CTS Corporation NYSE:CTS

Q2 2019 Earnings Call Transcript

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Call Participants

Ashish Agrawal
Chief Financial Officer and Vice President

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

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Presentation

Operator

Good day and welcome to the CTS Corporation Second Quarter Earnings Call. Today's conference is being recorded. At this time I would like to turn the conference over to Kieran O'Sullivan. Please go ahead, sir.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Thank you, Dory. Good morning and thank you for joining us today and welcome to CTS' second quarter 2019 conference call.

- Second quarter sales were $120.7M up from $118M in the same period last year.
- Gross margins were 34.1% in 2018 compared to 35.4% in the second quarter of 2018.
- Adjusted earnings per share were $0.40 cents compared to $0.39 in the second quarter of last year.
- Total booked business increased 4% to $1.875bn up from $1.80bn in the same period last year.

Ashish Agrawal, our CFO, is with me for today's call and will take us through the Safe Harbor statement. Ashish ….

Ashish Agrawal
Chief Financial Officer and Vice President

I would like to remind our listeners that this conference call contains forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements.

Additional information regarding these risks and uncertainties is contained in the press release issued today, and more information can be found in the company's SEC filings. To the extent that today's discussion refers to any non-GAAP measures under Regulation G, the required explanations and reconciliations are available in the Investors section of the CTS website.

I will now turn the discussion back over to our CEO, Kieran O'Sullivan.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Thanks, Ashish. In the second quarter of 2019, our sales grew by 2.3%. We saw softness in industrial markets with some customers being impacted by Chinese tariffs. We continue to see a burn-off of inventory with distributors, which is impacting our sales. Currency rates impacted sales unfavorably by $1.9M. Gross margin performance was impacted by weaker operational performance at our Ceramics foundry. The foundry challenges also impacted sales as we saw delayed shipments. The team is focused on the necessary actions to correct this issue, and we expect improvement in the third quarter. Operating expenses are being managed but not at the expense of strategic priorities to drive profitable growth. We ended the quarter with 20.2% adjusted EBITDA which is up 60 basis points compared to 2nd quarter of 2018.

Total booked business increased to $1.875bn driven by improved contract wins in the second quarter. We added 3 new customers in the quarter, one in industrial and two in defense applications.

We saw strong bookings for our Throttle Sensing Module in the Asia market as the China National 4 emission regulation takes effect in July. OEM’s are transitioning to electronic fuel injection systems to meet these new emission requirements for two-wheeler models. China National 6 emission regulations for vehicles will be implemented in 2021. This is important for us as it has the potential to increase demand for a variable geometry turbocharger actuator product which we have in development with two OEM’s. We received new orders for a low power OCXO crystal product for application in under-sea seismic exploration from two customers, and another potential customer is testing our product. We were awarded a four-year contract for piezoelectric rings for a gyroscopic guidance system with a defense OEM. This contract will provide future revenues approximately in the range of $8-10M. We were also awarded a sonobuoy defense program valued at $3.5M and an aerospace application for RF filters of $1M. In medical we received an award for an intravascular ultrasound application of approximately $0.5M, with samples in test with several new customers. In telecom we received an order for our micro actuators of $0.5M for an application in high speed data switching. We received 3 new awards for sensor products in automotive, one in North America and two in China. One of the platform awards is for a battery electric vehicle application. We secured several new awards for accelerator modules, two of the largest awards were with Japanese OEM's and one with a North American OEM.

In the second quarter, we received customer funding from two OEM's for RF sensing in vehicle after treatment systems. These joint development agreements along with our customer investments will ensure that our development program for this technology will be aligned with the needs of the marketplace. These customers are seeking to improve their emission management systems, drive better fuel consumption and improve warranty performance. Essentially our RF sensing technology has the potential to enable our customers to address their next generation 2024 ultra-low Nox emission requirements.

We continue to work our M&A pipeline. Our growth objective remains 5% through acquisitions and 5% through organic growth. We are committed to our strategy of driving profitable growth through technologies and products that Sense, Connect & Move. Our priority is to evolve our end market profile, so you will see us prioritize growth of our capabilities in industrial, aerospace and defense markets while we continue to evolve our product portfolio in the transportation market.

End markets remain challenging due to trade disputes and higher inventories in distribution. Though passenger vehicle volumes are softer, we continue to perform better than the market. The North America automotive market is tracking towards a 16.5M to 16.9M unit pace, down 2-3% for the first six months of this year. China volumes through June 2019 are down 10-12%. Sales improved somewhat in June as buyers took advantage of discounts. The European market continues to be soft, down 6-7% with only the Russian market demonstrating growth. Defense markets were strong in the quarter improving by double digits. We are keeping a close watch on volumes in various end markets and remain cautious about market trends over the next 12-18 months.

Profitable growth, margin improvement, ERP implementation and the appropriate capital deployment remain priorities for us this year. In addition, we have begun new initiatives towards 2025 performance goals for CTS.

For full year 2019, we are tightening our guidance and expect sales to be in the range of $470 - $490M compared to the prior guidance of $460-500 million. Adjusted earnings are now expected to be in the range of $1.55 - $1.65, compared to the prior guidance of $1.50-1.70.

At this time Ashish will walk us through the financial performance. Ashish…

Ashish Agrawal
Chief Financial Officer and Vice President

Thank you Kieran.

Second quarter sales were 120.7 million dollars, up 2.3% compared to last year. Sales to transportation customers increased by 8.7%, and sales to other end-markets decreased by 8.6% due to softness in the Industrial, IT and medical end markets. Currency rates impacted sales unfavorably by 1.9 million dollars.

Our gross margin was 34.1% for the second quarter versus 35.4% in the second quarter of 2018. Execution challenges in our ceramic foundry operation and material cost and wage increases were the main drivers for the decline. These were partially offset by approximately 1.8 million dollars in savings related to manufacturing transitions. We expect full year savings from the manufacturing transfers to be in the range of 3.0 to 4.0 million dollars. Exchange rates impacted gross margin unfavorably by approximately half a percent.

SG&A and R&D expenses were 23.3 million dollars or 19.3% of sales compared to 22.1% in the second quarter last year. 2018 expenses included one-time costs of approximately 1.5 million dollars. The remaining reduction in expenses is related to lower spending and timing of certain expenses. We remain focused on managing expenses as we work through challenging market conditions.

Our effective income tax rate in the second quarter of 2019 was 25.1%, down from 37.7% last year. Last year's tax rate included a 1.7 million dollar tax expense related to a one-time cash distribution from Taiwan. As we communicated previously, we expect our full year 2019 tax rate to be in the range of 23-25%, excluding discrete items.

Our second quarter 2019 earnings were 36 cents per diluted share. Adjusted earnings per diluted share were 40 cents, up from 39 cents in the second quarter of last year.

Now I'll discuss the balance sheet and cash flow…

Our controllable working capital as a percentage of sales was 16.0% in the second quarter. We had delayed payments from some customers that were received in early July. Our inventory levels are higher than planned. We are focused on improving in the second half of the year as we adjust inventories down for softer end-markets.

We generated 14.6 million dollars in operating cash in the second quarter. Capex was 4.1 million dollars. Year-to-date, we have spent 9.4 million dollars in capex. We now expect our 2019 capex to be in the range of 5-7% of sales, down from our previous range of 6-8%.

Cash was 105.6 million dollars at June 30, 2019 compared to 100.9 million dollars at the end of 2018. Our long-term debt balance was 50.0 million dollars at the end of June, flat with December 2018. Our debt to capitalization ratio was at 11.2% compared to 11.7% at the end of 2018.

During the second quarter, we repurchased 148 thousand shares of our stock for 4.2 million dollars. We have 20.6 million dollars remaining under the repurchase plan approved by our Board in February.

We remain focused on our ongoing SAP implementation. As we communicated previously, our goal is to complete the roll out to our remaining sites in the first half of 2020. We will keep you informed of our progress.

This concludes our prepared comments. We would like to open the line for questions at this time.

Question and Answer

Operator

And if you would like to ask a question, please signal by pressing star 1 on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, that is star 1 if you would like to ask a question. And we'll pause for just a brief moment to allow everyone an opportunity to signal for questions.

And we'll take our first question from Karl Ackerman with Cowen. Please go ahead.

Karl Ackerman
Cowen

Good morning, gentlemen. The narrowing of your outlook to the midpoint is somewhat impressive given the many cross currents from monetary policy and global trade, particularly production headwinds within automotive. Some of the larger automotive Tier 1 providers have called out that the market should decline low to mid-single-digits this year.

But based on your your outlook this year, it seems that you should actually outperform end demand and maybe many peers in your space. So I'm curious if you may discuss existing or new programs within actuators, RF sensors, brushless DC motors, or maybe even accelerator pedals that are enabling you to outpace global production this year. And I'm also particularly interested in the geographical areas of strength too, given the well-publicized challenges across China and Europe.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Karl, you've got a few questions in there, and good morning to you. First of all, as we've been saying for a few quarters now, we feel that if the market is down a few points, we'll perform better than the market and that's what we're seeing. We've seen strength in really a lot of the work that we've done from 2014, 15, and 16 and that's bearing fruit at this point in time.

You asked about actuators. We added a second customer. That customer is still in development, and we're also in development on next-generation products with existing customers. And the good news and the exciting news as well this quarter is that the small acquisition we did back in 2015 with the RF sensing has gained momentum with funding now from two customers, which we're excited about as well. We know that won't mean revenue until 2020+ and beyond that. But those things are moving well.

So we feel - it's the work we've been doing the last number of years that's giving us momentum, especially in the transportation market. When we look across the regions, we've seen North America, as I said, down 2% to 3% but we've been gaining with OEMs in that market. Europe has been challenging for everybody. We've added some customers there that we've talked about in the past and continue to pursue new opportunities and gain share.

And in the China market, where people are getting a lot of pressure, we're strong with the Japanese transplants and that really has worked pretty well for us. So hopefully that gives you some color around the market performance.

Karl Ackerman
Cowen

Understood. Given the visibility in the second half of the year, broadly speaking, how are you thinking about the tradeoffs between OpEx management and opportunistic M&A?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Well, on the OpEx side of it, we've always been very prudent about managing our costs, but not at the expense of making the right strategic choices. And on the M&A side of it, we've been very focused in terms of our strategy, products, and end markets that will fit our portfolio, and we continue to work that very hard.

Karl Ackerman
Cowen

Understood. Last one from me and I'll cede the floor. Regarding distribution, you know, we understand that you have very little indirect sales within the distribution channel, particularly given your exposure toward automotive. But any thoughts from CTS about how long you think inventory destocking in the channel may last for, and its impact on your industrial outlook? Thank you.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Karl, you're right about the percentage there of our overall business. I would tell you, we would think it's going to take another two quarters or maybe a little bit more to burn off all that inventory. There's going to be some differences across the regions, but it's still going to take a little bit of time to adjust that inventory.

Operator

We'll take our next question from John Franzreb with Sidoti & Company. Please go ahead.

John Franzreb
Sidoti & Company, LLC

Hi, Kieran and Ashish.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Hi. How are you?

John Franzreb
Sidoti & Company, LLC

Making sure you can hear me. Kieran, I guess regarding the revenue guidance, you know, tapping down the top line a bit. Has there been a fundamental change in when your end markets made you want to reassess what the revenue will look like?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Maybe a few points on that, John. Obviously, from an automotive perspective, we're just cautious a little bit in terms of where things are going. We've had strong progress in the commercial vehicle side of it, mid to heavy duty. We've seen there may be some softness in that going forward. So that’s something that’s staying very much on our mind.

And the other thing that you might have caught in my opening comments is Chinese tariffs on the industrial side. We've seen one or two customers where their growth is not what we expected. It's good regionally in North America and Europe, but when they go into China, they're being hit by the tariffs. So these are some of the things that have caused us to adjust the top end a little bit.

John Franzreb
Sidoti & Company, LLC

Got it. Got it. And you mentioned a problem that - at the ceramic foundry. Could you just walk me through the implications of that either on a revenue line, or actually on the revenue in the quarter and on the gross margin in the quarter. And then has that problem been resolved or does it continue to linger?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

So we're not happy about it. It's poor execution on our part. So you can tell it's got out full attention. From a sales perspective, it's probably somewhere in the region of 1% of impact on sales in the quarter. And what we've had is, you know, it's material formulations and if we get some variation in the material, it impacts our yields. If it impacts our yields, it then impacts our finishing and therefore, it creates inefficiency in the production environment.

So again, just call it what it is. It's poor execution by us. We know we can fix it, but not pleased to be in this situation. And again, it's got our full attention. Ashish, you want to add any color?

Ashish Agrawal
Vice President and Chief Financial Officer

Yes, John. On the margin side, it obviously has a negative impact on us. Similar to sales, probably in the 1% range and we would look to recover in the second half. As Kieran mentioned, there's a strong focus on it. We are working through several challenges. We expect to see some improvement in Q3 and more in the fourth quarter.

John Franzreb
Sidoti & Company, LLC

Great. And I guess back to the transportation topic that was kind of brought up. You mentioned you have been and you were outperforming the sector as a whole, but I didn't catch a number, how much your automotive sales were up in the quarter. Did you provide that and I just missed it?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Yes, I think we said, John, auto sales were up over 8%.

John Franzreb
Sidoti & Company, LLC

Eight percent?

Ashish Agrawal
Vice President and Chief Financial Officer

8.7% to transportation customers.

John Franzreb
Sidoti & Company, LLC

Yes, sir. Got it. And one last question. The reduction in the CAPEX spending, is that a change in plans or a deferral from something from this year to next year?

Ashish Agrawal
Vice President and Chief Financial Officer

So John, some of it is us just managing carefully where the CAPEX is being spent, making choices given the tougher end market conditions. And some of it is deferring so that, you know, ERP, we were hoping to accomplish more in 2019, as we have deferred that - some of the launches into 2020. Then some of that CAPEX also gets deferred into next year.

John Franzreb
Sidoti & Company, LLC

Great. Thanks, Ashish.

Ashish Agrawal
Vice President and Chief Financial Officer

In the second half, we'll be working through more clarity on timeline of various projects we are working on. And as we get closer, we'll provide more clarity on what the expectations are for 2020.

John Franzreb
Sidoti & Company, LLC

Great. Thank you, sir.

Operator

Once again, if you would like to ask a question, that is star 1 on your telephone keypad. We'll take our next question from Hendi Susanto of Gabelli Research, LLC. Please go ahead.

Hendi Susanto
Gabelli Research, LLC

Good morning, Kieran. Good morning, Ashish.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Morning, Hendi

Hendi Susanto
Gabelli Research, LLC

If I look at your annual guidance, it represents second half year-over-year between 3% decline and 5% positive growth. How should we think about the divergence of this wide range?

Ashish Agrawal
Vice President and Chief Financial Officer

Hendi, as we talked about in Kieran's comments, there is still uncertainty about the various end markets and the evolution of those both on the industrial side. We saw some softness in medical in the second quarter. So we are watching that carefully as well as distribution.

The largest end market for us is automotive and we still remain concerned about how that is evolving in the second half as well.

Hendi Susanto
Gabelli Research, LLC

So if I may revisit that question. In the positive scenario of 5% year-over-year growth in the second half, where will that growth come from?

Ashish Agrawal
Vice President and Chief Financial Officer

If you see our sales, we are getting traction on many different fronts with new programs, as well as new product launches that Kieran talked about in terms of where we are getting business wins traction. So that will be a key part. Kieran, did you want to?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Yes, Hendi, maybe some of the things we pointed out, new products like the throttle sensing module for the market in Europe is gaining good traction. Our RF products continue to gain good traction. The Medical side of it, as Ashish said, was a little soft in the second quarter. There were some adjustments of inventory there, but we're seeing orders pick up and we expect that to be good, and Defense has been good so far this year. And we continue that going forward.

Hendi Susanto
Gabelli Reasearch, LLC

Got it. Thank you for the insight. And then Kieran, I know that now that you have new ERP and then you would put, like, this, like, more new ERP system by the first half of 2020. In the long run, what can you do with your new ERP? Can you produce more cost savings or, like, increase your working capital efficiency?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

We definitely will increase our working capital efficiency. I can tell you that's a focus for us. Not happy with where we're at, at the moment. And Hendi, obviously, we're very much, and our message has been on the implementation. Because, you know, companies have problems here. When they implement, we're making sure we're doing it carefully and robustly.

But we're making that investment because when we're through this, it's going to give us more data around the company. We've done a lot of simplification over the last number of years, but we still see opportunity ahead. And as I talked about the 2025 goals, we've set some internal things that we have near term talked about, but we'll talk about those as we make progress and it will relate to ERP as well.

Hendi Susanto
Gabelli Research, LLC

Got it. Okay. Thank you, Ashish. Thank you, Kieran.

Ashish Agrawal
Vice President and Chief Financial Officer

Thank you, Hendi.

Operator

And it appears there are no further questions in the queue at this time. Mr. O'Sullivan, I would like to turn things back to you for any additional or closing remarks.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

I just want to thank everybody for joining us this morning and we look forward to updating you again in October on our performance. Thank you.

Ashish Agrawal
Vice President and Chief Financial Officer

Thank you.

Operator

This does conclude today's call. Thank you for your participation. You may now disconnect.