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Federal Signal Corporation

Fourth Quarter 2018 Earnings Conference Call

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PRESENTATION

Operator:

Good day, and welcome to the Federal Signal Corporation's Fourth Quarter Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Ian Hudson, Chief Financial Officer. Please go ahead.

Ian A. Hudson:

Good morning, and welcome to Federal Signal's fourth quarter 2018 conference call. I'm Ian Hudson, the Company's Chief Financial Officer. Also with me on the call today is Jennifer Sherman, our President and Chief Executive Officer.

We will refer to some presentation slides today, as well as to the earnings release which we issued this morning. The slides can be followed online by going to our website, federalsignals.com, clicking on the Investor Call icon, and signing into the webcast. We have also posted the slide presentation and the earnings release under the Investor tab on our website.

Before I turn the call over to Jennifer, I'd like to remind you that some of our comments made today may contain forward-looking statements that are subject to the Safe Harbor language found in today's news release and in Federal Signal's filings with the Securities and Exchange Commission. These documents are available on our website.

Our presentation also contains some measures that are not in accordance with U.S. generally accepted accounting principles. In our earnings release and filings, we reconcile these non-GAAP measures to GAAP measures. In addition, we will file our Form 10-K later today.

With that, I would now like to turn the call over to Jennifer.

Jennifer L. Sherman:

Thank you, Ian. I'm going to begin by giving my perspective on our performance in 2018 and the state of the business before turning the call back to Ian to provide some more detail on our fourth quarter and full-year financial results. I will then give some thoughts on our 2019 outlook before opening the line for any questions.

Overall, 2018 was an outstanding year in which our businesses reported record revenues and earnings. With the traction on our organic growth initiatives and benefits from the prior acquisition of TBEI, our net sales for the year exceeded $1 billion for the first time in over a decade. Both of our groups reported significant improvement in net sales and earnings, delivering Adjusted EBITDA margins towards the higher end of their target ranges. On a consolidated basis, we reported a 41% year-over-year increase in Adjusted EBITDA at an improved margin of 14.7%, up 210 basis points from last year and towards the higher end of our target range.

The teams did an outstanding job growing sales and improving margins on a year-over-year basis in an environment where many industrial companies face challenges from increasing commodity costs and supply chain disruptions. Because our teams were proactive in taking actions and response, the anticipated commodity cost increases, our pricing actions largely offset the impact in 2018.

The ongoing application of our Eighty-Twenty initiatives, or ETI, also contributed to impressive improvement in our margins, which continued to exceed those of many of our peers within the specialty vehicle space. This outstanding operating performance contributed to a 68% increase in our adjusted EPS compared to a strong 2017.

We have also further strengthened our balance sheet. Since completing the TBEI acquisition a little over 18 months ago, we have paid down approximately $96 million of debt, reducing our debt leverage ratio at the end of the year down to 1.3 times compared to 2.7 times at the closing of the acquisition.

With our current financial position, we have significant flexibility to fund both organic growth initiatives and M&A going forward. At the end of the year, we had $179 million of availability under our credit facility, with the option to increase that by an additional $75 million for acquisitions.

The strategic initiatives we have put in place over the last couple of years are continuing to gain traction. We are making great progress expanding into different end markets like utilities, with our suite of vehicles that utilize vacuum excavation technology over more invasive digging techniques. This success is a result of the investments we have made in new product development and channels.

During 2018, our sales teams performed approximately 2,800 demonstrations and presentations with prospective customers, which is more than double the 1,300 completed last year. At the same time, orders from utility customers grew by about 40% year-over-year. For the year, total vacuum orders from customers were up approximately $60 million, or 63% from last year.

With the continued momentum we are seeing with this safe-digging initiative, and with the benefits from recent new product enhancements to our sewer cleaner lines, we see significant growth opportunity. Last week, we announced plans to expand our Vactor manufacturing facility in Streator, Illinois in response to that growth potential. The major product line to manufacture this plant includes sewer cleaners, vacuum trucks, and hydro excavators. This project is expected to increase Vactor's production capacity by approximately 40% and add up to 90 additional jobs.

Overall, the expansion will add approximately 100,000 square feet to the existing facility. Construction is expected to begin in the first half of 2019, with the completion of the first phase of the project targeted by the end of the year. The teams have done a great job with the project plan, with the expansion being phased in a way that is expected to minimize disruption to the facility. We're expecting to invest up to $25 million over the course of the expansion project. This significant investment is also a testament to the talented and dedicated workforce that we are fortunate to have in the Streator area.

On the acquisition front, both TBEI and Joe Johnson remain on track to deliver on their previously-communicated accretion estimates. The Joe Johnson acquisition has contributed to the success of our aftermarket strategy and improved sales of our industrial products in Canada. During 2018, ESG's rental income increased by over 30% from last year, while total aftermarket revenues increased by $20 million, or 10%.

In connection with the Joe Johnson acquisition, we entered into an earnout arrangement which had specific financial targets tied to the underlying strategic rationale in support of the acquisition. With the traction we have realized on those strategic initiatives, the earnout is currently tracking towards 100% of the target. Payment of the earnout becomes due in June of 2019. We have continued to focus on new product development, as these efforts will provide additional opportunities to further diversify our customer base.

On previous earning calls, we have discussed the addition of a number of new products within our safe-digging portfolio vehicles, as well as several enhancements that were introduced during 2018, to add features and improve the functionality of our sewer cleaners. In addition to those new product launches in 2018, our Environmental Solutions Group also introduced the Crosswind 1, a new single engine street sweeper and its suite of proprietary tools for our Jetstream water blasting equipment. In its first year of production, we received orders for 60 new Crosswind 1 trucks.

Within our Safety and Security Systems Group, we are also seeing the benefits from adding resources to our sales and engineering teams in support of new product development. For the year, SSG sales were up organically by 10%, largely driven by improved demand for public safety equipment both domestically and in Europe. With this series of new products added to our suite of offerings, we have won a number of new conquest accounts in both geographies.

In Spain, our public safety business has partnered with one of its largest customers to introduce integrated system which manages all signaling and surveillance systems within an emergency vehicle. We continue to see the tangible output from the new product innovation process that we introduced in 2015. We estimate that new product introductions represented more than $50 million of our organic revenue growth in 2018. Continued commitment to new product development will remain a key priority in the years to come. With this focus and the ongoing traction on our strategic initiatives, over the long term we are expecting organic revenue growth to be a couple percentage points above GDP.

M&A will also continue to be an important part of our future growth. We intend to remain disciplined on the acquisition front, and, as a result, the timing of acquisitions can be difficult to predict. However, over time we are targeting a revenue CAGR in the high single digits resulting from a combination of both organic growth and M&A.

I'll turn the call back to Ian to go over the numbers.

Ian A. Hudson:

Thank you, Jennifer. Our financial results for the fourth quarter and full year of 2018 are provided in today's earnings release. Overall, our fourth quarter results represent a strong finish to an excellent year. Before I talk about the fourth quarter, let me highlight some of our full-year results for 2018.

Consolidated net sales for the year were approximately $1.1 billion, an increase of $191 million, or 21% compared to the prior year. Organic sales growth for the year was around $93 million, or 12%. Operating income for the year was $121.5 million, an increase of $47.9 million, or 65%. The improvement was driven by a $40.6 million increase in our Environmental Solutions Group and a $7.1 million increase within our Safety and Securities Business Group.

On an adjusted basis, consolidated operating margin for the year was 11.4%, up from 9.3% last year. Consolidated Adjusted EBITDA for the year was $160.5 million, up $47 million, or 41% compared to last year, and our consolidated Adjusted EBITDA margin was 14.7%, up from 12.6% last year and towards the high end of our target range.

GAAP earnings for the year equated to $1.53 per share, up 53% from $1 per share last year. On an adjusted basis, we reported full-year earnings of $1.43 per share, which is up $0.58 per share, or 68% compared to $0.85 per share last year.

Total orders for the year were approximately $1.2 billion, an increase of $155 million, or 15% from last year. The improvement included organic order growth of approximately $90 million, or 10%. On the back of this improvement, we ended the year with a consolidated backlog of $338 million, which was up $80 million, or 31% compared to last year.

For the rest of my comments, I will focus mostly on comparisons of the fourth quarter of 2018 to the fourth quarter of 2017. Consolidated net sales in Q4 this year were $279.4 million, an increase of $32 million, or 13% compared to last year. All of that growth was organic.

Consolidated operating income for the quarter was $33.4 million, up $12.3 million, or 58% from last year. The improvement included increases of $7 million and $2.9 million within ESG and SSG respectively. In addition, corporate expenses were down $2.4 million compared to the prior-year quarter.

On an adjusted basis, consolidated operating margin in Q4 this year was 12.1%, up from 9.6% in Q4 last year.

Consolidated Adjusted EBITDA for the quarter was $43 million, up $10.9 million, or 34% from last year. That translates to a margin of 15.4%, towards the high end of our target range, and up from 13% last year.

Income from continuing operations was $32.2 million in Q4 this year compared to $29.3 million last year. That equates to GAAP earnings of $0.53 per share, which compares to $0.48 per share last year. On an adjusted basis, EPS for Q4 this year was $0.39, an improvement of $0.15 per share, or 63% compared to last year.

Order intake for Q4 this year was almost $300 million, contributing to an increase in our backlog since the end of Q3 of approximately $17 million, or 5%.

Now, turning to our group results. Within ESG, fourth quarter sales were $217.3 million, up $25.3 million, or 13% compared to last year. This organic growth was largely due to increases in shipments of vacuum trucks and sewer cleaners, as well as higher aftermarket revenue.

ESG's operating income for the quarter was $26.9 million, up from $19.9 million in Q4 last year, and its operating margin for the quarter was 12.4%, up from 10.4% last year.

Adjusted EBITDA for the quarter was $35.5 million, an improvement of $7.5 million, or 27% compared to last year. That translates to a margin of 16.3% in Q4 this year, which is up from 14.6% last year.

ESG's fourth quarter orders were strong at $240 million but were marginally down in comparison to an outstanding order intake in Q4 last year, which included an estimated $15 million to $20 million of orders that were pulled forward.

Now, turning to the Safety and Security Systems Group, which delivered an outstanding quarter. Benefiting from several large orders for public safety products and warning systems, its Q4 sales were $62.1 million, an improvement of $6.5 million, or 12% from last year.

SSG's operating income for the quarter was $11.8 million, up $2.9 million, or 33% compared to Q4 last year.

Adjusted EBITDA was $12.7 million, up $2.7 million, or 27% from a year ago. SSG's Adjusted EBITDA margin for the quarter was outstanding at 20.5%, exceeding the high end of the target range and up from 18% last year.

Corporate expenses for the quarter were $5.3 million compared to $7.7 million a year ago. Corporate expenses in Q4 this year included benefits from fair value adjustments for certain reserves which benefited our earnings in the quarter by approximately $0.02 per share. In Q4 last year, corporate expenses included a $1.5 million hearing loss supplement charge.

Turning now to the consolidated income statement where the increase in sales contributed to a $10.4 million improvement in gross profit. Consolidated gross margin improved to 25.8% for the quarter, up from 24.9% last year.

Selling, engineering, general and administrative expenses of $38.4 million were down 4% compared to the prior-year quarter, largely due to the decrease in corporate expenses that I just mentioned. As a percentage of sales, these expenses for the quarter were down 240 basis points from Q4 last year.

Other items affecting the quarterly results include a $300,000 reduction in acquisition-related expenses, a $200,000 increase in other expense, and a $600,000 decrease in interest expense. In the fourth quarter of last year, we also recognized a $6.1 million pension settlement charge.

In Q4 this year, we recognized an income tax benefit of $1 million, largely due to the recognition of an $8.6 million tax benefit associated with the completion of a tax planning strategy in Spain, which was partially offset by additional tax expenses on the higher income. The tax planning strategy is expected to reduce cash tax payments in Spain over the next several years.

In Q4 of last year, we recognized a $16.9 million tax benefit, largely due to the recognition of a $20 million tax benefit representing the impact of the new Tax Act. Excluding the tax planning benefit, our effective tax rate for the full year of 2018 was around 24%. That rate included some nominal benefit from releases of tax reserves and stock option exercises. We currently expect a normalized full-year effective tax rate of between 25% and 26% in 2019.

On an overall GAAP basis, we therefore earned $0.53 per share in Q4 this year compared with $0.48 per share in Q4 last year. To facilitate earnings comparisons, we typically adjust our GAAP earnings per share for unusual items recorded in the current or prior-year quarters. In the current-year quarter, we made adjustments to GAAP earnings per share to exclude acquisition-related expenses and purchase accounting effects.

We also typically exclude special tax items, like the tax planning benefit in the current year and the impact of tax reform last year. On this basis, our adjusted earnings for Q4 this year were $0.39 per share compared with $0.24 per share in Q4 last year.

Turning now to cash flow, we generated $20.9 million of operating cash flow in Q4 this year, which was at a similar level to Q4 last year. That brings the total amount of operating cash flow in 2018 to $93 million, an improvement of almost $20 million, or 26% compared to last year.

The improved cash flow facilitated additional debt repayment of $8.5 million in the quarter, which brings the total amount of debt paid down during 2018 to approximately $62 million. We ended the year with $173 million of net debt.

In 2019, in addition to our annual cap ex of between $15 million and $20 million, we are anticipating additional cash outflows associated with the Vactor plant expansion and the Joe Johnson earnout payment that Jennifer just referenced. With that, we are not expecting to maintain the same level of debt repayment in 2019 as we did in 2018.

Our strong financial position allows us to continue to invest in organic growth initiatives like ongoing new product development and the Vactor expansion. At the same time, we remain committed to pursuing strategic acquisitions and funding cash returns for shareholders. On that note, we paid a dividend of $0.08 per share during the fourth quarter amounting to $4.9 million, and we recently announced a similar dividend for the first quarter of 2019.

We also funded opportunistic share repurchases during the fourth quarter, spending $1.2 million to buy back shares at an average price of $19.79. We had about $30 million remaining under our share repurchase authorization at the end of the year.

I'd now like to give a quick reminder of an upcoming change in the way that we account for leases. As with most public companies, at the beginning of 2019 we will be required to adopt a new lease accounting standard. Under the new guidance, the companies operating leases will be reflected on our balance sheet as a right-of-use asset with a corresponding lease liability. We currently estimate that this will be in the range of $25 million to $30 million.

In addition, we will also see a change to the historical recognition of the deferred gain related to—relating to the sale and leaseback of our Elgin and University Park facilities, which was completed back in 2008. That's the gain on sale, which originally totaled $29 million, is currently being recognized ratably over the lease term which expires in 2023.

On an annual basis, the gain recognition has represented approximately $2 million a year since 2008. Upon adoption of the new rules at the beginning of 2019, the remaining deferred gain of $8.7 million will be recognized as an adjustment to our retained earnings and we will no longer recognize any portion of the gain through the income statement. To facilitate comparisons with prior periods, when reporting our interim and annual non-GAAP results in 2019 we will be adjusting our previously-issued results for 2018 to exclude the recognition of this deferred gain. On this modified basis, our adjusted EPS for 2018 would have been $1.41.

That concludes my comments, and I would now like to turn the call back to Jennifer to talk about our outlook for 2019.

Jennifer L. Sherman:

Thank you, Ian. We entered 2019 with positive economic indicators across many of our end markets and strong order momentum across most of our businesses contributing to a healthy backlog. While ESG's backlog provides us decent visibility into the first half of 2019, lead times for certain products, particularly sewer cleaners and vacuum trucks, remain extended. We are taking steps to reduce those lead times. In addition to the plant expansion, we are also moving production of certain low-volume sewer cleaners to one of our solution centers.

Within our industrial markets, we remain encouraged with recent order intake and the strength of rental markets in North America. The number of used equipment units available at auction continues to be at normal levels, supporting healthy used equipment demand in the market. During 2018, that has helped us with the flow of sales out of and into the fleets of our rental partners.

Utilization levels within our own rental fleet are strong, particularly relating to products serving industrial markets like vacuum trucks, hydro excavators, and water blasting equipment, and as I have noted, I'm bullish about the growth prospects for our safe-digging line of products.

We continue to track industry data on new housing starts and activity within Class A trucks. Both of those have a generally positive outlook for 2019, although we are monitoring the availability of chassis at certain of TBEI's locations given our broader reliance on customer supply chassis there and some ongoing supply constraints.

On the municipal front, our U.S. markets remain healthy overall, with particularly strong demand for sewer cleaners. In SSG's police business, we expect to see continued traction on new product introduction, which may be partially offset by a scheduled model year changeover at Ford. This changeover may cause a temporary delay in the number of Ford police vehicles available in the first half of the year.

We continue to monitor market conditions in the Middle East where the number of large fleet orders has been slow in recent years. Although we do not believe those orders have been lost, the timing of receiving such orders remains uncertain.

Our ongoing focus on our Eighty-Twenty, or ETI principles, has also led to operational improvements in several of our businesses that underperformed in 2017. ETI is, and will remain, a critical part of our culture and we continue to educate our people on its principles, which include a disciplined approach to reducing product cost and improving manufacturing efficiencies across all of our businesses. During 2018, over 70 employees attended formal training on our ETI principles, and additional sessions are scheduled for the first half of this year.

Overall, our pricing actions largely neutralized the impacts of higher material costs in 2018. During the first half of 2019, we are expecting our material cost to be higher than the first half of 2018, but down slightly in comparison to the second half of 2018.

The acquisitions completed over the last few years are performing well and remain on track to deliver on the previously-announced accretion estimates. As we previously stated, acquisitions remain a priority for the deployment of our free cash flow. Our deal pipeline remains active. With our healthy cash flow generation and strong financial position, we are well positioned to pursue strategic acquisition candidates. During 2018, we looked at a number of acquisition opportunities, but valuation expectations have been high, and we are committed to maintaining a disciplined approach.

Our pro-forma debt leverage ratio at the end of the quarter is now down to a level that gives us significant flexibility to fund both organic growth initiatives and M&A. As Ian mentioned, the new lease accounting rules will mean that we will—that our operating results for 2019 and beyond will no longer include approximately $2 million of deferred gain recognition.

Turning to our outlook, our backlog entering 2019 was 31% higher than when we began in 2018. In addition, conditions in most of our end markets remain healthy and we are encouraged with the traction in our strategic initiatives.

Seasonal effects typically result in our first quarter earnings being lower than subsequent quarters, and we do not expect this year to be an exception given some of the abnormally cold weather that much of North America has experienced in recent weeks. Similar to many other industrial companies, the polar vortex led to several days of production disruption at certain of our facilities. We have also seen some delivery delays because of weather-related transportation issues.

Despite these challenges, we are anticipating year-over-year earnings growth, with our first quarter earnings expected to represent between 16% and 17% of our full-year outlook. We are expecting another strong year with revenue growth and adjusted earnings per share of between $1.48 and $1.60, the midpoint of which would represent a 9% improvement over a record 2018.

As I enter my fourth year as CEO, I'm really pleased with the growth that we've seen in recent years in our EPS, which has more than doubled since 2016. Looking forward, we intend to maintain our focus on new product development and other growth initiatives and our pursuit of value-added acquisitions. Taking these factors into account, we are aiming for top line growth at a CAGR in high single-digits, while maintaining our EBITDA margin performance within our target ranges and generating cash flow.

With that, we are ready to open the line for questions. Operator?

Operator:

Thank you. Ladies and gentlemen, if you would like to ask a question at this time, please signal by pressing star and then one on your telephone keypad. If you're using a speakerphone, please ensure your mute function is switched off to allow your signal to reach our equipment. Again, that is star and then one to ask a question.

We will now take our first question from Walter Liptak of Seaport Global. Please go ahead. Your line is open.

Jennifer L. Sherman:

Good morning, Walt.

Walter Liptak:

Hi. How are you? Good morning, guys. Congratulations.

Jennifer L. Sherman:

Thank you.

Walter Liptak:

Wanted to ask first about the cap ex program. You've got a range there, and I wonder how much of the cap ex is for the Phase 1, and what is the Phase 1, and then how much goes towards Phase 2, and why is there some variance in the 2019 cap ex number? What has to happen for you guys to spend the whole $25 million?

Ian A. Hudson:

The bulk of the $25 million, Walt, is in Phase 1, which is what we're expecting to complete by the end of the year. The Phase 2 is really a secondary addition that we would use to combine, kind of, two of the buildings. The investment for Phase 2 is probably—we're probably talking about a couple of million bucks, so the vast majority of it would be associated with Phase 1 that we'd expect to complete during 2018.

Walter Liptak:

Okay. Why did you put a range on it?

Ian A. Hudson:

We're going to spend up—so overall in both phases, we expect to spend up to $25 million on the Vactor expansion. In addition to that, we have our—kind of our annual run rate cap ex at our other businesses, and that's going to be between $15 million to $20 million. That's generally in line with what we spend in a fiscal year.

Walter Liptak:

Okay, great. Second question along the same lines, it sounds like your capacity constrained for some of the sewer cleaners and hydro excavators. Are lead times stretching out and are your lead times at least in line with the rest of the industry?

Jennifer L. Sherman:

Yes. I think our lead times right now are in line with the rest of the industry, but we—part of the motivation for the capacity expansion was to reduce those lead times and support future growth. We're really encouraged in terms of what we're seeing. I talked about in the call that our vacuum truck orders are up over $60 million in '18 versus '17, which represents 63% growth. We believe, as we've talked about before, in the safe-digging initiative. We're in early phases, so the Vactor team has done a super job in terms of developing plans that will have minimal disruption. I think that's important to understand in 2019, and we're going to be able to increase capacity 40%, so we should be very well positioned to support what we see as exciting opportunities going forward.

Walter Liptak:

Okay, sounds good. Is the new capacity—will that help production levels in 2019, or should we look at this as completed at the end of 2019 and you get some trucks through the new capacity in 2020?

Jennifer L. Sherman:

Yes. We're in a pretty aggressive schedule. We haven't broken ground and the teams are committed to getting it done in 2019, but I think it'll be more of a Q4 celebration, so I don't see a lot of impact in 2019, but I will say that our teams continued to, with our ETI, our Eighty-Twenty Initiative, focus on improving productivity, and part of the success that we had in 2018 was a result of producing more trucks at that Vactor facility. Internally, we call it BMT, build more trucks, and the teams have really responded and done a fantastic job, so we would expect that to continue.

Walter Liptak:

Oh, that sounds great. Maybe just one last one for me and then I'll get back in queue. What's your expectation for corporate expense for 2019?

Ian A. Hudson:

Yes, it's a generally—well, I think in Q4 what you saw, it was a couple of, I would say unusual items in both periods, so the $2.4 million drop that we saw is a combination of two main factors, really. In the 2017, we had a hearing loss settlement charge of about $1.5 million, and then this year we had some favorable adjustments to our reserves. As we go forward, the one variable in our corporate expenses is the hearing loss litigation. We've seen some—a lower level of trials in '17 and '18, so we benefited from that, so to the extent that there are more trials in '19, we may see an increase in our hearing loss legal fees, but we—we're not aware of that at this point, so we would expect probably our corporate expenses to be—they may increase slightly year-over-year, but as a percentage of sales they should be generally in line.

Walter Liptak:

Okay, great. All right. Thank you, guys.

Jennifer L. Sherman:

I'll put my former hat on, Walt, for a sec, is that the teams—the legal teams have just done a super job in terms of negotiating, as we've disclosed, some nominal settlements, and we're making significant progress in terms of putting the hearing loss litigation behind us.

Walter Liptak:

Oh, good. Yes. That sounds really solid. Thank you.

Ian A. Hudson:

Thanks, Walt.

Operator:

Thank you. We can now take our next question from Chris Moore of CJS Securities.

Jennifer L. Sherman:

Good morning, Chris.

Chris Moore:

Good morning. I just wanted to make sure I understand on the—kind of what's baked in on the top line growth. You had talked about organic growth of GDP plus a couple of points, and then, I guess ultimately, kind of high single-digit when you incorporate acquisitions, but for Fiscal '19 there are no acquisitions assumed in there. Correct?

Jennifer L. Sherman:

Correct.

Chris Moore:

I'm sorry?

Jennifer L. Sherman:

Yes, that is correct and if we do an acquisition, we would update the guidance at that point in time.

Chris Moore:

Got you, so the high single-digits is just kind of a more mid-term goal?

Jennifer L. Sherman:

Yes. I mean we look at that as—it can vary from year to year, again, depending on acquisitions, so we look at that as a longer-term goal.

Chris Moore:

Got it. You talked a little bit about kind of relative commodity costs, so can you talk a little bit about kind of commodity costs versus pricing increases; how you're factoring that into this year's guidance?

Jennifer L. Sherman:

Sure. Absolutely. Just a little bit of context; as we talked about previously, in the first half of '18, we realized the benefit of $0.03. In the second half of '18, we said that it could be a potential headwind of $0.03, so if you look at '18, it neutralized to zero, and that's a real credit to the teams in terms—in a very difficult commodity market with the—some of the aggressive pricing actions in our ETI initiatives, that we were basically, throughout the year, neutral.

We expect our first half commodity prices for '19 to be higher than the first half of '18, but slightly lower than the second half of '18. I know that's a lot to digest, so we should have more price realization from the increases that we put in last year, and we're expecting it, overall, to be neutral in the first half of 2019, and I think the other thing important to mention is we're expecting year-over-year Q1 earnings growth, so at this point we don't have a lot of visibility into the second half of the year, but for example, where most of our steel and aluminum spend is at TBEI and their quotes only hold for 60 days, so we should be able to—if we saw some changes in the second half of the year, again, we'll employ the same methodologies that we did in 2018 and address those.

Overall, we're expecting to deliver EBITDA margin performance in the upper half of our range, so we feel pretty good about 2019.

Chris Moore:

Got it. Looks like Joe Johnson's doing well. Do you expect at this point in time to expand the rental fleet further in 2019?

Ian A. Hudson:

Yes. I think it's something we always look at, Chris. We closely monitor the utilization of the various products lines that we have in the fleet. The size of the rental fleet at the end of the year was $97 million overall. That's up slightly from where we were at the time of the acquisition. We would look to make some investment. We've got some of that baked into the plan and some additional investment in the product lines where we see the strongest utilization, so there's definitely investment that we would be making next year.

The other thing on the rental side is that we have seen some strong demand from some of our rental partners as well during 2018. As they're able to sell more units out with their rental fleet, we've seen some nice replenishment of our—the rental fleets of our rental partners as well.

Chris Moore:

Got it. Last question, really kind of on the SSG side, just in terms of ability to continue that momentum into '19, and obviously the Q4 EBITDA margins were exceptional. Is that a level that can ultimately be sustained on an annual basis, or is there some anomalies there?

Ian A. Hudson:

Yes. I think you're right, Chris. The performance in Q4 was outstanding in that business. The lead times are much shorter than kind of the rest of the ESG business. It can range from four to six weeks, and so as we get to the end of the year, we sometimes see municipalities spend some of their remaining budget dollars, and so that can lead to some large projects that we may not have foreseen, so Q4 tends to be pretty strong on the municipal side. We saw kind of a similar pattern in Q4 of '17 when our margin was 18%. This time around it was 20.5%, so I think Q4, it tends to be the strongest of our margin performance. The cost structure of that facility is such that as we get more on the top line, we get some nice operating leverage from that facility, so that the higher the top line within that facility, a lot of it has a—the drop through is pretty attractive.

Jennifer L. Sherman:

Yes. I think that the two things I would add is, although we expect some disruption on the police side from the Ford year model changeover that I talked about, we're encouraged by what we've seen thus far. Mark Weber joined us the beginning of January. He's spent a lot of time down at SSG implementing and reinforcing our Eighty-Twenty principles, so we've seen benefits from that, and then the other part of the equation is the new product development. We're really starting to get some traction there. It's going to vary, as Ian noted, quarter-to-quarter. A lot of it depends on—they get some larger orders that can impact the mix, but overall, we're encouraged by what we're seeing at SSG into 2019.

Chris Moore:

Got it. That's helpful. Thanks, guys.

Operator:

Thank you. We will now take our next question from Marco Rodriguez of Stonegate Capital Markets.

Jennifer L. Sherman:

Good morning, Marco.

Ian A. Hudson:

Good morning, Marco.

Marco Rodriguez:

Good morning. Hey. Thanks for taking the questions here. Wondering if could kind of do a couple of quick housekeeping items here. First off, the adjustments to the reserves that lowered corporate expenses in '19, I think I may have missed it, but did you give a dollar figure for that?

Ian A. Hudson:

It was about a $0.02 benefit in the fourth quarter, Marco.

Marco Rodriguez:

Okay, and that's a one time? That's all done?

Ian A. Hudson:

Yes.

Marco Rodriguez:

Got you, and then on the Streator expansion, the additional 100,000 square feet, do you already have the land in which you're going to be putting that building, or do you need to acquire additional land for that?

Jennifer L. Sherman:

We're in the final steps of signing the purchase agreement for the land, but we have agreement with the city, and again, we're on track to complete the facility for the first phase of this by the end of 2019.

Marco Rodriguez:

Got it. Okay, and then maybe if you could talk a little bit on that expansion; obviously, the first stage done at the end of the year. How are you kind of thinking about the incremental revenue that that plant can do and how you kind of expect that to roll out into Fiscal '20?

Jennifer L. Sherman:

We talked about that, over time, we'll have 40%—increases our capacity by 40%, and so we're looking at the long term. We believe that the opportunity, although it's difficult to quantify for safe digging, is in the $250 million range, but a lot of that depends on how you define the market, so we're seeing year-over-year improvement as I talked about on the phone—I mean I talked about on the call. Our orders for vacuum trucks were up $60 million, so we are—believe that this capacity expansion is critical in terms of supporting that future growth.

Marco Rodriguez:

Understood, and then when talking about the ESG—the landscape that you're kind of looking at—the competitive landscape that is for the next 12 to 18 months, maybe if you could kind of talk a little bit about the opportunities you see, as well as some of the threats that are out there.

Jennifer L. Sherman:

Sure. I think the critical issue for Federal Signal, and what we've been focused on, is really new product development in terms of how do we differentiate our product vis-à-vis the competition. I was at our largest trade show last week, the WWETT Show in Indianapolis, and had an opportunity to spend time in our booth and with our dealers and look at some of the competitive competition, and what really distinguishes us is both the pace of our new product development, which has changed over the last three or four years, and the—our—we talked on the phone on the call about our demonstrations, so we found that those demonstrations are critical to increasing the adoption rate of some of these new features that we're increasing.

A great example of that for sewer cleaners is our rapid deployment boom. In addition to that, we introduced the single-engine street sweeper, the Crosswind 1, so I think that's really—as I spend time with our customers, our dealers, that's what really distinguishes the Company. The other thing I would point to is our aftermarkets initiative. With the acquisition of Joe Johnson, we have approximately 20 service centers across North America, so our dealers play an important role in terms of servicing our equipment, but we also can now service the industrial customers as needed, so that is yet another factor that differentiates ourselves, so overall I think we're building the right infrastructure to support what we see are some exciting growth opportunities.

Marco Rodriguez:

Understood, and then next question, kind of off of that one here, your new product introductions. You guys mentioned, I believe in the prepared remarks, that (inaudible)—I think it was $50 million of revenues in '18 were from new products. Can you maybe kind of give us a sense as far as what levels you might be expecting in Fiscal '19, and with these new product introductions and incremental increases or incremental betterments of current products, how—are there any certain points of time in the year where you'll have a bigger rollout of some of these new product information, or it'll be steady over the year?

Jennifer L. Sherman:

Yes. I mean it can vary from year-to-year. What I can tell you is we've got a number of products in the pipeline that we're working on right now, and as we looked at the outlook that we gave, both for 2019 and the longer-term, high single-digit growth output, we factored in, I think, a pretty healthy amount of organic growth of a couple of points above GDP, and that will really be driven by the pace or cadence of this new product development.

What I'm encouraged by is, when I spend time with the teams, is just the amount of kind of energy and commitment in terms of understanding what are the unmet needs of our customers and how can we satisfy those needs, so as we move forward, we've got a lot of great ideas in the pipeline. The teams are working on various stages, and the cadence will really vary year-to-year.

Marco Rodriguez:

Got you, and last question here, just kind of circling back on the EBITDA margins. I know that you had mentioned that you're expecting, I guess, for Fiscal '19 that you perform in the upper half of the range for both segments. Obviously, SSG is pretty much up at the upper end of that range that you forecasted before, and you had a very great Q4 there. Just trying to get a little bit better of a sense, as you kind of roll through Fiscal '19 with the development that you're doing at ESG and the new product launches, just trying to kind of get a little bit better of a sense as far as—do you expect sort of EBITDA margin expansion each quarter as you kind of roll through the fiscal year, and how should we kind of think about that?

Ian A. Hudson:

I think it can vary, Marco, from a number of different factors, particularly when you look at the aftermarket business on the ESG side, which tends to peak in Q2 and Q3 just because a lot of the rental activity and the service work is taking place in Q2 and Q3. Q2 and Q3 also tend to be TBEI's strongest quarters, but there is some seasonality that would impact the margin, so it's not going to be gradual improvement every—sequential improvement each quarter during the year. That's not what we would expect. We would likely expect to see similar patterns throughout the quarters as we saw during 2018 in terms of kind of the sequential variability, but I think, overall, on a consolidated level, as we said, I think performing in that upper half of our consolidated target range, that's what we're expecting for '19, and we think that's pretty strong performance vis-à-vis some of our peers.

Marco Rodriguez:

I appreciate your time, guys.

Jennifer L. Sherman:

Thank you.

Ian A. Hudson:

Thank you, Marco.

Operator:

Thank you. As a reminder, if you would like to ask a question, please press star and then one. We'll now take our next question from Steve Barger of Keybanc Capital.

Jennifer L. Sherman:

Good morning, Steve.

Ian A. Hudson:

Good morning, Steve.

Ken Newman:

Good morning, guys. It's actually Ken Newman on for Steve this morning.

Jennifer L. Sherman:

Good morning, Ken.

Ken Newman:

Morning. I do want to touch back on the strategic margin targets. Just given the fact that you are closer to the top end of your range already, do you foresee any ability to expand margins above the top end of that longer-term range, or is this really more capped by the product portfolio that you have in place? Do you need to do some M&A to really expand margins beyond the top end?

Jennifer L. Sherman:

I think it really varies. As we showed with SSG this quarter where they were above the top end of the range, it varies quarter-to-quarter, and there are a number of factors that we take into account. Ian spoke about the seasonality. Another critical factor is large fleet orders. We expect some production efficiencies with respect to completion of this Vactor expansion that we should be able to realize in 2020. We're outsourcing some work that we should be able to do in sourcing more efficiently, so what we're trying to give you with respect on the EBITDA ranges are targets through the cycle that we'll operate within, but clearly, as we showed with SSG, there are opportunities to operate above the range.

Ken Newman:

Right.

Jennifer L. Sherman:

The other thing I would add that I think is really important that changed in 2018, and we have some material about this in our Investor deck, is we changed our short-term incentive compensation program where there are EBITDA targets for each of our businesses that's tied to the performance of those businesses, and we expect improvement, so again, I think we're aligning the teams around operating in that top half of the range, and it'll vary quarter-to-quarter depending on the factors that I mentioned.

Ken Newman:

Right. Switching gears here to orders, obviously orders were pretty good for the full year on a consolidated basis, despite some pretty tough comps that you saw the year prior. Just any color, and maybe I missed it, but any color on order inquiries by business that you've seen year-to-date in the first two months of 2019, and what are some of the pushing points in terms of price that—if you're hearing any from your customers?

Ian A. Hudson:

Yes. I mean I think we've seen—certainly, in January, we saw pretty strong orders. We haven't seen any signs of any meaningful slowdown to this point. As you mentioned, Q1 of '18 was—is a pretty tough comp because of the effects of the pull forward that we saw. Between Q4 of '17 and Q1 of '18, we estimate that there was about $40 million of order pull forward, so that might distort the comparisons a little bit, but January orders look pretty healthy, and I think even with the Q4 orders being down by a nominal amount versus Q4 of '17, we still saw our backlog increase by about $17 million, or 5% from Q3 of last year, so—and we think that's pretty healthy.

Jennifer L. Sherman:

Yes. Your other question about price and what we're hearing is—again, I think one of the reasons that we were able to get the price realization we did in 2018 was because of the—our new product introductions that we made, and people are willing to pay for these enhanced features, so I'll reiterate. I think the teams did a fantastic job where we ended 2018 in a neutral position with respect to commodity cost vis-à-vis a lot of our industrial peers, and as we look into the first half of 2019 that we've got decent visibility, we're expecting again it to be—we should be in a neutral position also.

Ken Newman:

I guess as a follow-up to that question, then, is there any way you can help us kind of think about the dollar increase in orders, the mix between price volume, or obviously beneficial mix impacts with some of these new product developments?

Jennifer L. Sherman:

Yes. I think one of the things we talked about on the call was the $50 million of incremental revenue from new product introductions, so—and we think that's an important metric and one that our businesses continue to focus going forward.

Ken Newman:

Okay, and then last one for me, it does sound like these new organic initiatives are pretty top of mind for you going forward. Just curious, have you guys ever put out a—I guess a vitality index, or a way to measure how much some of these new products are incrementally impacting revenue? Any help in terms of figuring out where you are now and where you expect to go in 2019?

Jennifer L. Sherman:

We have, across our various businesses, because our businesses have different cycles, so we have different vitality indexes for each of our businesses, and a lot of it focused on, for example, something like a sewer cleaner, features of a sewer cleaner, for example, the rapid deployment boom or water recycling can be a very significant differentiator in the marketplace, so the short answer to your question is we've got individual targets for our businesses and they vary anywhere from 10% to 30%.

Ken Newman:

Understood. Thanks for the time.

Ian A. Hudson:

Thanks, Ken.

Operator:

Thank you. We will now take our next question from Walter Liptak of Seaport Global.

Walter Liptak:

Hey guys. Just a couple of really quick follow-ups on the margin questions. Jennifer, what inning would you say you're in with the ETI? It sounds like you've got new training programs that are going on for employees. What inning are you in?

Jennifer L. Sherman:

I firmly believe that there's always opportunity for improvement, and we talked about, I think it was on the second quarter call, the success that we've had using the ETI principles with Joe Johnson and the margin improvement that we saw, so we believe that, with any acquisition, that we're in earlier innings, but we still—I would say we're—it's a continued focus. We still think there's opportunity as we move forward, and I'm caught—when I was out at Elgin last week and with our plant manager and he was walking through some new ideas that they've got on ETI, and they were one of the first early adopters, so it can vary business-to-business, but I will tell you it's part of the culture. We incentivize people with respect to their accomplishments in this area, and I think there's a lot of opportunity going forward.

Walter Liptak:

Okay, great, and then the second one is on the ESG capacity. If my memory serves, you did a (inaudible) expansion at Streator, I don't know, it was 2004, something like that, and the margins, after the capacity went in, went up to sort of a—some record levels, in the high teens. How do you see the new capacity impacting profitability in like the 2020 time period?

Ian A. Hudson:

Yes. I think, Walt, if you look back to that last expansion, it was really intended to be the addition of the HXX line, and that product really was the one that was sold directly to oil and gas, and so some of that impact would have been just the mix effect. We had a lot of volume of high margin product that was sold to the customers in oil and gas. As we've mentioned, we've seen that certainly oil and gas has recovered a little bit in '18, but it's not to the same extent that it would have been over that time period, and we've seen something of a shift towards more of a rental activity on the oil and gas, so I don't know that you'll see the same correlation, but the reason for the expansion is because we see strong growth potential and to be able to perform within that impressive EBITDA margin range.

Walter Liptak:

Okay. All right. Great. Thank you.

Operator:

Thank you. As there are no further questions, I'd like to hand the call back to Jennifer Sherman for any additional or closing remarks.

Jennifer L. Sherman:

Before we sign off, I'd like to mention that we recently introduced a new mission statement in order to provide additional clarity as to our overall goals as an organization. We aim to be relentless in our commitment to our customers to building and to delivering equipment of unmatched quality that moves material, cleans infrastructure, and protects the communities where we work and live. Our new tagline is move, clean, protect.

In closing, I would like to reiterate that we are confident in the long-term prospects for our businesses and our markets. Our teams are performing at a very high level and remain focused on delivering high-quality results. We remain committed to investing in our businesses and our people to generate sustained long-term success for our shareholders. Our foundation is strong, and we are focused on delivering profitable long-term growth through the execution of our strategic initiatives.

We want to express our thanks to our stockholders, employees, distributors, dealers, and customers for their continued support. Thank you for joining us today and we'll talk to you next quarter.

Operator:

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now...