timeline for the TDS. So we're in the we just started installing that onto the Darlington reactor unit number two actually, and that will go on over the next several months and be completed sometime next year. As it relates to our FDA application, what happens there is we'll get approved, hopefully, for our product manufacturing configuration in Kanata, which you've seen, but also for the irradiation source, which in this case is the MURR reactor. Because the neutron spectrum does matter to the FDA, the different neutron spectrum can create slightly different product characteristics. And so you have to account for that in the application. And so what we would do is, assuming approval in our current configuration with the MURR reactor, we would submit a supplemental application to the FDA for irradiation at the Darlington site. Now that's typically a shorter timeline. So think of that as two or three month approval timeline would be typical and so, that's how that'll work. After we receive the approval on the initial configuration, then we would supplement.

Robert Labick
Analyst, CJS Securities, Inc.

Q

Super. Very exciting stuff. Congratulations. I'll jump back in queue.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. Thank you, Bob.

Operator: Thank you. The next question comes from the line of Scott Deuschle with Credit Suisse. Please proceed.

Scott Deuschle
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey. Good evening. Thank you for taking my questions.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Hi Scott.

Scott Deuschle
Analyst, Credit Suisse Securities (USA) LLC

Q

Rex, are the labor challenges more acute – are the labor challenges more acute in retention or is it more about hiring new talent? I know the two kind of go hand-in-hand in terms of the net shortfall, but I'm just curious, I would think the productivity would differ between those two groups. So, just curious if you can disaggregate the labor challenges for us a little bit more. Thank you.

Rex D. Geveden

President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. Certainly, certainly, certainly both of those factors are conspiring against the business right now. To think about how attrition is impacting the business, I'll take that one first Scott. Typical attrition for our business would be kind of mid-single digits historically. And in that I'm talking about both kind of planned attrition, the standard – the kind of forecastable retirement rates, along with some unplanned attrition, that would typically, let's call it 6% in the business, historically. That number's crept up into the high single digits over the last year or two. And so we've got a higher turnover rate and when you think about that on the scale of a workforce of 7,000 people, so think of that as, turnover in the range of 500 or more over the course of a year and that's what we're facing right now. And so that is a challenge. We've tried to hire a net 500 this year, we are trying to hire a net 500 this year. We've been – we've succeeded in hiring over 800, but we've also lost in a range of 500 so we've netted about 250 to 300 along the way. So, that's the kind of churn that we are dealing with. And as you imply in your question, that affects us in a couple of ways. One is, obviously, we're not ramped up fully to our workforce plan, which impacts production and also absorption. But the second thing is, obviously, with new workers, we have a higher learning curve and we've also got more intense training requirements. And so that's kind of the two-part problem that we're dealing with.

Scott Deuschle

Analyst, Credit Suisse Securities (USA) LLC

Q

That's super helpful. Has the attrition gotten any better in recent weeks as people maybe digest the slower macro environment and risks of going somewhere beyond BWXT? Has that dynamic that you've just described, has it changed at all in the past month?

Rex D. Geveden

President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. We're seeing it. We're monitoring this every day, obviously. But if you look at the month to month numbers, it looks like our attrition peaked in about the middle of the year and has been improving sequentially since that time modestly, but it has been improving. So, I think we've hit an inflection point on that one. And as to the latter point, I do believe that the challenging macroeconomic environment actually favors a company like BWXT, I mean for a couple reasons. One is that, with reduced 401(k) balances, we see a lower retirement rate and that helps a little bit. But the other thing, of course, is that as you as you walk into a recessionary period, stability starts to have a higher value than it does maybe in the past couple of years. And so, so we expect that attrition rate to move favorably for us if the economy does weaken like we anticipate it to do.

Scott Deuschle

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Well, I can attest to the point on 401(k)s. Just for Rob, quickly for you, can you walk through the working capital trends you're expecting for the business over the next few years? I think that's been an area of focus for you so just curious of what your thoughts are on working capital and the opportunity for improvement near-term or the medium-term as well? Thank you.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Yeah, yeah. We monitor that pretty closely. We've got a lot of different efforts going on. As you know, it takes some time to get the analysis straight and to actually figure out where you're going attack. But if you've been watching our trends our managed working capital has kind of been flattening out the past couple of quarters. And we expect next year some of the big headwinds that we had this year, specifically the steam generator project that we brought up in the past, we're seeing sort of our worst year of headwinds of about $20 million headwind this year. We've called that out in the past. That's going to flatten out and not be a headwind next year we hope, that that's our plan in terms of what we look at from a billing standpoint. And then it will get positive in 2024 and 2025. So that's been the biggest kind of headwind overall to managed working capital.

And then I would just call out [ph] 1z, 2z things (00:36:09) that we're just going to look through procurement, supply chain, and really get after some of our terms, how we're billing our customers. We have a good handle on where the opportunities lie and now it's just really getting our hands around it. So we've been looking at working capital days and percentage of sales and we think both of those can really be driven and I think will be successful in 2023 and beyond.

Scott Deuschle
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you so much.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Thank you, Scott.

Operator: Thank you. The next question comes from the line of Pete Osterland with Truist Securities. Please go ahead.

Peter Osterland
Analyst, Truist Securities, Inc.

Q

Good evening. I'm on for Mike Ciarmoli tonight. Thanks for taking our questions. So first, I just wanted to clarify on the labor situation, it sounds like it's mostly impacting the Government Ops business and you're not seeing similar issues regarding labor in Commercial Ops. Is that correct and what's driving the difference there?

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah, so it's mostly correct, Pete. The factors that differentiate those businesses are we tend to have a slightly older workforce in our government businesses, particularly in the Navy manufacturing business. And so, we've seen higher retirement rates. I think people sort of rethought their personal considerations when they went through the COVID period. So, that's part of it. It's also that's the part of the business that has the most intense touch labor in it, the craft labor and so that's where you feel it the most acutely, I would say. And then the other side of that is, I would say that we are experiencing that same labor problem in other parts of the business, but the growth is sort of masking it out. I mentioned on a couple of calls this year the challenge we've had in finding qualified rad techs in our medical business, for example, which actually lengthened our campaign for the Tc-99m program. But the growth has overwhelmed it there, frankly and so it's just showing up more in the Navy business.

Peter Osterland
Analyst, Truist Securities, Inc.

Q

Okay. That's helpful color. Thanks. And then switching gears, I just wanted to broadly ask on the SMR smaller market, what do you think so far in terms of the competitive environment? How much competition is currently out there for the content that BWX would provide on SMRs and what do you see as a base advantage in capturing growth in this market?

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. I think we're in a really good competitive position in that market and it's because of where we positioned ourselves strategically in that market. I'd say the competition is most intense at the level of reactor design and supply. Those whom are marketing, designing small modular reactors, although I think they can – many of them can win because the demand is going to be impressive, I believe, in the long run. But where we sit is kind of at the top of the supply chain and would look to supply companies like GE and others who are at the time who are, let me call them prime contractors. The reason that we stand out, BWXT stands out in that market, is because we have capabilities for manufacturing large components that are unmatched in North America. We mentioned here in the script that we have the largest nuclear manufacturing clean room in North America. We manufacture fuel, we design components, we design nuclear reactors. And so we can really answer the mail for a lot of companies who are attempting to sell reactors in that market. And so – and we've been, let me call it, design agnostic, a merchant supplier kind of, if you will. And we feel very well-positioned for the uptake in that market.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

I might add just from an overall geography, as you know, we're based in Canada, that country and specifically the province of Ontario, has really been forward leaning just about how much nuclear can be part of the clean energy solution. And so that's allowed us to essentially be in business for building new stuff while other geographies were not. And so we've continued to maintain such a unique posture in that market. And then if you would going to see what they're doing on the SMR side they're really forward leaning there too. So having that position, that incumbency position, and then also seeing where they're going on the SMR rates really kind of allows us to be on the forefront. And we see that a couple of years earlier than some other players in other geographies. So that's been a – [ph] so now it's better to (00:40:45) be lucky than good.

Peter Osterland
Analyst, Truist Securities, Inc.

Q

All right. Great. Thanks for taking the questions.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Thank you.

Operator: Thank you. The next question is from the line of David Strauss with Barclays. You may proceed.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Thanks. Good evening.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Hey, David.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Hey, David.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Hey. So your guidance for government growth for the full year implies a pretty big fourth quarter, could you just run through what's driving that exactly? Are you counting on a recovery on the labor side to be able to get there?

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

No, we're not counting on the labor. So generally, our fourth quarter always is the time that we're sort of snowplow all the efficiency efforts that we have all year and sort of open up [indiscernible] (41:40) take a look. So, that's just a natural time that we look at our business. Secondly, as you know, some of the businesses that we've announced over the course of the year, both Savannah River as well as SCO, you really had to ramp up to a certain level and gain efficiencies. So, that'll be a big quarter there. The last one I would call out is we do have some really good growth in our non -- what you think of as our core certain nuclear operations businesses around both down-blending and new metal and those businesses are just lining up to have a very good fourth quarter. So when you swirl that up, it seems achievable. It definitely is a large quarter, but we think we're going to hit that for the fourth quarter.

David Strauss
Analyst, Barclays Capital, Inc.

Q

Okay. It looks like you're implying double-digit growth for the fourth quarter, just want to make sure. Okay. And depreciation is that in factored is a big step-up in depreciation, does that still factor in as a headwind next year as well, at least from a bottom line EPS standpoint?

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

It is, David. As we were thinking about -- I mean, there's a couple of different things just roll off depreciation, as you say, will be an incremental headwind across the business and particularly in energy, right? They finally brought on some of their capital. It's taken a little while to get that productive. So we had a little bit of a lighter result in 2022 than we thought and that's what we've brought down ultimately over the course of the year, the depreciation, we'll get that load to the tune of about $5 million or $10 million headwind to earnings next year.

The second item that we've called out for you is the $55 million of sort of below the line headwind that really comes from the $15 million of interest expense, that's from that $0.5 billion of sort of revolver that we have, that those rates have gone up almost 3%. And so you just take 3% on the $0.5 billion that gets you to $15 million. And then the other part of that $55 million is the $40 million that we have from pension. As you know, that's really broken down into two pieces which is the asset performance underlying. We're pretty fully funded a little bit over $1 billion of both assets and liabilities. And when you just think about -- we're generally expecting about a 7% return there. As that balance has come down about 25%, that's about half of the $40 million, so that's about $20 million of the $40 million. And then the other $20 million is just what's going on with interest rate. So the liability has come down, but the interest rate has gone up over 3%.

And so you've got a doubling of the interest rate on your liability balance. So on first glance, you think the liability is -- yeah but then you have that that second impact. So you have the depreciation, you have the interest, and then you have the two components of the pension, and all of that we hope are sort of the bad guys. We actually see pretty good prospects next year for growing our business. We talked about the sort of mid-single-digit revenue growth overall and, hopefully, margin improvement. That sort of says your EBITDA could grow 5%, 6%, 7%. And so when you just look at what our EBITDA this year and you take that 5%, 6%, 7% and we started last year also at a similar posture, right, of mid-single digits and we hope to work higher.

But you should be able to sort of claw back at that $55 million and that a little bit of depreciation headwind. All that being said, it's going to be challenging next year. We're kind of at $310 million to $315 million but when you throw all of that up, I think you're going to have a very good underlying operating result. But offsetting that $55 million, it's going to be hard to probably clear more than, say, $3 a share. So all year, we're going to be clawing at that and we'll see where all of those pension and interest items come over the year, but that's kind of what we're aiming for next year.

David Strauss
Analyst, Barclays Capital, Inc.
Q

Great. That's helpful color. And then just to follow up on the prior question, the $200 million free cash flow next year, Robb, are you baking in neutral working capital or are you baking in some sort of net working capital headwind into that number?

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.
A

Yeah. So as we've said that our – let's deal with the easy one which is CapEx, nothing's changed there. And then I'll maybe outline a little bit about where we stand on operating cash flow for this year as well as next. So on a CapEx basis, we still see about $100 million of maintenance CapEx. And then we're – one of the reasons we downgraded CapEx guidance is that we just haven't deployed a significant amount of that SCO-related Project Pele CapEx. And so if you think about where we started the year, we were at $180 million to $200 million, call it $190 million, and we were able to spend $5 million – we'll see how the fourth quarter goes, $5 million to $10 million on that SCO project. And so that stub, if you will, of the remaining $25 million to $30 million will come on top of the $100 million next year. That's how we're seeing sort of 2023. So, that's the CapEx part of the equation.

And then on an operating cash flow standpoint, we do see a good improvement versus our guidance this year which is $260 million to $290 million. I think we've been running at about a $300 million LTM number. We'll see how we come in the fourth quarter. But I see doing greater than $300 million obviously in order to get to that $200 million next year. And so those are all those initiatives that we talked about earlier that just take some time to bear fruit. So I see you know no greater than $300 million by about that $120-ish million of CapEx if you throw all that up, that's where we're getting, the around the $200 million of free cash flow number.

David Strauss
Analyst, Barclays Capital, Inc.
Q

All right. Great. Thanks very much.

Operator: Thank you. The next question comes from the line of Peter Arment with Baird. Please proceed.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. Good evening, Rex and Robb. Hey, Rex, congrats on kind of the commentary around the SMR work. Can you give us a little bit of understanding of the cadence of how revenues would begin to be reflected? I know that Darlington, like [indiscernible] (47:56) has selected that to be kind of target for 2028. So how would that impact for you guys from a revenue perspective? Thanks.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. We said earlier, Peter, a couple of calls ago, I think that we expect revenue opportunities in the range of $100 million for each of those small amounts of the reactors that are of the GE type. And it's kind of similar to the situation that we saw on the refurbishment projects in Canada in the sense that a lot of the long lead material, design work, hardware work gets done early. And so that favors us from a revenue perspective because we're getting into design work for that reactor vessel right now. And so we would expect to be ordering long lead materials probably as early as next year. So that would ramp relatively soon for us.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc.

Q

It's terrific. And then just back to the labor commentary, so you said I think in your prepared remarks you're running about 10% below the head count plan and then you walk through some of the differences on attrition. Is that – should we expect you to try to do a similar plan for next year as you kind of continue to scale up and just wondering if you're approaching the labor market any differently as you're thinking about it now? Thanks.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. One correction, Peter, what I said in the script was we're off as much as 10% at certain sites. If you look at the aggregate number, it's more like 5% across the entire business. But I think we're not planning with the expectation of dramatic improvements in the labor market for next year's plan particularly because of the two factors that I talk about which are, one, is the attrition rate itself and being able to hire to our growth. And we do see more growth next year and so it's another -- it's an even higher hurdle. And then, of course, we have some efficiency challenges around new employees that are unique to this labor environment. So I'd say we're not planning on our thinking is not that we're going to have a full recovery from that problem next year.

Peter J. Arment
Analyst, Robert W. Baird & Co., Inc.

Q

I appreciate that. Thanks, guys.

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Yeah. Thanks, Peter.

Operator: Thank you. The next question comes from the line of Tate Sullivan with Maxim Group. Please proceed.

Tate Sullivan
Analyst, Maxim Group LLC

Q

Hi. Thank you. On your comments about the 2023 outlook and with what you've commented on the labor market, what are the sources of the expanding margins in 2023 if you can comment on some of the drivers there, please?

Rex D. Geveden
President, Chief Executive Officer & Director, BWX Technologies, Inc.

A

Okay.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Yeah. There's a couple factors that we have maybe we just move through the couple of different businesses. So as you know, our mix and government operations will improve over the course of the year. We do expect, as we've said, to try to claw back some of those non-nuclear businesses, those could come in at a high margin because we're basically taken the pain there, so that's one contributor.

The second contributor is that as we build our TSG business, as you know that doesn't come with revenue. And then as we just bring on a better base of microreactor business within AT, that's just absorbing the overall cost better. So those are our main businesses. And the final one I'd call out is within the non-nuclear operations business. We're really ramping a contract there which looks very similar to our down-blending contract that we've called out of new metal. So we're doing a processing business, that also is a high-margin business that we'll be ramping next year. So that's sort of the government operations part of the story.

In 2023 versus 2022 for the commercial business specifically, that really comes down to we've had a blockbuster year in field services overall in terms of dollars of profit, but those are a little bit lower margin for us relative to other businesses we have in that legacy NPG segment. So that will drop away whereas the BWXT medical really has higher margins. So you're really kind of dropping field services, lower margin for higher margin, base of business there would be the BWXT Medical.

Tate Sullivan
Analyst, Maxim Group LLC

Q

Great. Thank you, Robb. And then can you just review the comments on CapEx? So with the slightly lower CapEx for 2022, the timeline – anticipated timeline to reduce the maintenance CapEx levels. And then what's the reasonable decline in CapEx if you can comment on it for 2023?

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Yeah. I mean, overall, I really don't think anything's changed. Our overall commentary, we basically had the $180 million to $200 million this year. We bumped that by, as you recall, I think it was last quarter by $15 million, just basically trying to draw a line in the sand of saying half of that. We've estimated the SCO bill to be about $30 million. We really didn't get after a full load of that. So we're kind of coming in at our midpoint overall of non-Pele and then just a little bit and we'll see how the fourth quarter goes to tuck us under the $200 million. And then whatever's left, let's just take – if we only spent about $5 million of the Project Pele in 2022, well then the remainder of, call it, $25 million to get to a full $30 million we hope to do it for less than $30 million. We have line of sight to that. But if you just take that that scenario, you would layer $25 million on top of the $100 million that we've been talking about for maintenance to ultimately have a CapEx guide next year of $125 million.

And from that point, we're kind of at that – that project, we're hoping to deliver that prototype in 2024. So Project Pele will kind of be behind us, we think, in 2023. And then you'll be back to kind of $100 million cadence, if you will, for 2024. Now, why would that change? We are vying for a special project that will require some outfitting of the facility that we're in for Project Pele. But there are some different things that we're doing on the fuel side specifically on the DARPA project, the DRACO, some of you know about, that might drive a little bit of CapEx over and above that kind of $125 million next year, the $100 million if you will in 2024.

And then the other big one that's on the horizon that we're seeing some good progress on is in our nuclear medicine business. So as you know, our strategy there, as we outlined and posted on our website, is really about building into the therapeutics market, starting with the API – the active pharmaceutical ingredient which we have the facilities and are sort of unmatched in our capability now with all the different sources we have over radiation to pull off some of those unique therapeutics but really so we kind of have the capital on the ground for that part. What we don't have the capital on the ground for is what we do for things like [indiscernible] (54:59) where we're actually building the drug. So now that we have the API and we have line of sight on some of the most important ones we mentioned on the call, both with TCM as well as actinium, those are kind of the leading therapeutics, the API side of things.

But if we get into contract drug side of manufacturing, those come with generally multiyear contracts locked in volume, locked in pricing and you have to stand up some, again, tens of millions of dollars. You can think about a [indiscernible] (55:26) project where we come to you and say, we just want a new drug. We're going to do this. We're ultimately going to go through clinical trials and go on to production. And so that's where you'd, again, get a $20 million to $30 million step-up of a strategic capital investment over and above that $125 million if you will. So those are the two areas something on the microreactor side or something on nuclear medicine.

Tate Sullivan
Analyst, Maxim Group LLC

Q

Thank you very much, Robb.

Robb A. LeMasters
Chief Financial Officer & Senior Vice President, BWX Technologies, Inc.

A

Sure. Thanks, Tate.

Operator: Thank you. [Operator Instructions] There are no additional questions at this time. I will pass back to the management team for closing remarks.

Mark A. Kratz
Vice President-Investor Relations, BWX Technologies, Inc.

Thanks to you and thank you, everyone, for joining us today. If you have further questions, you can reach us by phone at 980-365-4300 or or by email through investors@bwxt.com.

Operator: That concludes today's conference call. Thank you. You may now disconnect your line.