



Federal Signal Corporation

Fourth Quarter Earnings Conference Call

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C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

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Felix Boeschen, *Raymond James*

Chris Moore, *CJS Securities*

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P R E S E N T A T I O N

Operator

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

I will now turn the conference over to your host, Mr. Ian Hudson, Chief Financial Officer. Thank you. You may begin.

Ian Hudson

Good morning, and welcome to Federal Signal's Fourth Quarter of 2020 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 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.

Before we begin, 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.

Jennifer is going to start today with her perspective on our performance, and then I will provide some more detail on our fourth quarter and full-year financial results. Jennifer will then go over our outlook for 2021 before we open the line up for any questions.

With that, I will 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. I'm immensely proud of how our teams have managed through these challenging times. It's hard to believe that it's been a little over a year since the first COVID-19 patient was reported in the U.S.

Since the outbreak of the pandemic, the health and safety of our employees has been our highest priority and we worked quickly to implement a host of measures to establish a safe work environment for our employees. These steps have included adjusting our office spaces and production processes at our facilities to comply with safe distancing guidelines.

During 2020, we invested in temperature screening capabilities at most of our facilities, issued a mandatory face mask policy, provided our employees with additional paid time-off, and made at-home test kits available for free to our employees and their family members. As the national COVID-19 vaccine distribution has gotten underway, it is clear to me that vaccinating our workforce is the single most effective tool at our disposal to protect our employees and customers and keep our businesses operating efficiently.

In a nutshell, putting this pandemic behind us is critical to our long-term success. With that in mind, we recently kicked off a company-wide effort to raise awareness about COVID-19 vaccines, assist eligible employees in gaining access to available vaccines, and encourage participation levels. Through the pandemic, our businesses have worked closely with local health departments. In Illinois, where we have three of our largest manufacturing facilities, many of our employees are now eligible to receive vaccine as essential workers.

In partnership with the local health department, we have organized an onsite vaccination event in March for all eligible employees at that site. I'm extremely appreciative to everyone that helped make this happen, and hope that we can host similar events at our facilities in other states when our employees become eligible. In addition to protecting our employees, one of our objectives in launching this initiative is to provide comfort to the customers and suppliers with whom we frequently interact in person, that our high percentage of our customer facing employees have received a vaccine.

We also want to provide a mechanism to encourage eligible employees to feel more comfortable traveling to support our customers. Sharing the same sentiment as others, we are anxious to move beyond COVID. During the fourth quarter, with the resurgence in cases across much of the country, many of our businesses experienced COVID related disruptions. The fact that we were able to navigate through these issues and deliver strong results was a real testament to our teams.

Thankfully, those trends are now improving. There's no doubt that these remain tumultuous and uncertain times. However, this experience has confirmed my strong belief that our workforce is unparalleled in its

passion, commitment and grit, and while we may have some challenging days or periods, I am confident that we will band together and work through these challenges as we have many others.

Overall, our performance in the fourth quarter represented a strong finish to 2020, a year in which we delivered the second highest adjusted EPS in the Company's history, surpassed only by the \$1.79 per share reported in 2019. Despite the impact of the pandemic on our top line, I was pleased with how our teams responded quickly, taking actions to control costs, which not only preserved our EBITDA margin, but improved it by 40 basis points on a year-over-year basis. In fact, both of our groups exceeded the upper end of their current target EBITDA margin ranges in 2020.

While many companies conserved capital in 2020, we were proactive in taking a number of actions to position the Company well for 2021 and beyond, as we continue to focus on our long-term growth objectives by funding strategic investments to support the future growth of the Company in three critical areas.

First, we have made significant investments in our existing plants to add additional capacity to support our long-term growth and to gain operational efficiencies through the use of newer machinery and equipment. We recently completed our plant expansion at Vactor and are making progress on expansions of our manufacturing facilities in Rugby, North Dakota, and Lake Crystal, Minnesota. Earlier in the year, we also completed the expansion of our MRL facility in Billings, Montana.

Second, we continued to invest in new product development, and we are seeing the benefits from these efforts with an estimated \$200 million of revenue in 2020 being generated from the sale of products introduced in the last three years. Among those products was the 2100i duel side sewer cleaner, which we launched in 2018. The 2100i sewer cleaner introduced intelligent controls on the truck and was entirely designed around our customer's needs for ease of use and operability. Two years following the launch, we continue to see strong results from that product line and positive customer feedback on the design.

During 2020, and on the back of our success with the 2100i, we launched a smaller sewer cleaner and a truck jetter machine that incorporates the same intelligent controls as the 2100i. The initial response to these products has been very positive. TBEI, our dump bodies business, was also successful in bringing several new products to market in 2020, addressing specific customer needs or improving our competitive positioning.

A few examples I would note are the launch of the J-Craft Apex dump body, which features smooth sides, with no seams, in a tough dump body that results in a significantly better flow of materials for the end-user; and the Dura Top SD, which is a heavy duty, abrasion-resistant dump body, with a simplified design that allows us to manufacture and fulfill the needs of our customers within a lead time of approximately six weeks, which is much shorter than manufacturers of competitor products.

Overall, revenues from these new products accounted for nearly 10% of TBEI's overall revenues during a year in which TBEI delivered the highest EBITDA margin under our ownership. Within SSG, we've increased our recurring revenue streams through CommanderOne, a product that leverages our existing install-based outdoor warning sirens, and provides a unique differentiator for Federal Signal siren control equipment.

Of our total R&D spend in 2020, approximately 20% was invested in electrification projects and we are pleased to report that during the fourth quarter, we received our first orders for our hybrid electric streetsweeper. Electrification will continue to be an important initiative for the Company moving forward.

Third, we reacted quickly to introduce several new digital marketing tools to enhance the customer experience of our customers under Reclaiming Tomorrow Together initiative. These tools, which include virtual equipment demonstrations and digital training academies, allow us to reach our customers in a new way. We also launched our e-commerce site in the fourth quarter, which initially focuses on certain product lines within our safety and security systems group.

Our strong cashflow generation supports not only these organic growth initiatives, but also ongoing debt repayment, cash returns to shareholders, and acquisitions.

In June of 2020, we completed the acquisition of PWE and last week we completed the acquisition of OSW Equipment and Repair.

In October of 2020, we issued our inaugural long form sustainability report. I'm incredibly proud of the progress we've made on our environmental, social, and governance initiatives, and thrilled to share our many accomplishments to the issuance of this report. With our commitment to continuous innovation, strong governance, and reduced resource consumption, we continue to build and deliver equipment that has beneficial impacts to both the environment and human safety. We are proud to be a company whose products have inherent environmental and social importance, and we hope that our pride is evident upon reading the report.

Let me now spend a minute on our recent acquisition, OSW. OSW is a leading manufacturer of dump truck bodies and a custom upfitter of truck equipment and trailers, and it's headquartered in Snohomish, Washington, with an upfitting location in Tempe, Arizona, and a service center at Edmonton, Alberta. Since acquiring TBEI in 2017, the geographic expansion of our existing platform of market-leading dump bodies and trailers has been an important strategic initiative.

The acquisition of OSW represents a highly strategic transaction, adding three premier brands that serve attractive infrastructure, construction, and other industrial end markets on the West Coast, Arizona, and in parts of Canada. We have previously noted that our dump truck businesses have a general correlation with new housing starts. The region in which OSW operates along the West Coast has been the fastest growing areas in the country in the last five years.

To capitalize on that growth potential and expand its reach, OSW completed two acquisitions in recent years and represents a good anchor tenet for future growth on the West Coast. With its main operations located in Washington State where the coronavirus pandemic first hit the U.S., OSW's financial performance was adversely impacted in 2020. However, it is a company with strong brands, several long-term contracts with municipalities, and a reputation for making quality products. The acquisition will also extend our current product offerings by filling in several gaps in the TBEI's existing trailer portfolio.

Although we expect this acquisition to be neutral to our 2021 earnings, the acquisition provides considerable opportunity for long-term value creation to the application of our 80-20 improvement principles, organic growth initiatives, and additional bolt on acquisitions.

I will now 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 2020 are provided in today's earnings release. Overall, our fourth quarter results represent a strong finish to the year. Before I talk about the fourth

quarter, let me highlight some of our full year results. Consolidated net sales for the year were approximately \$1.13 billion, down about 7% compared to the prior year.

Operating income for the year was \$131.4 million compared to \$147.1 million in the prior year.

Consolidated Adjusted EBITDA for the year was \$182.2 million compared to \$191.3 million in the prior year. That translates to a margin of 16.1% for the year, up 40 basis points from the prior year and above the high end of our target range.

GAAP earnings for the year equated to \$1.56 per share compared to \$1.76 per share in 2019. On an adjusted basis, we reported full-year earnings of \$1.67 per share compared to \$1.79 per share in the prior year.

For the rest of my comments, I will focus mostly on comparisons of the fourth quarter of 2020 to the fourth quarter of 2019.

Consolidated net sales for the quarter were \$295 million compared to \$314 million in the prior year. Consolidated operating income for the quarter was \$33.8 million compared to \$36.4 million in the prior year. On an adjusted basis, consolidated operating margin was 12%, up 10 basis points from the prior year.

Consolidated Adjusted EBITDA for the quarter was \$47 million compared to \$48.5 million in the prior year. That translates to a margin of 15.9% for the quarter, an improvement of 50 basis points over the prior year.

Income from continuing operations for the quarter was \$26 million compared to \$29.7 million in the prior year. That equates to GAAP EPS of \$0.42 per share for the quarter compared to \$0.48 per share in the prior year.

On an adjusted basis, EPS for the quarter was \$0.44 per share, which compares to \$0.48 per share in the prior year.

Orders for the quarter were \$276 million, down from record levels in the prior quarter, but up \$10 million or 4% from the third quarter of 2020. That momentum continued into 2021 with strong order intake in January contributing to a backlog of \$330 million at the end of last month. That represents an increase from \$304 million at the end of 2020.

In terms of our fourth quarter group results, ESG sales were \$238 million compared to \$252 million in the prior year. ESG's Adjusted EBITDA for the quarter was \$44.2 million, up 1% from the prior year. That translates to an Adjusted EBITDA margin for the quarter of 18.6%, above our target range and up 120 basis points from the prior year.

Our aftermarket revenues for the quarter were up about 11% year-over-year, again, contributing to the strong margin performance. Overall, our aftermarket revenues represented roughly 25% of ESG's revenues for the quarter, which is up from 21% in the prior year period.

SSG sales for the quarter were \$57 million compared to \$62 million in the prior year. SSG's Adjusted EBITDA for the quarter was \$11.2 million compared to \$12.6 million in the prior year, and its Adjusted EBITDA margin for the quarter was 19.6% compared to 20.3% in the prior year.

Corporate operating expenses for the quarter were \$9.8 million compared to \$8.4 million in the prior year, with the increase primarily related to unfavorable fair value adjustments of certain post retirement reserves, which represented a headwind of about \$0.02 in the quarter and higher M&A expenses.

Turning now to the consolidated income statement where the decrease in sales contributed to a \$5.6 million reduction in gross profit.

Consolidated gross margin for the quarter was 25.7% compared to 25.9% in the prior year. As a percentage of sales our selling, engineering, general, and administrative expenses for the quarter were down 40 basis points from the prior year. Other items affecting the quarterly results include a \$700,000 increase in acquisition related expenses, a \$1.1 million increase in other income, and a \$600,000 reduction in interest expense.

Compared to the prior year, tax expense for the quarter increased by \$2.8 million, largely due to the recognition of fewer discrete tax benefits than in the prior year quarter. Although it was up on a year-over-year basis, our effective tax rate for the quarter was lower than we expected at around 23%, primarily due to the recognition of benefits associated with stock compensation activity and other discreet items, which collectively added about \$0.03 to our fourth quarter EPS.

For 2021, we currently expect a tax rate of approximately 24%. That rate includes an estimate of tax benefits associated with stock compensation activity, similar to those recognized in recent years. On an overall GAAP basis, we therefore earned \$0.42 per share in the quarter compared with \$0.48 per share in the prior year.

To facilitate earnings comparisons, we typically adjust our GAAP earnings per share for unusual items. During the fourth quarter, we made adjustments to GAAP earnings per share to exclude acquisition related expenses, pension related items, coronavirus related expenses, and purchase accounting expense effects. On this basis, our adjusted earnings for the quarter were \$0.44 per share compared with \$0.48 per share in the prior year.

Looking now at cashflow where we generated \$57 million of cash from operations in the quarter, bringing the total amount of operating cash generation for the year to \$136 million. That represents a year-over-year improvement of \$33 million or 32%. The improved cashflow facilitated a \$30 million debt reduction in the quarter, as well as continued strategic investments in new machinery and equipment and other organic growth initiatives, like the expansion of several of our manufacturing facilities. In 2021, we are currently anticipating that our Capex, including investments associated with ongoing plant expansions, will be lower than in 2020, and in the range of between \$20 million and \$25 million.

We ended the year with \$128 million of net debt and availability of \$280 million under our credit facility. As a reminder, we executed a new five-year \$500 million credit facility in July of 2019. We also have the option to trigger an increase in our borrowing capacity by an additional \$250 million for acquisitions.

Our net debt leverage remains low, even after factoring in the OSW acquisition that we completed last week. We remain committed to our long-term capital allocation priorities of investing in organic growth initiatives, pursuing strategic acquisitions, and funding cash returns to 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 that we are increasing the dividend by 13% to \$0.09 per share in the first quarter.

That concludes my comments. I would now like to turn back the call to Jennifer for our outlook for 2021.

Jennifer Sherman

Thank you, Ian.

Looking forward, we remain focused on delivering strong results while continuing to execute on our long-term strategy. Our strong balance sheet provides opportunities for us to drive both our organic growth initiatives and pursue additional strategic acquisitions like OSW. Over the last several years, we have transformed our end market exposure and implemented a revenue diversification strategy that has enabled us to adjust as needed to market conditions.

Our aftermarket business has grown to represent about a quarter of ESG's revenues, and we see additional opportunities to grow that business. For example, late in 2020, we accelerated an initiative at one of our FS Solutions centers to expand our parts offerings by insourcing manufacturing of certain parts that we had previously procured from third parties.

We have also worked to develop strong contingency planning protocols, continue our journey of 80-20, and invest for growth. We are closely monitoring the potential actions that the new administration may take to boost the economy, including potential federal stimulus packages that may be provided at the state or local level to aid municipalities whose budgets have been impacted by the pandemic, and a potential infrastructure bill.

While there's still uncertainty as to the magnitude and timing of any federal stimulus package, I would like to provide a framework of what we know and what we believe the potential benefit to Federal Signal could be. The initial proposal under the American Rescue Plan COVID Relief Package calls for approximately \$1.9 trillion of economic stimulus, with initial projections of approximately \$350 billion going to state, local, and territorial governments, with the goal of keeping frontline workers employed, distributing the vaccine, increasing testing, reopening schools, and maintaining essential services.

As a provider of equipment used for these essential services, like sewer cleaning and street sweeping, Federal Signal is well-positioned to benefit from additional aid that may be provided to state and local sources for these purposes. We have recently completed our annual market planning process with our dealer partners and they remain cautiously optimistic about market conditions in 2021, noting that both corporate and sales tax collections appear to have held up better than originally anticipated, which should add stability to their revenue sources.

Although the dollar amounts that have been cited in the potential infrastructure bill are uncertain, it is clear that the U.S. is in desperate need of renewed investment in its infrastructure. An estimated 47,000 bridges and 40% of our highways are in need of replacement, whereas entire sewer systems have exceeded their useful life cycles.

We expect that a long-term infrastructure bill will provide visibility for project planning that could see capital equipment demand increase in such areas as roads, bridges, broadband, clean energy, and public transportation buildout. We anticipate that this would provide benefits for the majority of our product offerings, including equipment sales and rentals of dump truck and trailers, safe digging trucks, road marking equipment, sewer cleaners, and street sweepers.

Within our industrial markets, we continue to be bullish about our prospects with respect to our safe digging initiative, and are monitoring further developments on the regulatory front. We are also optimistic that the recent increase in oil prices could generate increased demand for the sale and rental of our industrial products.

We have positioned Federal Signal in a manner in which we fully participate in the post pandemic recovery by increasing capacity within our facilities, reducing lead times to a level where we can better respond to customer needs, investing in new product development, and gaining market share. On the flip side, we are anticipating that some of the cost savings that resulted from actions taken in 2020 are expected to return in 2021, representing an estimated year-over-year expense headwind of approximately \$8 million.

Like many companies, we have noted an increase in material costs over the last several weeks, and we are responding accordingly. We are also monitoring the availability of chassis at certain locations linked to a nationwide shortage in semi-conductors, and expect to be proactive where appropriate so that any supply chain disruption is minimized. This could have more of an impact on TBEI. As we get more visibility into the year, including the timing of widely available vaccines, we are committed to increasing our target EBITDA margin range.

On the M&A front, our deal pipeline remains active, and some of the logistical challenges that were experienced in 2020 have started to ease a little. We continue to believe that M&A will be an important part of our future growth.

Now turning to our outlook. We are encouraged by conditions in our end markets and the ongoing execution against our strategic initiatives, and are monitoring the potential for additional tailwind.

As a reminder, seasonal effects typically result in our first quarter earnings being lower than subsequent quarters. Mainly due to the pandemic, 2020 was a bit of an anomaly in that regard. We started off 2020 with record production levels during the first quarter at our largest facility and minimal impact from the pandemic, which did not meaningfully impact our operations until the last few weeks in March.

In the first quarter of 2020, we also recognized a benefit of approximately \$0.02 per share associated with fair value adjustments to certain reserves. As a result, in 2020, our first quarter represented a higher share of our full year earnings than we typically would expect. While we are very encouraged with recent order trends, including the sequential quarterly order improvement that we experienced since the second quarter of 2020, our operations are still being impacted by disruptions associated with the pandemic.

These factors range from operational inefficiencies related to employee absenteeism, to the impact of the recent lockdown measures that have been put in place across much of Canada, most notably in Ontario. In addition, several of our businesses have been impacted by the adverse weather conditions that much of the U.S. has been experiencing in recent weeks.

For example, our three facilities in the Houston area and our dump truck facilities in Alabama and Mississippi had to be closed for several days due to the harsh weather conditions. Fortunately, we did not experience any significant damage to our operations, but we did lose several days of production. Considering the factors impacting the first quarter, we currently anticipate the second half of 2021 to be stronger than the first half.

There still remains uncertainties surrounding COVID, commodity costs, and chassis availability. Yet, despite this, we are expecting a strong year in 2021 with top-line growth, double digit improvement in pre-tax earnings, and adjusted EPS of between \$1.73 and \$1.85.

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

Operator

Your first question is from Steve Barger of KeyBanc Capital Markets. Please state your question.

Steve Barger

Hi, thanks. Good morning.

Jennifer Sherman

Morning.

Steve Barger

Your guidance indicates you expect top line growth and that makes sense. You've got a fairly easy comp. Do you think you can get back to 2019 levels of just over \$1.2 billion this year that would imply kind of a high single digit organic growth rate or total growth rate, I guess?

Ian Hudson

Yes, I think so, Steve. I think when you layer in the acquisition as well, I think we would be expecting that.

Jennifer Sherman

I think the other thing I would say is we're still early days in 2021, but we're encouraged by the sequential improvement we saw in orders in Q4, and January and February orders have been strong. We're encouraged by what we're seeing.

Steve Barger

That's great. Do you expect positive year-over-year growth in every quarter, or will the headwinds you talked about likely make 1Q down year-over-year and then returning to growth as the year progresses?

Ian Hudson

Yes, I think that's what we were trying to signal, Steve, with Q1. Q1 last year was just extremely strong for us. I mean, we came out really strong. Jennifer talked about the record production of Vactor, our largest facility, and we really didn't feel much of an impact of the pandemic really until the second quarter. The pandemic is still here and we're still navigating through some operational challenges. There was also a couple of kind of non-recurring benefits that we had in Q1 last year that may not repeat.

I think Q1 is a tough comparison and that's really what we were trying to signal; but the rest of the year, we feel pretty good about. But just with Q1 and the weather challenges that we've seen recently, we'd expect the second half of the year to be stronger than the first half of the year.

Steve Barger

Understood. You spent a lot of last year and you still have some ongoing projects expanding capacity, and I know mix matters, but what level of revenue do you think the platform will be able to support once you get through that? I'm just trying to get a sense for how much growth you can sustain before requiring additional capacity expansion. Does this take you to \$1.5 billion, \$1.6 billion?

Jennifer Sherman

Depending on the plant capacity. At Vactor, the capacity would support between 30% and 40%, and at many of our other facilities, the number is similar. We feel like the investments that we've made make us very—we're in a great position with respect to some of our organic growth initiatives, but also some of the smaller acquisitions that we're looking at because some of those product line acquisitions, we would be able to move into some of those facilities.

Ian Hudson

Yes. I think, Steve also, the expansions give us flexibility too. As we look at acquisitions there may be just product lines that we can fold into our existing footprint. We also have our FS Solution centers, which are spread across much of the country. Jennifer talked about the parts initiative we have there. We can be fairly flexible with our footprint, and the expansions give us additional flexibility.

I think one of the challenges we've had this year is because the expansions have actually helped us with the social distancing that we've had to adhere to in the manufacturing facilities, that's actually helped spread out a little bit more this year. I think long-term once we're through this pandemic, I think the flexibility of our manufacturing model is going to be important as well.

Jennifer Sherman

Yes. One thing I would add is, in past rebounds, one of the challenges that we've had is we cut so much and then our lead times get very extended. When the rebound occurs, our lead times are so long that frankly we have lost market share to competition. We've been laser focused on reducing those lead times so we're well-positioned to respond to the market. I think that that's one of the accomplishments and we're really proud of what the team's been able to do in 2020.

Steve Barger

That flexibility and ability to respond quickly should lead to better incrementals, is that what's giving you confidence to ultimately expand your EBITDA margin targets whenever that happens?

Jennifer Sherman

Yes.

Steve Barger

One more and I'll get back...

Jennifer Sherman

One other thing I would add has been the traction we're getting on new product development.

Steve Barger

Yes. I'll ask one more and I'll jump back in line. With your second truck body deal now, just what do you think the addressable market is for those products that you compete in? And maybe talk about, in a backward looking way, I know that if there's an infrastructure bill, it will really drive that higher, but what do you think that truck body addressable market is?

Jennifer Sherman

We look at both the dump body and the trailer body. We look at both of those. The OSW acquisition's more focused in the dump body. Overall, we look at kind of somewhere around \$1.8 billion, but it's a very regional play, as I tried to indicate in my comments. I was out in Seattle earlier this week welcoming the new employees, the meeting with the Management team, I'm really energized about longer term what this acquisition can add to our TBEI business.

They had a tough 2020, we've got some work to do, but they are the leading brand on the West Coast. And this opens up new geographies to us from their two locations in the Seattle area, their upfitting center in Tempe, and then their location up in Edmonton. It puts us in a position to have a great anchor tenet for kind of future expansion on the West Coast, which, frankly, was a void in our footprint.

Steve Barger

Got it. Thanks. Nice job.

Jennifer Sherman

Thank you.

Operator

Our next question is from Mike Shlisky at Colliers Securities. Please state your question.

Jennifer Sherman

Good morning, Mike.

Mike Shlisky

Hello. Good morning.

Can you maybe start off—can you point us at least directionally on Adjusted EBITDA margins for each of the two segments? Do you think you'll have expansion in both, or one up one down this coming year?

Jennifer Sherman

I think we're expecting to see expansion of both. It can vary quarter-to-quarter but we're encouraged by, again, the order trend we've seen, as I talked about earlier, in Q4, beginning of the year. OSW is one that, similar to other acquisitions that we've done, has a lower EBITDA margin, particularly given some of the challenges that they faced in 2020, but we're excited about the synergies and about the possibilities. As we've effectively proven in the past, our intention is to bring them up to our target EBITDA range over the next couple of years. That creates kind of additional opportunity for us.

Mike Shlisky

Got it. Just kind of moving on to the infrastructure build potential here, perhaps it's not the best comparison, but can you take us back to when the big highway bill was passed probably going on about six years ago now? When that was passed, what happened back then? Did you start getting calls about new equipment as soon as the ink was dry on the bill, or did people wait until the following fiscal year as budgets were announced? What would be the lag time between if and when they passed it, and if and when you start seeing some decent orders?

Jennifer Sherman

A couple of things I'd kind of note is we're a very different business today than we were six years ago. We didn't have the TBEI business. We didn't have MRL, and we really didn't have meaningful, safe digging. That would be the first thing I would point out. I think, frankly, we have more of a focus on it today as an organization than we did in the past. There's more visibility, we're monitoring it, we're working with the teams. We have plans in place. We have stock trucks available.

Our biggest challenge, as I previously referenced in the past, has been as we come out of these challenging times, the markets tend to recover pretty quickly for many of our products and then our lead times get extended. In the past, they've been extended out past a year. We're very focused on having equipment available so we can quickly respond to these market opportunities. We're monitoring closely. We think it will benefit our TBEI businesses, our safe digging businesses, our road striping businesses. It's kind of across the board.

Mike Shlisky

Okay. Maybe one last one. I just want to get a bit of commentary, if you would, on the balance sheet plans for 2021. Here in the fourth quarter, you brought down your debt and still had cash at a multi-year high. I'm sure you were holding on to some of that cash for the acquisition you did of OSW. Beyond that, can you take us through some of your plans for the balance sheet for the year, especially as it relates to inventories? And in capital, if you have plans to keep those lead times from getting to extend it, do you have to invest in some additional inventory in 2021.

Ian Hudson

Yes. There's a little bit of that, Mike, just as we've talked about trying to be in a position to fully participate in a recovery, particularly if there's a meaningful infrastructure bill. There's some strategic investments that we're thinking about making in some additional stock units. We also talked a little bit about procuring some additional chassis just to maintain some flexibility there.

There may be a little bit more investment on the inventory side than we would typically have, but nothing overly significant. Those are some of the things we're looking at. I think historically, if you go back the last five, six years, the playbook has almost been, buy, integrate, delever. Buy, integrate, delever, and so I think that's one of the things that we would be looking at because acquisitions are going to continue to be an important part of the growth of this Company.

Jennifer Sherman

Yes, and we would expect that we will be doing more acquisitions in 2021.

Mike Shlisky

Got it. Fair enough, guys. Thanks so much. Appreciate it.

Operator

Our next question is from Felix Boeschen of Raymond James. Please state your question.

Jennifer Sherman

Good morning, Felix.

Felix Boeschen

Hi. Good morning, everybody.

You guys made some brief comments about this in the opening, but could you maybe flesh out a little bit more what you're seeing on supply chains right now, maybe specifically with regards to chassis availability? Then the second part of it, how has labor availability tracked for you all kind of throughout the quarter?

Jennifer Sherman

I think that with respect to chassis, I'll divide my comments up into kind of two categories. If you look at Vactor, Elgin, about 50% of the time we supply the chassis, and about 50% of the time the customer supplies the chassis. We have and we've dealt with chassis availability. This is something that our teams have a core competency in terms of dealing with because if you go back in time, 2018, there were some chassis issues and we effectively worked our way through it.

We're in a position now where we're procuring more chassis to make sure that we're in a position that we can either supply the chassis ourselves, or if a customer can't get access to a chassis, we'll have chassis available for those customers. Mark Weber and the teams have done a really nice job of mapping out all of '21 and adding some significant cushion in there because, as we talked about on the call, we believe that the second half is going to be strong. I think there's a lot of upside here depending on what happens and we're positioning ourselves for that upside.

The second category I would talk about is TBEI. As I noted in my prepared remarks, that's a little bit different of a situation because we don't own the chassis. The customer supplies the chassis. We've been working very closely with those customers to make sure that they're procuring the chassis that they need to satisfy that demand. Again, I guess I would say is, we've been down this road before and we've effectively managed the situation, and I'm confident that our teams will be able to do the same this year.

Ian Hudson

Felix, just on labor availability, the second part of your question. I think we're very fortunate in many of the areas in which we operate in that we have great access to highly skilled quality work workforce. We have not had significant issues with labor availability. One thing we have been navigating through is some absenteeism related to really COVID related issues.

I think as Jennifer mentioned, in the fourth quarter with many of the cases resurging in the early part of the fourth quarter, we had some fairly significant absenteeism at some of our facilities, the requiring to quarantine individuals and things of that nature. Thankfully, those trends are improving across the country as well as within our locations.

As Jennifer mentioned, we are also getting some good traction on our initiatives to get our eligible employees access to the vaccine. I think we are starting to see some light at the end of the tunnel here, which is a positive.

Jennifer Sherman

Yes, this is a great fact. Our largest employee base is in Illinois, and in our Illinois employee base, 50% of our employees are in the vaccine process. It's something I'm really proud of because we all believe that putting this pandemic behind us is critical. One other thing I would note is as we set forth in our ESG

report, the social part of the programs we offer is important. We tend to be the premier employer and something we're very proud of in the communities where we live and operate.

Felix Boeschen

Got it. That's super helpful. I appreciate all that color.

I was hoping to maybe touch on the aftermarket momentum you're seeing a little bit. Would you kind of expect that piece of the book to outgrow the rest of the ESG business into 2021? Any puts and takes you can give us around that will be super helpful.

Ian Hudson

I think, Felix, it's certainly something that the momentum is definitely there. We talked about it growing as a percentage of ESG's revenues. Q4 was up to 25% versus 21% in Q4 of 2019. I think particularly as we've talked about being ready and well positioned for a recovery, be it through an infrastructure bill or economic stimulus or anything like that, having access to a rental fleet gives us more flexibility that we didn't have previously when markets recovered quickly.

That's our rental fleet. We also have several dealer partners that also have our equipment in their rental fleet. That's another important piece. I think it's certainly something that we are hoping will continue to grow, but that's not to say we don't want to continue the sale of new equipment. I think growing the total dollar amount of our aftermarket business is something that we're focused on. We have got several initiatives to grow that aftermarket business.

We talked about the parts initiative where we're insourcing the manufacturing of certain parts at one of our FS Solutions locations; again, highlighting that flexible manufacturing model that we have. I think it's been a very successful strategic initiative that we've had and it's really been a meaningful contributor to the strong margins that we've had over the last few years.

Felix Boeschen

Okay. Fair enough, and then just last one for me, you made some interesting comments about oil and gas in the investor presentation. Could you remind us of the total exposure you have to that end market in the business? Is some of that, or is most of that concentrate on the rental side? Just any puts and takes would be helpful. I'll leave at that.

Ian Hudson

Exactly, Felix. It's a relatively small part of our 2020 revenues. I would say it's certainly less than 5%, but it is primarily concentrated currently in that rental fleet. We do track utilization of our rental fleet geographically, and then we make decisions based on where we will place that rental fleet. We've been tracking demand. I think one of the things that we had noted earlier in the year was that utilization levels have slowed down a little bit. Some of that was due to oil and gas.

With that, we were able to kind of scale back the investment in the rental fleet of our own. We actually stepped up the sale of used equipment to reduce the overall size of the fleet. We had some really strong sales of used equipment in Q4 that was up about \$6 million on a year-over-year basis. Used equipment sales were strong in Q4. Some of that, what we've seen recently, is a little bit of an uptick in the industrial activity, not just within our rental business, but some of our other businesses that focus on industrial products.

That's a really encouraging sign for the industrial markets that have been fairly significantly impacted during 2020.

Jennifer Sherman

And one thing I would add is an uptick in oil creates an opportunity for our safe digging equipment. There's upside there and that's really what I was trying to indicate in my remarks.

Felix Boeschen

Got it. Thank you. I appreciate it.

Operator

Our next question is from Chris Moore of CJS securities. Please state your question.

Jennifer Sherman

Good morning, Chris.

Chris Moore

Good morning.

Maybe just talk a little bit more about steel crisis. Jennifer, I know you said it probably mostly impacts TBEI. Just trying to get a sense of the ability to pass through, how quickly you can reprice if you have much steel inventory at this point in time. I'm trying to understand, if there is an impact, when you might feel it.

Jennifer Sherman

Yes. Obviously, this is something that we monitor very closely. To put it in context, we have about \$45 million of direct steel purchases each year, and that, obviously, can vary with volume. Fifty percent of that relate to TBEI. On top of that, we have another \$10 million of direct aluminum purchases which is all TBEI. I think what's important here is the TBEI business, they don't have the kind of extended backlogs that Vactor and Elgin might have. They have the ability to pass on price increases and steel surcharges as necessary. That team is very active in terms of monitoring, as all of our teams are, the commodity costs and taking appropriate actions as necessary.

We've also locked in our pricing at many of our businesses. For example, our Vactor and Elgin business has locked in steel pricing through into the third quarter at pretty favorable prices, and our TBEI businesses, it's less, but they have more of an ability to quickly react as necessary. It's something that Mark is working very closely with the teams on. I think the other thing I would point to is, go back to 2018 and look at how we managed our way through this. The teams did a fantastic job and we're using those same protocols again. We also have our 80-20 program.

We're constantly looking at, how do we offset that material and labor inflation as a goal. I think it's something that, like other companies, we're closely monitoring but we have plans in place to address.

Chris Moore

Got it. Helpful. In your early comments today, you talked about the electrification opportunity. I wonder if maybe you could just talk a little bit further about that. Are there specific product lines that excite you? Just any additional thoughts on that initiative.

Jennifer Sherman

Sure. It's a critical initiative. We spent 20% of R&D budget in 2020 on electrification, and the way we're approaching this is we're approaching it at the group level. We've got group ESG resources that are working on this electrification project. We started with one of our streetsweeper projects. I'm really excited that we got our first orders for that product in the fourth quarter. Our intent is we've got a plan where we're going to take that electrification technology and push it through our portfolio as the products allow. It's something that we recognize is an important unmet customer need, and we believe that we're ideally positioned to address it going forward.

A number of municipalities have announced goals of having a certain percentage of their fleet be electric vehicles by a certain date. We track those goals and we want to be the leading provider of that equipment to those entities.

Chris Moore

Got it. That's very helpful. I'll jump back in line. I appreciate it.

Jennifer Sherman

Thanks, Chris.

Operator

Our next question is from Greg Burns of Sidoti and Company. Please state your question.

Greg Burns

Good morning.

Jennifer Sherman

Morning.

Greg Burns

How much revenue do you expect OSW to contribute in '21?

Ian Hudson

It's obviously a partial year, Greg, so we're looking at somewhere between \$35 million and \$40 million.

Greg Burns

Okay, and in terms of the incremental operating expenses that you expect to come back online, that incremental \$8 million, what is that in reference to? Is that GAAP Opex for this year, the annualized run rate from the fourth quarter? What do we base that off of?

Ian Hudson

The \$8 million, more than half of that is going to be employee related expenses, be it through, obviously, we had furloughs, at some point of the year, we had some salary actions that the Executive team took as well as all of our salaried employees really took in the second half of the year.

Some of that is going to come back and there is a merit component of the year-over-year. It's really a year-over-year variance on a GAAP basis, but about more than half of the \$8 million is employee related. Medical is probably going to be a bit of a headwind as you go in because it's been pretty low this year with less people going to the doctor, so that's another part of it.

There's also T&E. We've scaled back T&E pretty significantly in the Q2 and Q3, and as we've talked about getting primarily our sales resources back to visit with customers, that's picking back up again so that'll be another headwind.

Jennifer Sherman

I think I would add too, we're adding sales resources in certain areas to support some of the strategic initiatives that we've talked about on the call.

Greg Burns

Okay, and then just on the question about the electrification projects. When you look at the market, do you see the demand for electric accelerating the replacement cycles here? Could you see an accelerated demand or turnover in your customers' fleets given the demand for electric? How do you see that play out? Maybe what's the total market opportunity for electric?

Jennifer Sherman

Yes, we've taken a close look at the data and our two takeaways is, the answer to your question is, yes, in the larger municipalities and in those towns where the large universities are located.

Greg Burns

Okay. Thank you.

Operator

Our final question is from Steve Barger of KeyBanc Capital Markets. Please state your question.

Steve Barger

Thanks. I just want to go back to electrification as well. Where are the R&D dollars going? Are you buying batteries from a third party and the work is to integrate it into the product, or how are you proceeding down the road towards electrification?

Jennifer Sherman

Yes, we are buying batteries from third parties, and the dollars are along the integration path and working to integrate that technology into our products. We also have created a number of prototypes. Our approach has been we've created the prototypes.

We've shared those prototypes with various municipalities for feedback, and then we've taken that feedback and incorporated the feedback.

This was phase two when we got the orders, but then we also have some dedicated resources, both internally and externally, that we've been working with on the longer-term electrification project for Federal Signal.

Steve Barger

What percentage of the product line do you think lends itself to electrification?

Jennifer Sherman

The smaller the product, the more likely it is to be subject to electrification. I think we're going to let the experts, the battery experts, figure out some of the demands of the larger product lines like sewer cleaners, but as you know, we have a number of smaller products that we think would be right for electrification. The larger ones, like sewer cleaners, they haven't quite figured that out yet, but I'm confident, over time, they will.

Steve Barger

Got it, and I know OSW had a tough year in 2020, like a lot of companies, but what's their organic growth rate been if you look at it, say over 5 or 10 years?

Ian Hudson

It's been high single digits over the last three to four years. They also did, as we mentioned, Steve, they did a couple of acquisitions in 2019. The one up in Canada was one of them and then there was also a more local acquisition that they did. Organically it's grown high single digits, and then they've also tacked on two acquisitions in 2019.

Jennifer Sherman

Yes. I feel very strongly, even stronger, after visiting this week that tough year in 2020, we've got some work to do, but longer-term outstanding brands, great Management team, some great contracts, and I really believe that this can be that anchor tenet on the West Coast for future smaller acquisitions or organic growth. As I said earlier, it really fills in that—if you look at our footprint, there's a nice swath up the middle of the country, but on the West and East Coast this fills an important void.

Steve Barger

Sorry, if I missed this, I went to the website, it looks like there's a lot of SKUs. Do they build for stock, or is this completely custom order? Again, going back to the earlier conversation on capacity, is there opportunity to shift production to drive margin or prune product lines that don't move?

Jennifer Sherman

Yes, we think this business is ripe for 80-20, our 80-20 principle. To answer your question, it's a lot of custom work, but again, we have, as you can imagine, knowing us, a pretty specific plan in place to improve their EBITDA margin performance over time.

I'm just excited about the level of activity and the quality of the Management team and the footprint, frankly, with the two locations in Washington State, the upfitting center in Arizona, and then the manufacturing facility up in Edmonton. As you know, we've got other manufacturing facilities in Edmonton, so we're looking at, how do we optimize that footprint there also?

Ian Hudson

Steve, in terms of footprint, their main manufacturing facility is a very impressive facility. One of the acquisitions that they completed in '19, they've actually consolidated that into their footprint in the main operations.

Steve Barger

Last one for me. Unless I'm mistaken, this was a record year for free cashflow, and conversion was over 100%. As you look forward, thinking about working cap or integration cost, or anything else, do you expect you can exceed the \$107 million of free cashflow this year, and can you keep conversion around 100% for 2021?

Ian Hudson

Yes. I think our goal is 100% on cash conversion on net income basis, Steve. There's a couple of things that obviously we—there was about \$7 million of deferrals that we had under the CARES Act. About half of that is due to be paid in 2021 and then the remainder is paid in 2022. That will be a little bit of a headwind from a cashflow perspective. There's also certain investments that we may make in rentals.

As I mentioned earlier, we scaled back some of that investment in the fleet in 2020 with the lower utilization. As and when things pick back up again, we may choose to make some additional investments in the fleet. I think overall, we would be targeting 100% cash conversion. This year, as you said, was a record; it was just a fantastic cashflow generation year.

Jennifer Sherman

I think the only thing I would add is, we talked about is the chassis situation. Part of the solution to that is to invest in chassis, particularly given some of the shortage issues and the fact that we believe the second half is going to be strong. We want to be well positioned to respond to that customer demand and we believe having those chassis is part of that equation.

Steve Barger

Given that you're thinking about double-digit improvement in pretax earnings, even if conversion were to slip a little bit with some of the items that you've talked about, it sounds like you can still maintain or maybe beat the \$107 million.

Jennifer Sherman

Our goal is to be better, at least at 100% or better.

Steve Barger

All right. Have a great year. Thanks.

Jennifer Sherman

Thanks. Appreciate it.

Operator

We have reached the end of the question-and-answer session. I will now turn the call over to Jennifer Sherman for closing remarks.

Jennifer Sherman

In closing, I would like to reiterate that we are confident in the long-term prospects for our businesses and our market. Our teams are performing at a very high level, despite some significant challenges during 2020, 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 to 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

This concludes today's conference, and you may disconnect your lines at this time. Thank you for your participation.