SPAR - Q3 2018 Spartan Motors Earnings Conference Call
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Company Representatives:
Juris Pagrabs; Group Treasurer and Director of Investor Relations
Daryl Adams; President and Chief Executive Officer
Matt Long; Interim Chief Financial Officer

Analysts:
Matt Koranda; Roth Capital Partners
Ryan Sigdahl; Craig-Hallum Capital Group LLC
Steve O'Hara; Sidoti & Company

Presentation

Operator: Good morning, and welcome to Spartan Motors 2018 Third Quarter Conference Call. [Operator Instructions]

This call is being recorded at the request of Spartan Motors. [Operator Instructions]

I would now like to introduce Juris Pagrabs, Group Treasurer and Director of Investor Relations for Spartan Motors. Mr. Pagrabs, you may proceed.

Juris Pagrabs: Thank you, Keith. Good morning, everyone, and welcome to the Spartan Motors 2018 Third Quarter Earnings Call. I'm Juris Pagrabs, and joining me on the call today are Daryl Adams, our President and Chief Executive Officer; and Matt Long, our Interim Chief Financial Officer.

For today's call, we've included a presentation deck, which will be filed with the SEC and will also be made available on our website at spartanmotors.com. You may download the deck from the Investor Relations section of our website and follow along with our presentation during the call.

Before we start today's call, please turn to Slide 2 of the presentation for our safe harbor statement. You should be aware that certain statements made during today's conference call which may include management's current outlook, viewpoint, predictions and projections regarding Spartan Motors and its operations may be considered forward-looking statements under the Private Securities Litigation Reform Act of 1995. I caution you that, as with any prediction or projection, there are a number of factors that could cause Spartan's actual results to differ materially from projections. All known risks that management believes could materially affect the results are identified in our Forms 10-K and 10-Q filed with the SEC. However, there may be other risks that we cannot anticipate.

Please turn to Slide 3. As of January 1, 2018, the company adopted the new revenue recognition standard, ASC 606, using the modified retrospective transition method. The adoption had minimal impact to net income in Q3. As a result, reported consolidated sales from cost of products sold were lower by $4.9 million and $4.6 million respectively. Consolidated net income net of tax was about $200,000 lower. The adoption reduced reported consolidated backlog by $32.2 million, reducing both FVS and ER reported backlog by $9.3 million and $22.8 million respectively.

For more details regarding ASC 606 and its impact on the company's financial results, see the company's quarterly report on Form 10-Q filed for the quarter ended September 30, 2018.

On the call today, Daryl will provide an overview of the third quarter alongside a business update, and Matt will provide a more detailed review of the third quarter results and our outlook for the remainder of the year before proceeding to the Q&A portion of the call.

At this time, I'm pleased to turn the call over to our Daryl for his opening remarks.

Daryl Adams: Thank you, Juris. Good morning, everyone, and thank you for joining us on our third quarter conference call.

The Spartan team's performance this past quarter was exceptional in the face of so many significant cross-industry challenges. I'm extremely proud of how they handled this adversity. The third quarter proved to be very challenging and difficult for Spartan Motors, as all three of our business segments faced increasing operating pressures fueled by an incredibly robust but volatile business environment.

Going into the quarter, we were optimistic that most of the headwinds encountered in Q2 were behind us, primarily commodity costs and chassis shortages, based on aluminum and steel pricing and what our OEMs were telling us. However, these headwinds continued in the third quarter, and in some cases escalated, having a negative impact of approximately $6 million on our quarterly bottom line results.

If not for the significant industry-wide headwinds and the operating issues we sustained as a result, we would have achieved results well ahead of our internal operating plan for the quarter. I want to emphasize that despite the headwinds, the underlying business and operational fundamentals in each of our segments remained incredibly strong. Order activity remains robust in all segments, particularly at FVS, and its related backlog, including the multiyear USPS truck body order, is up 48% compared to a year ago. With that, let's review the quarter and the headwinds that negatively impacted the quarter.

Revenue for the third quarter rose 19.6% to $226.2 million from $189.2 million a year ago. The increase in sales was driven by strong growth in FVS and SCV, partially offset by a decline in ER. Our strong top line results benefitted from increased volume related to USPS truck bodies, Reach vehicles, improved production volume at our vehicle upfit centers, primarily relating to an e-commerce order and strong luxury motor coach chassis sales.

Gross profit margin decreased 350 basis points to 11.6% of sales from 15.1% of sales, which includes significant material cost headwinds of approximately $3.5 million, fueled by tariff-driven increases in commodity and component costs. This is in addition to the $1-million headwinds we incurred during Q2.

While we have taken pricing actions to offset these costs when available, we are seeing large purchase component pricing increases from major suppliers. We do expect some of these tariff-driven headwinds to continue into 2019 based on industry-wide conditions, and we have proactively announced a 4% price increase effective January 1 in our ER segment.

In addition to the tariff-driven increases in commodity and component costs, our third quarter bottom line was negatively impacted by production and labor inefficiencies and shipment delays due to the following headwinds: chassis shortages and supply component delays during the quarter at our Bristol facility disrupted our workflow, causing a 10-day plant shutdown, created labor inefficiencies and led to additional operating expenses for overtime that was required to meet customer demand. Normally during such plant shutdowns, we would have laid off workers, but with the extremely tight skilled labor market that the entire industry is facing, we chose to keep them on our payroll to avoid longer-term disruptions.

On a positive note, after these delays were resolved late in the third quarter, our production efficiency rebounded quickly to over 90% and some weeks over 100%, which reinforces the significant impact these headwinds had on our operations, as well as our continued progress in operational fundamentals based on the Spartan Production System.

Driver shortages and freight logistics difficulties continued to have direct impact on getting components and chassis on time to meet production timetables and our ability to deliver finished vehicles to our customers in a timely manner. Freight disruptions also negatively impacted our launch at our Ladson, South Carolina, facility in support of our new e-commerce upfit order. As a result of an aggressive customer-dictated launch plan, we incurred unplanned startup costs of approximately $350,000 related to expedited procurement and shipping costs.

Additionally, due to Hurricane Florence, we sustained a weeklong plant shutdown, further disrupting operations in South Carolina. We also experienced labor shortages at multiple locations, particularly in Charlotte, Michigan, contract manufacturing facility during the quarter, which impacted our Isuzu N-Gas production capabilities and shifted units into subsequent months. As you can see, the litany of increased operating pressures we faced during the quarter significantly impacted our profitability.

For the third quarter of 2018, net income decreased to $5.2 million, or $0.15 per share, compared to net income of $13.5 million, or $0.38 per share, last year. The prior year net income does include benefit from a $6.3 million or $0.18 per-share tax valuation allowance adjustment due to the company's improved financial condition. Despite the tough operating environment, I am pleased with the underlying fundamentals of each of our business segments.

Now please to turn Slide 5 so I can provide an update of a few business highlights and developments, starting with FVS. Last mile delivery, including refrigeration, continues to expand and represents a significant growth opportunity for us. As we've indicated in the past, we've been working closely with some of the largest and most innovative parcel and grocery delivery companies to provide them with solution-based vehicles, upfit products, including new refrigeration capabilities, and electric power chassis.

Last month Amazon and Mercedes announced a 20,000-unit order for the Sprinter cargo van. We are currently operating in Mercedes' ship-through facility located in Ladson, South Carolina, north of Charleston, producing customer-specific upfits at a rate of 70 per day. As we indicated last quarter, we anticipated the customer order could be split across OEM platforms.

We are happy to report that we have been awarded an 1,800-unit order on the Dodge ProMaster platform for the same e-commerce customer. We will produce the upfits in our ProMaster ship-through facility located in Saltillo, Mexico. We continue to make good progress on a 2,141-unit truck body order for the USPS. According to plan, we are producing seven to eight units per day, and as of third quarter, about two thirds of our $80-million revenue target for 2018 has been recognized.

Our work-driven design process, blending customer needs with vehicle and upfit-based solutions, continues to drive sales across multiple product lines and locations. Most recently, both Frito-Lay and UPS selected Spartan's Utilimaster go-to-market brand to supply them with innovative Class 3 truck bodies called small packs, some of which have refrigeration capabilities as well.

As e-commerce grows and the overall parcel delivery landscape changes to more and smaller package deliveries, longtime customers such as UPS have responded in kind. Most recently, UPS has contracted Spartan Utilimaster to upfit a fleet of 100 Dodge ProMaster vans.

Anticipating customer needs and responding to sustainability initiatives continues to be at the forefront of our investment in electrification. EV chassis development, in partnership with our customers and suppliers, will continue to receive attention in 2019 and beyond. Anticipating this future growth, we've worked hard to secure proven, well-established partners in the EV space. New suppliers such as Zenith and Cummins Electrified Power join Motiv to give Spartan first-to-market electric vehicle production capabilities across vehicles Class 1 through 6, including those that require refrigeration. Because we are the only one in the industry with this capability, Spartan and Utilimaster now have access to a broader base of customers who wish to supplement their fleet with electric power chassis.

Please turn to Slide 6, and I will continue with emergency response. Our ER business saw another successful quarter of profitability despite the industry-wide headwinds impacting the quarter. The operational changes we've implemented have resulted in continued improvements in productivity, efficiency, quality and profitability in our facilities.

At the end of the last quarter, we were working on a number of initiatives to improve our market position and enhance our margins. Our new order-to-ship process at Brandon is fully implemented and operational, and we recently started a manufacturing pilot of the same at our Snyder facility. This process improvement will take nearly 80 days out of the order-to-ship process and speed up delivery time.

We successfully shut down our fully integrated U.S. Tanker plant in Delavan, Wisconsin, into the Brandon facility located in South Dakota. We also successfully relocated the production of the S-180 Pumper to our Brandon facility to maximize both commodity and labor efficiencies.

As we continue to focus on acquisition-related disruptions, like removing dealer territory conflicts, during the quarter, we streamlined several single dealerships in the key Midwest markets and we expect to complete the dealer rationalization by the end of Q1 2019.

We have also initiated expansion of distribution coverage in Georgia and Florida, fifth largest U.S. market, and we solidified a long-term distribution contract with a Canadian dealer. And finally, now that we have earned professional engineering certification on the LTC aerial product line, obtained with this new acquisition, we are reintroducing these very popular aerial products starting this quarter.

Please turn to Slide 7, and I'll continue with Specialty Chassis and Vehicles. In the SCV segment, our momentum continues to grow in both the over and under-400-horsepower segments as we continue to gain market share with the current and new OEMs. I am pleased to report we added NeXus RV to our growing list of premium Class A diesel RV manufacturers. Powering their custom Class A chassis model, the Bentley Diamond, is Spartan's K1 360 chassis, a new entry for them into the Class A diesel space. Spartan's ability to penetrate and win in this market segment grants us access to both younger buyers as well as RV owners wishing to step down into a more nimble coach size without sacrificing the quality, durability and innovation they've come to expect from Spartan.

Business with our long-term customer Isuzu World Truck North America continues to grow. Production demands required us to add a second shift on our Charlotte campus, adding to our highly skilled and flexible workforce to support our contract manufacturing operations for Isuzu N-Gas and a new larger F-series.

With that, I'll turn the call over to Matt to discuss Spartan's financial results for the third quarter, as well as our outlook for 2018.

Matt Long: Thanks, Daryl. Please turn to Slide 9. As Daryl mentioned, the underlying fundamentals of the business remain strong, and the operational and organizational improvements we've made over the past two years have provided a solid foundation that will continue to drive profitable long-term growth for Spartan Motors despite the significant industry-wide headwinds that continued in the third quarter.

We responded as quickly as possible to these near-term challenges during the quarter and have implemented a number of proactive steps and cost reduction actions to help mitigate the headwinds, including continued rationalization of our manufacturing footprint, shutting down our ER tanker facility in Delavan, Wisconsin, and consolidating the manufacturing of the UST products in the existing Brandon, South Dakota, campus; move production of all S-180s from Charlotte to the Brandon campus; in so doing, all Spartan pumper manufacturing operations will be under one roof where we can leverage both commodity and labor efficiencies; and reductions at our Charlotte, Michigan, corporate office, primarily in office and support functions.

Third quarter adjusted EBITDA decreased 17.8% to $10.6 million from $12.9 million. Adjusted EBITDA margin declined approximately 210 basis points to 4.7% of sales from 6.8% of sales a year ago. Adjusted net income decreased 18.9% to $6 million from $7.4 million in the third quarter of 2017. Adjusted EPS declined to $0.17 per share from $0.21 per share, which excludes the $6.3 million, or $0.18-per-share, tax valuation adjustment. Our backlog at September 30, 2018, remained strong and ended at $484.9 million, compared to $537.7 million at September 30, 2017. We had $214 million of USPS truck body in backlog a year ago, compared to $159 million remaining at the end of Q3. Excluding the USPS order, backlog on a consolidated basis is up slightly year-over-year, reflecting solid improvements in FVS and SCV. As Juris mentioned, the reported backlog was reduced by $32.2 million with the adoption of ASC 606.

Please turn to Slide 10, and I'll walk you through the adjusted EBITDA bridge from our initial expectations to our actual results for the quarter. Tariff-driven increases in commodity and component costs resulted in a negative impact to adjusted EBITDA of approximately 21% compared to our initial expectations. Chassis availability, freight and the logistics issues combined negatively impacted our expectations by another 10%, while labor shortages and the impact of Hurricane Florence added another 6% or 7%. Partially offsetting these headwinds were the impact of positive pricing actions realized during the quarter, particularly in ER.

Now let's take a look at the results by operating segment, starting with FVS segment on Slide 11. FVS reported revenues of $118 million, compared to $78.6 million last year, an increase of 50.6%. The revenue increase reflects increased volume related to USPS truck body, Reach vehicles and upfits. Adjusted EBITDA decreased $1.6 million to $7.2 million from $8.8 million a year ago, largely due to an unfavorable sales mix, higher commodity and component costs, increased freight and transportation costs, and two plant shutdowns, one relating to Hurricane Florence and the other due to chassis shortages resulting in production and labor inefficiencies, as well as shipment delays.

Adjusted EBITDA margin decreased 510 basis points to 6.1% of sales from 11.2% a year ago. Backlog remains strong at $275.2 million, compared to $292.5 million at September 30, 2017. Excluding the multiyear USPS truck body order, backlog totaled $116.2 million, up 48.6% compared to $78.2 million at a year ago. And if you exclude the $9.3-million impact for ASC 606, backlog was up 60.5%.

Moving on to Slide 12. In the ER segment, third quarter 2018 revenue decreased $5.6 million to $60.3 million from $65.9 million last year, primarily due to lower volume and unfavorable sales mix, partially offset by improved pricing. Adjusted EBITDA in the ER segment decreased $1.9 million to $600,000, or 1% of sales, from $2.5 million, or 3.8% of sales, in the prior year. The decline in adjusted EBITDA reflects reduced volumes, higher commodity and component costs, as well as supplier disruptions resulting in production and labor inefficiencies.

Our ER backlog was $175.7 million, compared to $213.3 million at September 30, 2017, which reflects the $22.8-million reduction from adopting ASC 606, as Juris mentioned previously. Excluding the impact of 606, backlog was down $15 million, or 7%.

Let's move on to Slide 13 and the SCV segment. Revenue was up 5.5% to $51.7 million from $49 million, due mainly to a $1.9-million increase in luxury motor coach sales, chassis sales as a result of increased volume, driven by market share gains and continued strong industry demand. Adjusted EBITDA increased $800,000 to $5.9 million from adjusted EBITDA of $5.1 million a year ago, primarily resulting from the strong momentum in luxury motor coach chassis and partially offset by operating inefficiencies due to labor and chassis component shortages and higher commodity and input costs. Adjusted EBITDA margin increased 90 basis points to 11.4% of sales from 10.5% of sales a year ago. Backlog at the end of the quarter was up 6.6% to $34 million, compared to $31.9 million a year ago, reflecting continued strong luxury motor coach sales and corresponding Spartan chassis orders.

Please turn to Slide 14, and I will discuss the outlook for the remainder of 2018. It's been a challenging quarter, but we remain committed to doing everything we can to soften the impacts we have experienced to date. As we go forward, we are seeking additional ways to minimize our exposure to these headwinds as we believe they will persist through the balance of the year and beyond.

Based on our results year-to-date and these ongoing headwinds, we are adjusting our current outlook for 2018 as follows: Revenue remains unchanged in the range of $790 million to $850 million. Net income is expected to be between $14.4 million and $16.4 million, adjusted EBITDA in the range of $29.3 million to $31.3 million, effective tax rate of approximately 24.5%, earnings per share between $0.41 and $0.47, assuming approximately 35.3 million shares outstanding, and adjusted earnings per share of $0.42 to $0.48.

On Slide 15 you'll see a bridge we've put together explaining the revised suggested EBITDA guidance at midpoint for 2018. As you can see, we anticipate the tariff impact on commodity and the component costs to yield additional operational pressures, combined with the impact of chassis shortages, freight logistic issues and tight labor markets, to have a combined impact of approximately $10.2 million on full year EBITDA.

Turning to our balance sheet on Slide 16. Spartan's balance sheet remains strong. Total liquidity at the end of the quarter was $132 million, reflecting $15.7 million in cash and $116 million in a borrowing capacity, which is more than adequate to support our working capital requirements and acquisition opportunities as they present themselves. The borrowing capacity reflects a new $150 million secured credit facility that we upsized during the quarter from the previous $100 million facility. The new facility has a five-year term with more favorable financial covenants providing increased liquidity to fund our working capital needs, as well as our M&A growth strategy. In accordance with ASC 606, we have $43.6 million of contract assets on the balance sheet, representing revenue with corresponding profit recognized on products in process but not yet invoiced to the customer.

I would like now to turn it back over to Daryl for his closing remarks.

Daryl Adams: Thanks, Matt. Please turn to Slide 17. In summary, I want to emphasize that the underlying fundamentals of our three business segments remain strong. The hard work we've done over the past three years on implementing operational and organizational improvements to drive profitable growth is not lost. We will continue to work hard to deliver on our commitments.

Based on this new revised guidance for 2018 and headwinds still in front of us, including changing realities around low-cost country sourcing, many of you are likely questioning whether our 2020 targets of $100 million in revenue and 10% adjusted EBITDA margins are still achievable. We do believe our financial objectives remain obtainable, but not within the original timetable we outlined at our Analyst Day a year ago. Due to these recent supply disruptions and industry-wide headwinds, those financial objectives will now include our M&A growth strategy as well. While we anticipate these unfavorable industry-wide conditions to persist, our long-term expectations have not changed, as we see opportunities for continued margin expansion through 2020 and beyond, and we remain committed to our strategic plan. We will remain focused on executing an overall strategic plan, including our capital allocation strategy, which reflects funding our growth initiative, including acquisitions, and creating shareholder value.

Operator, we are now ready to take questions.

Questions and Answers

Operator: Yes, thank you.

And the first question comes from Matt Koranda with Roth Capital.

Matt Koranda: Hey, guys. Good morning.

Daryl Adams: Morning, Matt.

Matt Long: Morning.

Matt Koranda: Just wanted to see if we could look at Slide 15. It's a helpful bridge to your 2018 guide. But wondered if you could kind of cover each of those individual headwinds or buckets that you've kind of bracketed out as it pertains to 2019. I know you said that there are certain headwinds that persist into the early part of 2019, so is there a way to sort of build that bridge for us or help us understand which of those are sort of stronger headwinds than others as we head into next year?

Matt Long: This is Matt Long, Matt. We're still in the process of really getting our arms around 2019 as it stands right now. But a large portion of material is still probably questionable, depending on what happens with tariffs and so on. But from our perspective, many of these were certainly not anticipated on our part, so I don't know that we're yet ready to talk about '19.

Matt Koranda: Got it. Did the industry challenges change your view on your acquisition pipeline in any way or change your capital deployment strategy going forward? Just curious to get your take on that, and maybe, I don't know, does it make certain potential acquisitions soften up on price a bit if you're still willing to go that route?

Daryl Adams: Hey, Matt. This is Daryl. No, it has not. I mean, we view this as, as I mentioned, our business fundamentals are strong. The efficiencies came right back up once we had the chassis. So, we're trying to keep the team focused on things that we can control, even though some of these are uncontrollable to us. So, our M&A strategy remains, the pipeline's strong, we're still focused on the acquisition opportunities that were laid out in our strategic plan and our plan to build out our locations around the country. I'm not sure if we've seen any softening in the multiples yet of the acquisition targets, but obviously we're trying to get to the lowest cost we can when we're negotiating on the valuation.

Matt Koranda: Okay, that's helpful. Wanted to drill down into the Fleet Vehicles Segment if we could. Is there a way to sort of help us understand which of those buckets in the headwinds that you guys have eliminated were sort of the greatest headwinds in Fleet Vehicles specifically? I would assume that it's probably the tariff and material impact, and maybe the chassis shortage, but what else should we sort of understand as sort of the [inaudible] headwinds that you faced in the quarter?

Matt Long:In FVS, this is Matt again, it is the tariff-driven commodity costs, is a huge portion. We also had product mix with the USPS, which is a lower-margin business from what our normal is. That's probably the biggest beast, to your point, for FVS, is commodity cost and component cost.

Daryl Adams: And I think if I can add one, Matt, the logistics of getting these trucks, these trucks can't be put on a trailer, similar to some of our F-series and N-series trucks from Isuzu. These need to have drivers. And a driver shortage left a bunch of these products sitting on the shipping lot out in Pennsylvania for us. So, we're working now to work through those and should have them cleaned up by the end of the year, but that impacted Q3 as well.

Matt Koranda: Okay. Did that impact from a revenue standpoint, then?

Daryl Adams: Yes.

Matt Long: Yes, yes. Both revenue and EBITDA.

Matt Koranda: Is there a way to quantify the impact that you guys felt from that specific issue?

Daryl Adams: I'm not sure, Matt, that we'd go into that depth of detail.

Matt Long: Level of detail.

Daryl Adams: That depth of detail.

Matt Koranda: Okay. How about this: From the Bristol shutdown you mentioned, any way to sort of dimension that impact or the headwinds for the quarter from that issue in particular?

Matt Long: Well, from the script, and I think Daryl talked about it, the chassis shortages impacted the Bristol plant to the point that we had a 10-day shutdown. So, while we did our best to get as much cost out of there as we could, that's a very tight labor market, and so we had to be prudent with layoffs, to be able to still have the skilled labor to come back when the chassis did arrive.

Daryl Adams: And I . . .

Matt Koranda: Okay. So, if I put that into the 5% headwind in the chassis shortage bucket in Slide 10, would that be fair?

Matt Long: Yes.

Daryl Adams: Yes. And you also had a little bit of the labor inefficiencies built in too, right? As I mentioned, and Matt just reminded everyone, that we made a decision not to lay people off because we knew chassis were coming. It wasn't an industry or a backlog issue; it was more we didn't have the products to build on. So, we were doing some Spartan Production System activities to work on lean and continuous improvement. But we missed over 200 chassis at Bristol in the quarter.

Matt Koranda: Okay. All right. So, I'm trying to just make sure I understand where that falls in the EBITDA bridge that you guys provided. So, it sounds like it's chassis, component and logistics delays as well as labor shortages, so essentially that whole middle portion of the waterfall chart that you've got, that is largely Bristol shutdown-related.

Daryl Adams: Yes.

Matt Long: Correct.

Matt Koranda: Okay, all right, got it. That's helpful. Okay, so let's just talk segment backlog really quickly in Fleet Vehicles. Up pretty strongly. Is the majority of that e-commerce-related? Could you just comment on the mix in backlog and sort of the growth there? And the delivery timeline for the non-USPS products?

Daryl Adams: Yes, I'll take the broad picture, Matt. I mentioned that it was USPS, right? So that could fall under e-commerce and traditional parcel delivery, as well as Frito-Lay, right? And we had the Amazon in the quarter, right? So, it falls in both last mile and more granular would be e-commerce and parcel delivery.

Matt Koranda: Okay. That's helpful. And then upfit capacity, it sounds like -- or at least your build rate was 70 units per day at Ladson. What does that equate to in terms of sort of capacity utilization? Do you have the ability to go higher on that front? Just some help there would be great.

Matt Long: Sure, and we did have to ramp it up a little bit more to try to catch up and get the units through the process to the customer. So -- and I think we did hit 90 for a period of time, but it all relates back to how many chassis can we get from Daimler, how many Sprinter chassis we can get, and then right now the contract that we have to meet is 70 per day. We're on target. We can flex up and flex down as needed. So, the capacity is not an issue there or down at Saltillo.

Matt Koranda: Okay, got it. And then I guess lastly, just in the Emergency Response business, so the backlog is a bit down even if you kind of strip out the impact of ASC 606. How do you think about market share and sort of the competitive environment there? What are your latest thoughts just in terms of how that's tracking?

Daryl Adams: Sure. I think we talked about it a little bit last quarter and we did some more processing of what's going on in ER. And I think we called it acquisition disruption this quarter, and to explain that a little bit, in 2017, because of the long build time and cycle time of these units, let's call it a year, in 2017 when we did the acquisition, the first four, five months, dealers were confused on what was going to happen and some of the salespeople were confused if they were going to stay. And then we had some dealer rationalization. So yes, take all that and fast-forward, and it comes into this period we're seeing right now, call it 18 months. Because we're working on the orders before the build time starts, which is a year, so maybe you put six months in front of that. So, it fell into this second quarter and third quarter. I will tell you, though, that we're seeing some really nice opportunities and we feel comfortable that we'll land a number of these before the end of the year. I think on our press releases we mentioned Calgary. We have a couple other large cities that we know have the funding and we're right in there and feel confident that we're going to win those as well. To me, the orders are good. The opportunities are out there, and we're starting to win those. So, you'll see them as we win them; we'll have press releases to talk about them, because we feel it's important for the shareholders to understand that.

Matt Koranda: Okay. And just to be clear, you haven't necessarily pulled back on quotations because you didn't like the economics of certain orders or anything? I think we had that discussion last call, but just wanted to clarify that.

Daryl Adams: No. And we're seeing everyone's taking pricing as we are, right? We took 3%, as a reminder, January 1 of '18, and we're taking another 4% January 1 of '19, and we're seeing the market react and basically do the same. So, we're all seeing the same trends in pricing across the industry.

Matt Koranda: Okay, very helpful, guys. I'll jump back in the queue. Thank you.

Matt Long: Thank you.

Operator: Thank you. And the next question comes from Steve Dyer with Craig-Hallum Capital Group.

Ryan Sigdahl: Good morning, guys. It's Ryan Sigdahl on for Steve.

Matt Long: Morning.

Daryl Adams: Hey, Ryan. You don't sound like Steve. Good morning.

Ryan Sigdahl: Sound better, right?

Daryl Adams: Oh, I don't know. You got your answer.

Ryan Sigdahl: You guys mentioned a 4% price increase in ER effective January 1, and you took 3% last year. Is that enough to offset the cost pressures, or I mean, can you maybe bifurcate that out, of how much you're pushing through versus absorbing by Spartan?

Daryl Adams: Yeah, I can't give you all that detail, but what I can tell you is we're taking that pricing on the full price of the truck, right? So, material is not the full price of the truck, and we're not seeing that significant increase in our labor, but we're seeing it in the component parts, right? Cummins, Allison on transmissions, some of our pump manufacturers, because these things come in from China. So, there's some impact, and we believe the 4% will cover it and give us a little room to the bottom line as well. But I think it's important to remind everyone, the pricing we took January of '18, this year, the 3%, we won't see that until January of '19. And the 4% we're taking at the end of this year, we won't see till the following, because it is about a one-year pipeline to get the product through the system. And that's what we started taking pricing, I think, if we go back, since I joined Spartan, we've taken some smaller ones, and now that the commodities continue to increase, we're continuing to price that in. And we feel we're ahead of it, and it will take care of the actions we see. Again, we thought that too coming into this year, but we have a commodities pricing change like with this year. I'm not sure it will cover all that, but we have some in there.

Ryan Sigdahl: Great. And then, I don't think you mentioned pricing on the other segments, FVS specifically, but any thoughts on taking price increases there to offset the cost pressures? And what do you think your ability to do that is with your key customers?

Daryl Adams: Yes. So, if we talk about FVS, I think if we mentioned it previously, we had some orders that were in the backlog, and I think that we say it's four to six-month backlog, approximately. So those are already priced. So, when the material impact started hitting us, it affected those units, but the new quotes that we were submitting, we did put in current material costs, and we continue to do that. So, we believe that that will work itself out. And I think the other thing that Matt mentioned is that we did commit, and I know we mentioned it last quarter. We went out and committed aluminum pricing on volume. So, we didn't hedge; we committed to taking volume because the price was going up so fast, we thought it was the right decision to do at that time. Unfortunately, a few weeks after we made that commitment, the pricing started to come back down. So, we do have to work through some of that, still. And that should be cleaned up by the end of the year, and then everything will be on current market price. And we also put in place a policy that on larger orders, I think it was 20 or more, or something around that, just don't hold me to that exact number, we are going out and committing to price to volume, which would set the price and fix the price after the lesson learned from this year. So continuous improvement on how we manage pricing at FVS and anything that's over 20 units or so on up, we're going to go out and commit to the materials so that we won't hit the fluctuation going forward.

Ryan Sigdahl: So just a follow-up on that: I know you're pretty tight-lipped on what 2019 will entail, but if you're pricing the current quotes which will flow through kind of early part of next year, is that enough that at least the materials and tariff headwinds will lessen, or is that headwind accelerating faster than you guys can keep up with it basically with your current pricing?

Daryl Adams: Go ahead.

Matt Long: It depends, really, on segment. So, back to what Daryl was saying, so the ER, obviously, we've got a long lead time. So, we're assuming that our pricing will compensate for the majority of that. The segment that was impacted the most as it stands now is FVS, and FVS will be quoting that next round of orders, fleet orders, and we will adjust pricing accordingly. So, as we do POs, we're able to adjust. So, we anticipate to offset a good portion of that. Our exposure goes up beyond what we've priced in, we'll have a little bit of a miss there. But otherwise we have that covered. And in the SCV segment, it's a PO basis, and we adjust before we hit that PO. So, for the most part, we're covered. It's just the intervening time between when we quote and when we take the order. Does that answer your question?

Ryan Sigdahl: Yes, that's helpful. And then lastly from me, you mentioned margin expansion through 2020, not necessarily commenting on 2019 in that statement, but with the increased headwinds, it sounds like limited visibility but you guys are taking pricing, working on some productivity improvements, do you think it's enough, broadly speaking, next year to at least hold the gross margins, or potentially even expand them?

Daryl Adams: Yes, like I said earlier, we thought that coming into this year. So, my answer would be, if we don't see the type of tariffs and material impacts and items that we saw this year, yeah, we believe we will. Right now, I'll say yes, without any unforeseen-type issues like we had this year, we should be okay.

Ryan Sigdahl: Great. Thanks. I'll leave it there.

Daryl Adams: Thank you.

Matt Long: Thank you.

Operator: Thank you. And the next question from Steve O'Hara with Sidoti.

Steve O'Hara: Hi, good morning. I guess I'm just confused about the materials and commodity cost pressures that you saw. I mean, I guess I'm just curious about why the pressures that are so impactful now versus, I mean, commodities have risen pretty significantly in the past, and I'm just wondering why the impact is now, or is it more on the materials side where you guys are buying materials, and those costs have gone up, maybe with the lag from commodity cost pressures and those prices being passed on to you?

Daryl Adams: Yes, Steve, we're talking tariffs and material impacts. We're talking a 10% tariff that was put on aluminum and then a 25% that was put on steel. And now that's starting to work through the supply base, right? And Cummins and Allison and some of the bigger suppliers are passing that on, and we mentioned we went out and committed to material when the price was going up on aluminum. And the other thing we're starting to see now too is that the processors, where we had them locked in, are ignoring that and increasing their processing costs. So, it's not only the ingot price you're seeing go up, it's also the processing, or the conversion rate, on the aluminum go up as well. So, it's not so much if you want to put aluminum in commodity, yes, it's aluminum, steel, it's a commodity, yes, but we're seeing that and mostly the tariffs on those.

Steve O'Hara: Okay. And then just relative to the price increases that you're putting in, It seems like the–y would roughly meet the pressures that you've seen on the commodity side within different business segments, I guess. And if that's not the case, correct me there. But -- and then, what about the USPS order? How is that kind of indexed, or is it indexed for any changes in pricing that you're seeing? Cost pressures that you're seeing?

Daryl Adams: Yes. So, on your first question, right? The pricing we're taking is on the entire unit, not just on the material cost, so it's on the total cost of the unit. I'll remind you that we still operate in a competitive environment, and we still have to be competitive on our pricing. And I also remind you that we still have operational improvements at each location. We're not done with those yet, right? That will offset what we believe or add to the gross margin and adjusted EBITDA as we move forward. Those have not stopped. We continue, right, to stick with the Spartan Production System, the operational improvement fundamentals that we're working on, and we still have those projects in works. And then on the USPS, that was a fixed unit pricing across all the suppliers. We all signed agreements. And so that pricing is not affected by what we've seen.

Steve O'Hara: Okay, and maybe just a follow-up on the comments about competitive environment. I mean, are there competitors -- are your competitors maybe -- I mean, obviously, maybe they have a better -- more efficient manufacturing system and operations, et cetera. But I mean, are competitors being illogical in terms of their willingness to eat the cost increases, or are you seeing them kind of raise prices as well? I mean, I would think that, I mean, with commodity cost pressures, I mean, I would think that everybody's kind of seeing the same impact, and that would kind of lead me to believe the market would act rationally and increase prices. I mean, is there a reason not to think that's the case?

Daryl Adams: Well, let's walk through each one. So FVS, I think, very competitive market. The competitor for the most part is not a public company. But when our backlog increases, normalized backlog increases 60% quarter over year -- quarter, right? Q3 last year to Q3 this year. That's telling us that we're gaining market share, our pricing is competitive, and we feel comfortable with the pricing we're taking. We go to Specialty Chassis, again, gaining market share, taking some pricing in, and so we feel good on all the pricing, and with FVS we can re-price every opportunity with current material price. So, it's not like we have a long-term contract with fixed material. Every PO, we can adjust the pricing. The problem was we had that backlog and we didn't have that policy of anything over 20, we're going to go out and commit to volume on aluminum. So, we've taken a bunch of actions that we feel comfortable with going forward to be competitive in the market and still gain market share and grow the business.

Steve O'Hara: Okay. And maybe just a last follow-up. I mean, you talk about taking market share and taking pricing up. I mean, do you think there's a gain in the market share because maybe you're not being as aggressive on pricing, or do you not think that's the case?

Daryl Adams: I don't think that's the case. I think people announce taking pricing, but then they may discount, and we're not doing that. Especially on the ER side

Steve O'Hara: Okay. All right.

Daryl Adams: All right, thank you.

Matt Long: Thank you.

Operator: Thank you. And as there are no more questions at the present time, I would like to return the floor to management for any closing comments.

Juris Pagrabs: Thanks, Keith. And thanks, everyone, for joining us today on our call. Please, if you have any additional questions, just follow up with us and we'll be happy to set up a call with you. Just a heads up, we'll be in Chicago next week at the Baird conference, so if you want any opportunity to do a one-on-one, I think our schedule still has some slots open, so feel free to reach out. Thanks, and have a great day.

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