Federal Signal Corporation

Fourth Quarter Earnings Conference Call

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CORPORATE PARTICIPANTS

Ian Hudson, *Chief Financial Officer*

Jennifer Sherman, *Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Michael Shlisky, *D.A. Davidson*

Felix Boeschen, *Raymond James*

Gregory Burns, *Sidoti & Company*

Steve Barger, *KeyBanc Capital Markets*

Chris Moore, *CJS Securities*

Walt Liptak, *Seaport*

PRESENTATION

Operator

Good morning, and welcome to the Federal Signal Corporation Fourth Quarter Earnings Conference Call.

Please note this event is being recorded.

I would now like to turn the conference over to Ian Hudson, Chief Financial Officer. Please go ahead.

Ian Hudson

Good morning, and welcome to Federal Signal's Fourth Quarter 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, federalsignal.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.

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Before I turn the call over to Jennifer, I'd like to remind you that some of the 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.

Jennifer is going to start today with a recap of the year and then I will provide some more detail on our fourth quarter and full year financial results. Jennifer will then provide her perspective on our performance and go over our outlook for 2023 before we open the line for any questions.

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

Jennifer Sherman

Thank you, Ian.

I'd like to start by giving my profound thanks to each of our employees and our business partners for their ongoing commitment to the Company.

As I reflect back on my tenure as CEO, I take great pride in the growth that we've experienced since 2016. Since then, through a combination of organic growth initiatives and M&A, our sales have doubled from a little over $700 million in 2016 to more than $1.4 billion in 2022. That represents a compound annual growth rate of around 13%.

With M&A representing about two thirds of our top-line growth since 2016, acquisitions have played a key role in increasing shareholder value. We are committed to remaining disciplined in our approach to both diligence and valuation and have established a reputation as a partner of choice.

In fact, of the 11 transactions announced over this time period, eight have been internally sourced. We have also gained traction on our key organic growth initiatives which have helped us to further diversify our revenue streams and end-market exposures and become a more resilient Company. I'm also inspired by the manner in which our businesses have achieved these stellar financial results, which are outstanding both in absolute terms and in comparison to our specialty vehicle peers while navigating through a series of complex challenges, including a global pandemic, unprecedented inflation levels, and worldwide supply chain disruption.

Our team's successful execution against our long-term financial framework and growth strategy has created meaningful value for our stockholders with our cumulative returns outpacing each of the key benchmark indices we monitor.

As I look ahead, I remain bullish about our long-term prospects and the ongoing execution of our strategy. I take encouragement from our active M&A pipeline, the additional financial flexibility provided by our increased credit facility, and the fact that although we are currently performing at a high level, there is still room for further growth with the capacity we've added in recent years.

Despite ongoing supply chain tightness in the marketplace, 2022 was a record year for Federal Signal. Our teams remained relentlessly focused on serving our customers, helping us to deliver the highest net sales and adjusted EPS in the Company's history, record orders and an improved EBITDA margin of 15%

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towards the high end of our target range. In addition to our strong financial performance, we also made progress against several of our long-term strategic objectives in 2022.

Within our Environmental Solutions Group, we again saw increased aftermarket demand with particular strength in rental utilization and parts and used equipment sales. Overall, our aftermarket revenues in 2022 were up 10% over last year.

Demand for our range of safe digging trucks also remained high, with orders up 41% year-over-year. This growth follows investments we've made in facility expansions, new product development, and channels for this key strategic initiative.

Our investments in electrification projects continued, and we are encouraged that these efforts will provide additional opportunities to further diversify our customer base, penetrate new end markets and gain access to new geographic regions. We made several strategic investments for the future by purchasing new machinery and equipment aimed at automating and insourcing production of certain components.

During 2022, we also completed the acquisition of our facility in University Park, Illinois, which is home to our domestic SSG operations and our aftermarket parts business. Our 80/20 improvement initiatives remain a critical part of our culture, and we continue to focus on reducing product costs and improving manufacturing efficiencies across all our businesses. We demonstrated our commitment to returning value to our stockholders, funding a combined $38 million of cash dividends and share repurchases.

To highlight our ongoing focus on operating in a socially responsible and sustainable manner, we also published our third annual sustainability report in May of '22. I'm incredibly proud of the progress that we've made in our environmental, social and governance initiatives and thrilled to share our many accomplishments highlighted in this report. We measure our performance utilizing several leading ESG rating agencies, and we are pleased with the improvement of ratings during 2022.

Our ongoing commitment to the communities in which we operate is also a differentiating factor in our ability to attract talent and support strong labor relations. During 2022, the union at our Rugby, North Dakota manufacturing facility was decertified following a process that was initiated by our employees.

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

Ian Hudson

Thank you, Jennifer.

Our financial results for the fourth quarter and Full Year of 2022 are provided in today's earnings release.

Before I talk about the fourth quarter, let me highlight some of our full year consolidated results. Net sales for the year were approximately $1.43 billion, a record high for the Company and an increase of $222 million or 18% compared to last year.

Organic sales growth for the year was $130 million or 11%. Operating income for the year was $160.8 million, an increase of $30.1 million or 23% from last year. Adjusted EBITDA for the year was $215 million, up $34.5 million or 19% compared to last year. That translates to a margin of 15% this year, up 10 basis points from last year.

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GAAP earnings for the year equated to $1.97 per share, up $0.34 per share, or 21% from last year. On an adjusted basis, we reported full year earnings of $1.96 per share, up $0.21 per share or 12% from last year.

Orders for the year were $1.69 billion, another Company record, and an increase of $153 million or 10% from last year. With the strong momentum in customer demand, consolidated backlog at the end of the year was at an all-time high level of $879 million, an increase of $250 million or 40% from last year.

For the rest of my comments, I will focus mostly on comparisons of the fourth quarter of 2022 to the fourth quarter of 2021. Consolidated net sales for the quarter were $392 million, an increase of $19 million or 30% compared to last year. Organic sales growth for the quarter was $71 million or 24%. Consolidated operating income in Q4 this year was $46.6 million, up $16.5 million or 55% compared to last year.

Consolidated Adjusted EBITDA for the quarter was $61.1 million, up $21.1 million or 53% compared to last year. That translates to a margin of 15.6% towards the high end of our target range and up 230 basis points from last year. GAAP EPS for the quarter was $0.57 per share, up $0.25 per share or 78% from last year.

On an adjusted basis, EPS for Q4 this year was $0.57 per share, an improvement of $0.17 per share or 43% compared to last year. Orders in Q4 this year were $444 million, the second highest quarterly orders in the Company's history. In terms of our fourth quarter group results, ESG sales were $325 million, an increase of $80 million or 33% compared to last year.

ESG's Adjusted EBITDA for the quarter was $57.6 million, up $21.4 million or 59% compared to last year. That translates to an Adjusted EBITDA margin of 17.7% in Q4 this year, towards the high end of the group's target range, and up 300 basis points from Q4 last year.

SSG sales in Q4 this year were $66 million, up $10 million or 18% compared to Q4 last year. SSG's Adjusted EBITDA for the quarter was $13.2 million, up $2.2 million or 20% from last year. SSG's Adjusted EBITDA margin for the quarter was 19.9%, up 20 basis points from Q4 last year. Corporate operating expenses in Q4 this year were $10.2 million compared to $4.1 million in Q4 last year, which included a non-recurring $3.5 million benefit from the reduction in the fair value of contingent consideration associated with acquisitions.

Turning now to the consolidated statement of operations, where the increase in sales contributed to a $29.2 million improvement in gross profit. Consolidated gross margin for the quarter was 24.7%, up 230 basis points compared to last year. As a percentage of sales, upselling, engineering, general and administrative expenses for the quarter were down 70 basis points from Q4 last year.

During the fourth quarter of this year, we recognized $500,000 of expense from acquisition- and integration-related activity, compared to a $3 million benefit in Q4 last year with the majority of the year-over-year change driven by the prior year consideration benefit I just referenced. Other items affecting the quarterly results include a $600,000 increase in amortization expense, a $3.2 million increase in interest expense, and a $700,000 increase in other expense.

In Q4 last year, we also recognized a non-cash pre-tax pension settlement charge of $10.3 million associated with a pension annuitization project. Income tax expense for the quarter was $7.4 million compared to a $300,000 income tax benefit in the prior year with the year-over-year change largely due to higher pre-tax income levels and a $1.9 million reduction in discrete tax benefits. Including discrete tax benefits, our effective tax rate for the Full Year of 2022 was approximately 20%.

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For 2023, we currently expect a tax rate of between 25% and 26%, excluding any discrete tax benefits. On an overall GAAP basis, we therefore earned $0.57 per share in Q4 this year, compared with $0.32 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 quarters. In the current year quarter, we made adjustments to GAAP earnings per share to exclude acquisition-related expenses and debt settlement charges. On this basis, our adjusted earnings in Q4 this year were $0.57 per share, compared with $0.40 per share in Q4 last year.

Looking now at cash flow, where we generated $40 million of cash from operations during the quarter, bringing the total amount of year-to-date operating cash generation to $72 million. Early in the fourth quarter, we executed a new five-year, $800 million credit facility replacing the $500 million credit facility that was previously in place.

During the fourth quarter, we completed the acquisition of TowHaul for an initial payment of approximately $43 million. In early January, we completed the acquisition of Blasters for an initial payment of approximately $13 million. Our current net debt leverage ratio remains low even after factoring in recent acquisitions. We ended the quarter with $316 million of net debt and availability under our credit facility of $428 million.

With our financial position strengthened by the increased borrowing capacity under our new credit facility and our healthy cash generation, we intend to pursue additional strategic acquisitions like our recently announced Trackless deal. We also have significant financial flexibility to invest in organic growth initiatives and fund cash returns to stockholders.

On that note, we paid a dividend of $0.09 per share during the fourth quarter, amounting to $5.4 million, and we recently announced a similar dividend for the first quarter.

That concludes my comments, and I would now like to turn the call back to Jennifer.

Jennifer Sherman

Thank you, Ian.

Overall, our fourth quarter results represented a strong finish to a record year. Within our Environmental Solutions Group, increased sales volumes, contributions from recent acquisitions and strong price realization contributed to a 33% year-over-year net sales increase and a 300-basis point improvement in EBITDA margin.

During the fourth quarter, production and shipments at our Streator and Elgin manufacturing facilities improved by approximately 20% as compared to the third quarter. The production improvements are encouraging and demonstrate that we are benefiting from the actions taken to mitigate the global supply chain shortages, including investing in additional safety stock inventory, bringing additional suppliers online, re-engineering products and in-sourcing where possible.

With its supply chain continuing to improve, our Safety and Security Systems Group also delivered impressive results during the quarter, including 18% top-line growth and an EBITDA margin of approximately 20%. This performance was achieved despite a week-long plant shutdown at our University Park facility in December due to a power outage. The management team worked tirelessly to bring production back online, and I cannot express enough gratitude to the hardworking employees at our

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University Park facility for their efforts to partially mitigate these impacts and deliver essential equipment to customers, including working substantial overtime and on previously scheduled holidays.

With its consistently strong performance over the last several quarters, at this time we are increasing the EBITDA margin target for our Safety and Security Systems Groups to a new range of 17% to 21% from the previous range of 15% to 18%.

Demand for our product offerings continues to be as strong as ever as demonstrated by our outstanding fourth quarter order intake of $444 million, contributing to another record backlog entering the year and reflecting strength across our end markets. This order strength has continued so far into 2023. I recently attended two large specialty vehicle trade shows, where the sentiment among our dealer network and customers remains bullish as municipalities, both small and large, are continuing to place orders at historic levels based in part by a surplus of funds directly attributed to funds provided by economic stimulus packages.

In 2021, the Treasury began distribution of the first $175 billion tranche that was earmarked for state, local and territorial governments for a variety of purposes, including the maintenance of essential infrastructure such as sewer systems and street. The second $170 billion tranche was scheduled for distribution beginning in 2022. This positive dealer sentiment is supported by the ongoing strength of U.S. municipal orders, which were up 13% year-over-year, with notably strong demand for street sweepers and sewer cleaners.

In fact, in 2022, our municipal orders for street sweepers are up around $34 million or 22% over last year, while sewer cleaner orders are up $27 million or 15% over the prior year. We are also seeing strong domestic municipal demand within SSG with orders for public safety equipment up 10% year-over-year.

Over the last few years, several major urban domestic municipalities had paused, making investments in public safety equipment in response to the defund police movement. This trend appears to have started to reverse. We have also seen strong demand for our public safety equipment from international markets.

Turning to the $1.2 trillion Infrastructure Bill, which has $550 billion for new investments in roads, bridges, power, water and broadband infrastructure, public transportation, airports, we are beginning to see demand pick up in the form of equipment inquiries from contractors who are working with state departments of transportation agencies and roads, bridges and related projects.

Additionally, conversations among our dealer channel indicate contractors are now planning out projects through 2024 and are beginning to make inquiries based on their large equipment needs directly tied to these infrastructure funds.

Within our industrial end markets, we saw a 10% year-over-year improvement in domestic orders during 2022. The improvement has been almost across the board, but most notably for our TRUVAC safe-digging trucks and our Guzzler industrial vacuum orders, which collectively were up $67 million or 62% year-over-year.

While industrial order strength continues, we continue to experience some softness in orders for dump truck bodies as customers and dealer-provided stock chassis and pool chassis for all size classes remain a primary constraint for this product offering, as dump bodies typically receive lower prioritization from dealers when chassis availability is limited based on allocations from OEMs.

As chassis availability improves, we expect to see increased orders based on pent-up demand, particularly with the anticipated need for dump trucks for infrastructure-related projects. We remain committed to our vehicle electrification initiative and continue to identify new ways to integrate

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electrification into our suite of products and offer solution to our customers on their path towards reducing their carbon footprint and improving air quality without compromising performance.

We are experiencing high demand for our dealer network for demonstrations of our plug-in hybrid Broom Bear and hybrid Pelican Sweeper products. We are also excited to announce that Elgin will be introducing a full-size all-electric sweeper at the CONEXPO trade show in March. A fully electric Rugby Vari-Class platform dump body will also be featured at this trade show. We continue to incorporate recent acquisitions into our electrification roadmap and Deist will be introducing a new Switch-N-Go system on a Class 4 electric chassis at the NTEA Work Show next week.

With the continued advancements in electrification, we have also developed dedicated resources and partnered with industry experts to research and identify the most relevant state and federal funding information for sweepers actively linking our customers to EV funding opportunities.

In addition to electrification, our innovation teams remain committed to providing solutions to solve customer problems and have launched more than two dozen new products in 2022. Examples include the TRUVAC TRXX series of trailer-mounted safe-digging products, Vactor's launch of a five-cubic yard version of the impact-compact combination sewer cleaner, and Elgin's introduction of a non-CDL Broom Badger Street sweeper. Jetstream also introduced its largest pump product, the 5200Q pump, which is capable of more than 700 horsepower, and Ground Force launched a new 200-ton capacity Belly Dump coal trailer.

With a focus on features and functionality, our solutions aim to simplify ease of operation and training, reduce operating costs, and maximize asset utilization. Innovation will continue to play a critical role in our long-term growth. With lead times for new equipment continuing to be extended, we expect demand for our aftermarket offerings to remain high as it was in 2022, when our aftermarket business represented 27% of ESG's revenues. In fact, quoting activity for spring rentals so far this year has been practically double what it was at the same time last year.

With the combination of high rental demand and strong used equipment sales in recent quarters, we are planning to add units to our rental fleet to replenish units that were sold in 2022. As a result, we are expecting that a larger portion of our first quarter production of Vactor, TRUVAC, and Elgin units will be used to replenish our rental fleet in comparison to the prior year.

We also see additional opportunities to grow our aftermarket business by expanding into new geographies we believe to be underserved. In Colorado, for example, we have now secured a new facility which we expect to be fully operational during the second quarter.

In early January, we completed the acquisition of Blasters, a leading manufacturer of truck-mounted water blasting equipment. Blasters designs, manufactures and sells the Liquidator, an ultra-high pressure, water-based road marking and rubber removal truck. Blasters also engages in the sale of certified pre-owned units and supports the recurring aftermarket needs of its customers through parts and service offerings.

The acquisition represents a strategic product line addition to Mark Rite Lines, thereby giving us the opportunity to cross launch both businesses, robust market positions, and allowing us to serve our shared customer base with a comprehensive range of world-class products and solutions for road and surface infrastructure maintenance. I recently attended the ATSSA's trade show in Phoenix, where the combined MRL Blasters booth generated a lot of interest.

Last week we announced the signing of the Trackless Acquisition Agreement. Trackless is a leading Canadian manufacturer of multi-purpose offroad municipal tractors and a variety of attachments which

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provide year-round value to its customers. The interchangeable Trackless attachments can help customers achieve carbon reduction and other environmental goals by operating a single highly-versatile unit instead of several purpose-built vehicles. Trackless also supports the recurring aftermarket needs of its customers through a comprehensive parts offering, sales of which represent up to 20% of annual revenue.

With our Joe Johnson Equipment subsidiary currently the largest distributor of trackless products in North America, we have a great appreciation of Trackless products and a reputation for quality and innovation. We are excited about the opportunities to leverage our existing distribution channel to expand the geographic reach of Trackless products and accelerate the growth trajectory of this business. The acquisitions of Blasters and Trackless will further bolster our position as an industry-leading diversified manufacturer of specialty vehicles for maintenance and infrastructure markets.

Our deal pipeline remains active, and we continue to believe that M&A will be an important part of our growth.

Turning now to our outlook. Conditions in our end markets remain strong. With ongoing execution against our strategic initiatives and opportunities to drive improved efficiencies, we are confident that we will have another record year in 2023. We have started to see the benefits from Federal Stimulus Funding in our recent order trends contributing to a record backlog entering 2023 and improvement in supply chain.

Although seasonal effects typically result in our first quarter earnings being lower than subsequent quarters, we are anticipating year-over-year growth with earnings in the first quarter of 2023 expected to represent a similar percentage of our full year outlook as in 2022. For the full year, we are expecting net sales of between $1.58 and $1.72 billion, double digit improvement in pre-tax earnings and EBITDA margin performance towards the upper end of our current target range.

We also currently expect to report adjusted EPS of between $2.15 and $2.40 per share, despite an aggregate year-over-year EPS headwind of approximately $0.23 per share resulting from the normalization of our tax rate and higher interest expense. Our outlook also assumes a nominal contribution from Trackless acquisitions, which we currently expect to complete during the second quarter.

With an active M&A pipeline, ongoing investment in new product development, recently completed capacity expansions, good access to skilled labor, and anticipated multi-year tailwinds from infrastructure legislation, economic stimulus, our businesses are well-positioned for long-term sustainable growth.

With that, we are ready to open the lines for questions.

Operator.

Operator

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

Our first question is from Mike Shlisky with D.A. Davidson. Please go ahead.

Jennifer Sherman

Good morning, Mike.

Mike Shlisky

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Good morning. Yes. Hello, good morning, and thanks for taking my questions.

The first question is probably the one you have written down to answer once the Q&A starts. The most obvious one is, I'm glad you raised one segment's margin targets. What kept you from raising the other ones?

What should we be watching for in '23 to hopefully make that second jump there?

Jennifer Sherman

As we talked about last year, we saw supply chain started to improve in our SSG segment earlier than the supply chain improvement fraction in our ESG segment. We want to make sure when we increase these margin targets that we're going to hit the targets. Although we're encouraged by the supply chain improvement we saw in Q4 for ESG, we still need some time to make sure that that's going to stick.

Supply chain improvement has not been linear in our world. We have good days and bad days. The good news is we're having more good days than bad days, but we go a little bit forward, a little bit sideways, a little bit backwards, and we move towards the top.

It's really driven by the improvement, the sustainable improvement, that we've seen in supply chain where SSG pre-dated ESG. But we're watching it carefully and we're committed to increasing.

Mike Shlisky

Great. Thanks for that.

I didn't hear much commentary this quarter around chassis supply. I was curious, is there a reason? Was it just things are back normal for you? Or it's just not something that's been as much of a focus as it has in the past couple of quarters?

Jennifer Sherman

Let me start with TBEI.

Chassis supply is still a problem. In terms of prioritization for our TBI customers, we don't own the chassis in that situation, so typically we're lower in the queue, and it is a constraint right now. Based on the public comments made by some of the chassis OEMs, we're hopeful as we get to the second half of the year that we're going to see improvement.

On our non-TBEI vehicle businesses, we're still on allocation, but we've gotten better at allocation. We've been able to go out and procure some additional chassis. Our dealers have been able to procure chassis, some of our customers have been able to procure chassis.

Would we like more chassis? Absolutely. But we've done a pretty good job of maneuvering our way through this and again, we're hopeful that we see more chassis availability in the second half of the year, but we don't control that.

Ian Hudson

Yes. I think, Mike, just to build on Jennifer's point, obviously we've made a strategic decision to provide more chassis. When you look at our inventory on the year-over-year basis, about $13 million of that

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increase is because we've invested in chassis. We're doing that really to try and serve our customers, but it's come with a headwind to our gross margin.

In Q4, for example, it was a headwind of about 70 basis points of our gross margin was because we supplied more chassis. I think that is something that over time we would like to go back to more steady state. But given the environment we're operating in, we've made the decision to provide more chassis than we typically would.

Mike Shlisky

Great.

Want to throw one more in, and perhaps a two-part question on the Trackless deal.

Can you share—does that company use an off-the-shelf engine, or a large company brand engine, in their machines? Are there opportunities to get any purchasing synergies there with other businesses like your street sweepers, etc.?

The other part of the question is, I notice they've got an industrial mowing business, vegetation maintenance. That's not been a focus of Federal Signal in the past, to my knowledge, nothing tremendous. Are you looking to expand more into the green parts of the infrastructure going forward?

Jennifer Sherman

Let me start with this is a deal that I've been working on, our team has been working on, since 2015. Our JJE team, as we talked about in the prepared comments, is the largest distributor of Trackless equipment. We know the company well. It's an outstanding company.

With respect to—yes, they do purchase large engines, from a large engine supplier. Yes, we believe there's synergies there and we're excited about that. This acquisition, although is smaller, is a—I think has great growth opportunities.

We're planning on having a kind of winter attachments package and a summer attachments package. The summer attachments package would include the mower attachment that you referenced.

We believe, again, that this particular company, very well managed, a great company, will be able to offer, depending on the geographies, either summer, winter, or both, or either or. It really helps our customers reduce their carbon footprint also, because instead of having several multipurpose vehicles, they can have one vehicle with multiple attachments.

Then again, we believe with our footprint, the opportunity to grow their after markets business, that attachment, is great.

I was absolutely thrilled. The management team is fantastic, and we really think there's a ton of opportunity going forward.

Mike Shlisky

That's great color. I really appreciate it. I'll pass it along.

Ian Hudson

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Thanks, Mike.

Operator

The next question is from Felix Boeschen with Raymond James. Please go ahead.

Jennifer Sherman

Morning, Felix.

Felix Boeschen

Hi. Good morning, everybody. Hi, Jennifer. Good morning.

I was curious on the top line guide, if we could maybe talk about some of the key puts and takes. As I think about going from '22 to '23, I think there's going to be obviously some M&A impact, some price impact. You mentioned aftermarket being a growth source.

I'm wondering, Ian, could you bucket those for us, and maybe talk about what you're implying on some of core volumes in the guide?

Ian Hudson

Sure. I think obviously, the guide is a year-over-year increase at the aggregate level of between 10% and 20%. The organic component is around about 6% to 16%, with the delta obviously being the acquisition contribution.

Of the organic growth component, it's a pretty wide range, I think, and that's reflective mainly of supply chain, particularly on the dump truck side of the business. I think when you look at the organic growth of 6% to 16%, on the lower end, price would probably be about half of that, with volumes making up the difference. Then obviously, as you go further up the range, that's going to be mainly volume driven.

Felix Boeschen

Okay, got it. Super helpful.

Then you talked about adding to the rental fleet, and I think you talked about doing it in the first quarter. Maybe this is a bigger picture question, but how do you think about utilization of that rental fleet today? Where do you think the fleet size could go in the next coming years here, just as we think about obviously infrastructure being a driver and so on.

Jennifer Sherman

Let me start with quotes are up so far this year pretty meaningfully, so we're expecting to have a good year on rentals.

Number two is we have strong rental partners. We're not, as you know, the only entity that rents our equipment. We have several strong rental partners, and our expectation is to continue and invest in those rental partners. We expect the fleet, partly because of supply chain challenges, there's a tremendous amount of demand for used equipment in 2022, so we're replenishing in Q1 to get back to where we were.

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It's important we do that in Q1 because as we get into the summer, particularly in areas of Canada and the Northern half of the U.S., that equipment has pretty high utilization. I'll share with you that our utilization has been strong throughout 2022, and we expect that to continue into 2023.

In terms of the size of the rental fleet, we don't have plans to dramatically grow the fleet. We're going to respond to customer demand and continue to be disciplined and we're also going to rely upon our rental partners.

Felix Boeschen

Okay.

Then my last one, and maybe this is better for Ian, but I'm curious if we could talk about free cash flow conversion into next year and maybe beyond.

But obviously, Capex is stepping down post the facility additions. Working capital has obviously been a big headwind in 2022. I am curious how you think about the conversion into 2023.

Then, just to confirm, there really wasn't anything baked in from either a repurchase or a debt paydown perspective in the guide. Is that right, Ian?

Ian Hudson

There's a little bit of debt paydown assumed, just based on what we're expecting from a cash generation standpoint. I think if you look at the full year, obviously our cash conversion was impacted with some of the investments we had to make in inventory levels, mainly.

Our conversion was below our target. We typically target conversion of 100% on a net income basis. I think for this year we're about 60%. We are expecting that to improve as we go into '23. I don't think it will be all the way back to our target because I think what we're trying to do is balance the needs to have inventory supply chain, as Jennifer mentioned, is not solved. It's improved, but we still are fighting through challenges on a regular basis.

I think we will be up from where we were in '22, but maybe not all the way back to our target level because we still have record backlogs that we're actively trying to work down those backlogs and reduce lead times. I think we'll still see some investment in inventory.

Jennifer Sherman

Yes. For example, Ian referenced investments we're making in chassis, and that's an important investment in terms of serving the needs of our customers.

But our teams are focused in terms of both balancing the inventory we need to support our backlogs and supply chain challenges. We have inventory reduction goals at each of our businesses for '23.

Felix Boeschen

Understood. Thank you for the time. I'll pass it on.

Ian Hudson

Thanks, Felix.

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Jennifer Sherman

Thank you.

Operator

The next question is from Greg Burns with Sidoti & Company. Please go ahead.

Jennifer Sherman

Morning, Greg.

Ian Hudson

Morning.

Gregory Burns

What is the interest expense for next year?

Ian Hudson

We're guiding to between $18 million to $20 million on a full year basis.

Gregory Burns

Okay, great.

Then you mentioned production being up, I don't know if it was in dollar or units, but up 20% sequentially. Where are you in terms of your capacity utilization? I know you've added a lot of added capacity over the last year or so, but obviously you've been production constrained because of supply constraints. How much more capacity do you have?

If you could produce to demand, how many more units or how much more revenue could you be generating per quarter?

Jennifer Sherman

What we were talking about when we were talking about the increases we saw in production, that was at our Vactor and Elgin facilities. Depending on the quarter, we were running between 60% and 70%, depending on the quarter last year.

There's plenty of room for future growth.

Gregory Burns

Okay.

Then with the Trackless acquisition, just so I understand the platform. Do they sell those attachments solely for their own units or do they—are these attachments sold to other—can someone buy their attachments and then attach it to their own trucks?

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Jennifer Sherman

Theoretically, I guess you could buy their attachments and attach it to their own trucks but the purpose of it is for the tractors they manufacture.

Gregory Burns

Okay. Perfect. Thank you.

Operator

The next question is from Steve Barger with KeyBanc Capital Markets. Please go ahead.

Jennifer Sherman

Good morning, Steve.

Steve Barger

Good morning.

If we look at the midpoint revenue guide it implies high-single or low-double digit unit volume growth, but the midpoint of EPS suggests about 20% incremental margin. I know there's still supply chain challenges, but when you think about footprint and mix, how do you think the portfolio should flex in a perfect state on volume increases?

Ian Hudson

I think in a perfect state, Steve and I will probably...

Steve Barger

Well, let's say, a good state.

Ian Hudson

I will caveat this by saying our guide wasn't a perfect state. But in a good state, typically with the backlogs where they are right now, we typically can generate some decent operating leverage in anywhere from 20% to 30%, I think we've seen in the past.

I think we would be expecting somewhere within that range from an operating leverage standpoint for both groups.

Jennifer Sherman

But again, when we put the guidance together, we did not assume a perfect state. We had assumed a...

Steve Barger

Sure. Understood. Yes, I know there's still challenges out there.

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Going back to the conversation on cash flow conversion. Over five years, you've averaged 97%, free cash flow conversion has been around 66% with the last two years below that.

As you pursue this acquisition driven strategy, should we assume that you just become more capital intensive over time? Or will there be opportunities to take some of those acquired assets and consolidate them? Can you talk about how you think about that?

Ian Hudson

I think, Steve, the last couple of years have been unusual because that would include two large building purchases. We bought both University Park and our Elgin facilities. That caused our Capex to be elevated the last couple of years. That would be—if you normalize for those two things, which we wouldn't expect to recur going forward, I think that would be more in line with what we would expect.

Steve Barger

Okay.

If I look back at the acquisition track record, the deals have gotten a little more expensive, trending closer to 2 times price to sales. Has the margin profile gotten better as well? Or are you seeing more expensive deals because of financial conditions or scarcity value or whatever the case may be?

Ian Hudson

The couple that we've completed in the last couple of quarters, I think the margin profile is attractive and that's really what's been of interest. When you look at it on a percentage, or a multiple of sales, that's what's driven that increase.

But I think the margin profile of what we've acquired in the last several quarters is towards the upper end of that target range. That's one of the things that when we look at increasing those target ranges for ESG, that's one of the factors that is in play.

Jennifer Sherman

I'll add there, if you look at the last couple of acquisitions, they have been sustainable through cycle margin profiles. We like that part of the business, and we also believe that the aftermarket parts of those businesses is an important part of the valuation equation.

Steve Barger

Understood.

I know this can be tricky to know for a private company, before you drive synergies, but has the cash flow profile or the cash flow conversion for those acquisitions mirrored what you target for Federal Signal? Or is there anything that can keep you from getting there?

Jennifer Sherman

It absolutely mirrors what we target for Federal Signal. All of these businesses have been relatively low Capex. A great example would be Trackless. They've invested in best-in-class equipment. There's very little investment that's required on our part in terms of to grow that particular business.

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Steve Barger

Okay. Very good. Thanks.

Ian Hudson

Thanks, Steve.

Operator

The next question is from Chris Moore with CJS Securities. Please go ahead.

Jennifer Sherman

Good morning, Chris.

Chris Moore

Good morning, guys. Good morning.

Back to the revenue guide for a second. The organic range is 6% to 16%. Is there any significant difference in the assumptions in the overall health of the economy at the lower and higher ends? Or is it really more just a function of how the supply chain treats you?

Ian Hudson

I think it's mainly a function of supply chain, Chris, because I think, obviously the backlog at the end of the year, that gives us great visibility. I think what we've seen so far this year, the orders have been pretty strong as well.

In terms of the visibility the backlog provides, it gives us great visibility. Supply chain is a primary driver of the size of the range. Again, it's mostly on the dump truck side of the business.

Chris Moore

Got it. That's helpful.

I think, Jennifer talked about lead times still being something of an issue. Vactor seems to be a good barometer on lead times. My understanding, last fall there was 10 to 11 months there versus a normal 6 to 9. Has that changed much at all?

Ian Hudson

About the same. We've increased the output in the production, but at the same time, the demand has remained really strong.

Chris Moore

Got it. Just one last for me.

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Everyone's waiting for the new normal to return. It doesn't look like that's going to happen. Maybe you could talk a little bit about some of the things that you were forced into doing that you're not going to go back on. Whether that might be sourcing or making internally.

Just trying to understand how Federal Signal's positioned a little bit better post-pandemic.

Jennifer Sherman

There are silver linings in everything and the silver lining that's come out of this pandemic supply chain is Mark Webber has really led a great initiative in terms of coordination among our businesses for critical parts.

We've had several examples. One is our Elgin business had a problem with a part to China, and our Jetstream business stepped in and is now manufacturing that part. Our sewer cleaner business had a problem with a part, and our SSG business stepped in and was able to manufacture that part. We have examples across the enterprise where, given the various capabilities that we have, we can step in and help sister businesses. That's been very beneficial.

We've started to insource more in terms of, we need to make sure that we've got, in certain situations, critical parts, and that's been an important part of the success that we had in 2022.

In general, our supply base, because of our exposure to public revenue source, we've had a—our supply base is primarily a North American supply base, and it has been historically. That has benefited us through the tariff situation, through the pandemic and through the supply chain challenges.

We have great suppliers and our teams have done a great job in terms of—we continue to pay our suppliers timely through the pandemic. In the supply chain environment they've partnered with us to work through, and we've often been at the top of the queue.

I do believe we as a Company are much more nimble. We've qualified additional suppliers, which is important, and I think we're incredibly well-positioned for 2023.

Chris Moore

Perfect. I'll leave it there. Thanks, guys.

Ian Hudson

Thanks, Chris.

Operator

The next question is from Walt Liptak with Seaport. Please go ahead.

Jennifer Sherman

Good morning, Walt.

Walt Liptak

Hi. Good morning, guys.

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Great quarter and great long-term, too. That was impressive hearing about the CAGR over the long term.

I want to ask about the first quarter. You talked about it being seasonally lower, but you also said that you're going to be adding to the fleet. I think we can work out the numbers from the guidance. But I wonder if you just provide a little bit more details on what's going on seasonally, why you can't get more trucks out the door?

Ian Hudson

I think what we are trying to signal is the production is still—we're not expecting a big drop in production, but a lot of the production are going to rental units of our own, that go in our own rental fleet. We're using production for essentially units that won't generate that immediate income because they go into our own rental fleet. It's almost like an intercompany transaction.

That's the main reason that we were just calling that out, because while we're not expecting production to drop off, a lot of that production will be for units that go in our own rental fleet. That was the primary message we were trying to indicate there because with the strong used equipment sales that we've seen throughout 2022, and with the continued high demand for rentals in both the U.S. and Canada, we need to replenish our rental fleet. That's typically what happens during Q1, and that's typically one of the reasons Q1 is a softer quarter for us. But what we're trying to say is this quarter it might be more pronounced than it was last year.

Jennifer Sherman

I would just add is the historical seasonality of our business, Q1 is our softest quarter.

Walt Liptak

Okay.

What do you expect the operating leverage to look like in the first quarter?

Ian Hudson

In the first quarter. For the full year, I think we're looking at leveraging in the 20% to 30% range, as we talked about. I'd have to get back to you on the first quarter.

Walt Liptak

Okay. All right. Thanks.

Then if I can ask one on inflation and in selling prices. Are you still seeing inflationary pressure? What are the pricing strategies? Are you still finding that you need to increase prices in 2023?

Jennifer Sherman

Yes, we are still seeing inflationary pressure, particularly on the various component parts that we buy, often without a lot of notice. We have made it clear, both to our dealers and our customers, that we will react when needed and pass those costs on as necessary.

Ian Hudson

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We've seen steel has come down. We have seen that so there's some relief. But for some, as Jennifer said, for some of the other components, we haven't seen much relief to this point. We typically have an annual price increase that goes into effect, so that's something that will be considered as well.

But for overall in '22, what we saw was sequential improvement on a year-over-year basis in that price-cost dynamic. For the full year we were favorable. Most of that came in Q4, so we're encouraged with the actions that we've taken in response.

This is obviously in absolute dollar, not necessarily back to the margins that we were at before, but we were favorable on a year-over-year basis during '22.

Walt Liptak

Okay, great. Okay.

Then the last one for me is just on the EV products. It sounds like some of the products are getting commercialized. Are you taking orders or are those orders somehow tied to some of the government pro-infrastructure programs and other sorts of government funding that may still be in the pipeline?

Jennifer Sherman

We started to take some orders on certain product lines. As I mentioned in my prepared remarks, we have a program that's available on, for example, in our street's sweeping business that identifies public funding that's available to assist customers in purchasing EV equipment. We've launched that. We're starting to get some traction on that. Then certain products, we're in the demo phase as we talked about that.

But I'm pleased with the progress that we've made and its important part of our new product development pipeline.

Walt Liptak

Okay, great. Thank you.

Jennifer Sherman

Thank you.

Ian Hudson

Thanks, Walt.

Walt Liptak

The next question is from Dave Storms with Stonegate Capital Markets. Please go ahead.

Dave Storms

Excuse me. I actually meant to withdraw my question.

Jennifer Sherman

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Okay.

Operator

Showing no further questions, this concludes our question-and-answer session. I would like to turn the conference back over to Jennifer Sherman for any closing remarks.

Jennifer Sherman

In closing, I'd like to reiterate that we are confident in the long-term prospects for our businesses and our markets. Our teams are performing at a high level and remain focused on delivering high quality results. We continue to aggressively address supply chain challenges and we believe we are winning in the marketplace with our customers.

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 would like to express our sincere 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

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

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