CTS Corporation NYSE:CTS

Q2 2020 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 2020 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

Good morning, thank you for joining us today and welcome to CTS’ second quarter 2020 conference call.

I’ll start by sharing a few thoughts on our company and our business performance.

- As we mentioned on our last earnings call, we expected the second quarter to be our most challenging quarter this year due to the impact of COVID-19.
- Operationally, all our plants are running, though we continue to experience challenges at our Mexico locations. The return to the appropriate production staffing levels has been impacted by state and local regulations. Our leadership and global teams are prioritizing the safety of our employees and adapting quickly to serve our customers’ needs.
- Sales were $84M down 30% from the second quarter of 2019. As expected, we saw significant challenges in the transportation end market. Sales in the rest of our business were stable.

- Second quarter gross margins were 31.6% compared to 34.1% in the same period in 2019.
- We delivered an adjusted EBITDA margin of 16.7% despite a 30% drop in sales.
- Second quarter adjusted earnings per share were $0.16.
- We had a promising new sensor win in transportation for application in hybrid electric vehicles and continue to make progress with RF product wins in defense. We added thirteen new customers in the quarter.
- We ended the quarter with $146M in cash and $141M in debt.

We expect a prolonged market recovery from the impact of COVID-19. As a result, we are implementing a restructuring plan to realign our cost structure to the new demand environment. This plan will be completed over the next 24 months.

Ashish Agrawal 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

The challenges of the COVID-19 pandemic have been unprecedented. I want to express our appreciation to all our employees, customers and partners for their support as we worked to get our factories online this past quarter. Our people demonstrated remarkable flexibility in our operations and supply chain. Our first focus is the safety of our employees and compliance with state and local regulations, while doing everything we can to meet our customers' requirements.

The temporary expense reduction measures we discussed in our last earnings call are still in effect. As I mentioned in my opening comments, we are announcing a restructuring plan, which we expect to be completed over a 2-year timeframe. This plan is necessary to realign our operating cost structure to the new demand environment as we transition through the prolonged impact of COVID-19. More details of the plan will be shared in the quarters ahead. At a macro level, it will involve site consolidations and streamlining other operating costs to leverage economies of scale across the company. The plan is expected to deliver an annualized EPS improvement of $0.22 to $0.26 by the second half of 2022.

We remain focused on our strategic growth investments. Growing our business and expanding our range of sensing, connectivity and motion products is a priority. New business awards were $105M for the quarter, a solid performance given several OEMs continue to push out business decisions due to COVID-19 and the resulting wide-scale shutdowns in Europe and North America in the quarter. We added 13 new customers in Q2, 6 in industrial, 3 in medical, 3 in defense, and 1 in Telecom.

In transportation, we had an exciting win for a new high load current sensor for a premium European OEM. This is a new hybrid vehicle application. Since it is a customized design, we are still evaluating broader market potential. We also secured several wins for passive safety sensors with existing customers and with a new customer, a large ride height sensor award with a North American OEM, as well as accelerator module wins with several OEMs across all regions.

In defense, we were awarded two RF programs with existing customers. We had multiple wins for military underwater applications, secured a contract with a European OEM and we received our first order for textured ceramic material. Textured ceramic provides enhanced piezoelectric performance at a lower cost point. Over time, we expect this new material formulation to expand our available market. It has the potential to grow at higher single-digit levels.

With temperature sensing, we secured wins in industrial, defense and medical applications and added new customers. Our precision frequency product was selected for a design win in a 5G small cell application. We also had design wins in pro-audio and in medical applications for encoder products.

We continue to advance product innovations. Our focus in the transportation market is to develop sensor solutions that are agnostic to the underlying propulsion technology, thereby strengthening our growth in the next decade as hybrid and electric vehicle penetration grows. We are researching new material formulations as we target growth in defense, industrial and medical markets. We are also developing custom ASIC solutions to strengthen our frequency product portfolio.

We made more progress in our ceramic foundry operation this past quarter, and we expect further improvements this year. We are also using our expertise in ceramic formulations to improve yields and margins in our temperature sensing acquisition.

In our Focus 2025 initiative, we are concentrating on four areas –

1. Driving profitable growth
2. Building stronger customer relationships
3. Improving our operating systems and
4. Strengthening talent and culture globally

As part of our emphasis on profitable growth we are evaluating the product portfolio for longer-term growth and margin expansion. Our focus on M&A is to strengthen our pipeline as we seek to expand our range of technologies, products, customers and geographic reach.

We are sharpening our go-to-market strategy by adapting our sales and application engineering setup to build stronger customer relationships. Working more closely with our customers on next generation products and applications is more important than ever as we emerge from the COVID-19 pandemic.

To advance CTS operating systems, we have added a senior person to lead this initiative. We aim to build capability and drive continuous improvements. Our goal is to eliminate waste and enhance profitability. This will be a multi-year initiative.

Strengthening our talent pipeline and leadership bench while aligning our culture globally will enable us to achieve our vision of being a leading supplier of sensing and motion devices and connectivity components, enabling an intelligent and seamless world.

We remain cautious on the broader economic environment in the second half of 2020. From a light vehicle view, it is still too early to close the book on the pandemic. Premium brands are expected to rebound faster than volume brands. In the US, sales of used cars increased while the SAAR for 2020 is closer to 13 million, down 23% from last year. On hand days of supply were at 54 days, down 20% from the five-year average which should help short term demand. We expect an improving sales trend in the third quarter providing operations run normally. European sales are forecasted to decline 26% from last year. The China market continues to recover with volumes predicted to be down 14% in the 21-22 million range for the year. We continue to see growth in Medical and defense markets.

We suspended guidance for 2020 earlier this year due to continued market uncertainty. Our liquidity remains solid, with a positive net cash position. We aim to emerge from this crisis a stronger company.

At this time Ashish will take us through the financial performance … Ashish…

Ashish Agrawal
Chief Financial Officer and Vice President

Thank you, Kieran…

Second quarter sales were $84.2M, down 30% compared to the prior year. Sales to transportation customers decreased by 53%, and sales to other end-markets increased by 14%. Our temperature sensing acquisition added $5.4M. Organic sales to non-transportation customers were up 1%. We continue to get traction in the aerospace and defense as well as medical end markets and saw robust double-digit sales growth rates to customers in these markets.

Our gross margin was 31.6% for the second quarter, impacted by substantially lower sales.

We are making progress on various actions to improve our tax rate. As a result, we expect to be closer to the lower end of the previously communicated range of 23-25% excluding discrete items. As we complete our work on this effort, we expect some further improvements in the tax rate in 2021.

Our second quarter 2020 earnings were 15 cents per diluted share. Adjusted earnings per diluted share were 16 cents.

As we communicated back in April, due to lower volume expectations, we implemented measures to reduce cost through temporary payroll reductions, suspension of 401K contributions, furloughs, plant shutdowns, reduced board compensation, and control over all discretionary spending. Revenue in the second quarter was significantly lower, and conditions remain uncertain. We will regularly evaluate market conditions to determine the extent and duration of these temporary measures.

As Kieran mentioned, we have started implementing a restructuring plan due to the prolonged impact of Covid-19. We expect restructuring costs to be in the range of $10 to $12M over the next two years. Anticipated annualized savings are in the range of 22 to 26 cents per share by the end of 2022. Savings from the restructuring, once fully implemented, will help offset the impact of the temporary cost reduction measures as those costs return. Timing for some aspects of the restructuring project is being finalized, and we will communicate more on the timing of savings and costs in the coming quarters.

In terms of cash, we were net cash positive by approximately $5M, an improvement from zero net cash at the end of the first quarter. We have access to an additional $157M through our revolving credit facility.

In March, we borrowed $50Mfrom our credit facility. We are continuing to maintain this position to ensure adequate liquidity for the next several quarters at all our sites globally. Including this additional debt, we remain well within our debt covenants, and at this time, it is our expectation that we will remain compliant.

Our controllable working capital as a percentage of sales was 21.2% at the end of the second quarter. The increase was driven primarily due to the sharp reduction in revenue in the second quarter. In dollar terms, controllable working capital increased slightly from Q1 to Q2, and our focus remains on improvements in the coming quarters. Our teams are maintaining emphasis on reducing inventory levels across our operations and on receivables collection.

We generated $11.8M in operating cash flow in the second quarter. Capex was $2.7M. For the full year, we are expecting capital expenditures to be approximately 4% of sales. We are committed to investing in programs that help us progress our strategic growth objectives.

We are continuing to implement SAP and went live successfully at another large manufacturing location at the beginning of July. This go-live was accomplished despite most of the implementation team working remotely due to COVID-19 related travel constraints. This was a significant accomplishment by our team in Matamoros and the SAP implementation team. With the go-live in Matamoros, we have completed the rollout to plants that provide approximately 80% of the company's revenue. We are on track to complete the SAP implementation around the middle of 2021.

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

Question and Answer

Operator

Thank you. If you would like to ask a question, please signal by pressing star 1 on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment.

Again, that is star 1 to ask a question. And we'll take our first question from Justin Long.

Justin Long
Stephens

Thanks and good morning.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Good morning, Justin.

Ashish Agrawal
Chief Financial Officer and Vice President

Hi, Justin.

Justin Long
Stephens

Thanks and good morning. So maybe to start just given things are changing so rapidly in the world today, could you provide a little bit more color on how your revenue trended throughout the second quarter kind of month-to-month and then any update on what you're seeing so far in July?

Kieran O’Sullivan
Chairman, Chief Executive Officer and President

Yes. Probably the best way to describe it is, obviously April and May were tough months for us. June was a more normal month. And we've seen a similar increasing trend in July just to give you a sense of how sales are going.

But the earlier part of the quarter was particularly tough. And if you look at the quarter as well, and that 55% in transportation, if you remember, last year we were particularly strong from a comp basis on the commercial vehicle and that really skewed us a little bit this quarter as well because that was a tough market for us. And we are - on the light vehicle side, we are in line with where the market is from everything we see.

Justin Long
Stephens

Okay. That's helpful. And I think you made the comment that in the third quarter, you expect sequential improvement in revenue. I know you're not giving formal guidance, but is there any additional color you can share on kind of roughly how much of a pick up we could see in 3Q and maybe talk about the progression you're expecting for the transportation end markets versus the non-transportation end market sequentially?

Kieran O’Sullivan
Chairman, Chief Executive Officer and President

Yes. So the non-transportation markets performed solidly. You saw we were up 1% organically. We still expect steady performance there. I'm not going to give you percentages because it's a moving target. They are a little bit at the moment.

On the transportation side, what I'd like to emphasize is an improving trend. And the reason why we're a little cautious is we've got some challenges in our Mexico operations where we're not fully staffed due to local regulations. And while it's improving, we need that to get back to a full run rate. But the best way to give you a message on the third quarter is we expect it to improve. We've seen that improving trend already in July. And we've to make sure we try and support and make that happen.

Justin Long
Stephens

Great. And last question from my end, more on the margin side. Ashish, you mentioned that there were some temporary cost-outs. I know you talked about those earlier in the year. Can you help us think about, you know, back half of this year, you know, how those could come back online, given the sequential pickup in revenue that you're expecting?

Ashish Agrawal
Chief Financial Officer and Vice President

So the cost reduction measures are made up of several components. And given the level of sales reduction we saw in the second quarter that could be the quarter where we have the maximum impact. And we would expect smaller impact of the cost reduction measures, the temporary measures.

Some of them will continue through the third quarter. And then as I mentioned, we'll continue evaluating. As volume levels in the market are changing, we'll adapt our approach to those temporary measures.

Justin Long
Stephens

Okay. But you still feel like if revenue is getting better sequentially then directionally adjusted operating margin should get sequentially better as well.

Ashish Agrawal
Chief Financial Officer and Vice President

That would be a good assumption, Justin, yes.

Justin Long
Stephens

Okay, thanks. I appreciate the time.

Ashish Agrawal
Chief Financial Officer and Vice President

Thanks, Justin.

Operator
And next we'll go to John Franzreb with Sidoti.

John Franzreb
Sidoti

Good morning, guys. I guess I want to start a little bit about the discussion on the revenue sequentially. If I heard you properly, you expect revenues to be up, but you also expect the European revenues to be down 26% and China to be down 14% or are you referencing that as the second quarter, what actually happened?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

No, John, that's a reference. And those percentages are on a full year basis, year-over-year from '19 to '20.

Ashish Agrawal
Chief Financial Officer and Vice President

For the industry.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

For the industry.

John Franzreb
Sidoti

And that's your expectations for the full year, '20 versus '19?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Yes. On the transportation side, yes. And to give you a sense, we clearly stated that from Q2, which is going to be our most challenging quarter. We expect revenues to improve in Q3.

And obviously we want to make sure that operations stay stable and we're improving in Mexico. But that's an important improvement that we need to have to go through the quarter fully. And again I want to emphasize our June and July performance was trending in the right direction.

John Franzreb
Sidoti

Got it. So what's the North American portion of the transportation in that assumption? That's Europe and China?

Ashish Agrawal
Chief Financial Officer and Vice President

John, we don't break out our numbers for the different end markets by region. But as we've talked about, they'll be generally in line with what our overall business is.

John Franzreb
Sidoti

Okay. I know you kind of - it doesn't sound like you want to provide too much color on consolidation efforts you're going to do. But I imagine you're wanting to begin at some point this year and gradually work through 2022. So is it fair to assume we will see some sort of profit improvements from these actions in 2021 or is that not fair to assume?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

So, John, if you look at it, you'll see we have minimal impact in the second half of this year, more of the impact as we get to the second half of 2021 and into '22. The projects are more longer-term projects, but they're very focused.

John Franzreb
Sidoti

Got it. Thank you, Kieran. All right. And just two quick questions, I guess, to kind of inter-relate. What have your supply chain issues been like? And Mexico has been a problem with a lot of other suppliers. What are your thoughts about when that kind of, I don't know, eases up the restrictions on the local and federal level down there?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

John, as far as supply chain overall, we've been doing pretty well, and we're really pleased with how our plants have come back online. And in Mexico we are monitoring everything as you can imagine on a daily basis.

The staffing levels are limited by the local regulations so going from code red to a code orange, you're allowed to increase your percentage at the plant. And there has been some positive news but we want to see it stabilizing and continuing to move.

John Franzreb
Sidoti

Okay. And one last question, just because it came up yesterday on the call. When the company was getting government reimbursements from government sponsored programs that were part of both the cost of goods sold and SG&A lines. Did you guys receive any of those kind of government reimbursements?

Ashish Agrawal
Chief Financial Officer and Vice President

So, John, there are certain portions of government incentives that we are getting a benefit from, but we chose not to move in the direction of getting financing through the programs. But there are certain tax incentives that we are taking benefit of. But they are not significant enough to have a material impact on our financial result.

John Franzreb
Sidoti

Okay. Thank you, Ashish. Thank you, guys. I'll get back into queue.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

All right. Thanks, John.

Operator

And, again, if you would like to ask a question that is star 1. We'll take our next question from Karl Ackerman with Cowen.

Karl Ackerman
Cowen

Hey, good morning, gentlemen. I wanted to follow-up first on the opex commentary. You know, you mentioned you take some cost actions - or are in the process of taking some restructuring actions this quarter. You know, that, of course, would follow some actions you took in both the December quarter and March quarter.

So I guess just as a catch-up, how much cost have you taken out of the model at this point and how much would you view as temporary that gets reinvested in the business versus how much is permanent?

Ashish Agrawal
Chief Financial Officer and Vice President

So, Karl, the actions that we have taken over the last couple of quarters to adjust the structure were more in line with what was happening in the commercial vehicle market at the end of last year and then the impact that we were dealing with in the second quarter, which was more temporary in nature.

The restructuring that we are implementing will allow us to offset the impact of the temporary measures that we were able to implement in the second quarter once we start realizing the full benefit. So that should give you some idea of the magnitude of the impact on both sides.

Karl Ackerman
Cowen

Okay. So it sounds like the - it sounds like the restructuring actions that you're taking today are going to be, you know, limited from a margin recovery standpoint in second half. Certainly it will lower your fixed costs. Much of the benefit seems to be in '21 and '22 if I understand you correctly.

Ashish Agrawal
Chief Financial Officer and Vice President

Yes, Karl, as Kieran mentioned, we are expecting a bigger impact from the restructuring actions in the second half of '21 and then going into 2022.

Karl Ackerman
Cowen

Got it, Okay. Another follow up if I may, is how would you characterize your inventory in the channel today? And from a working capital perspective, what steps are you taking to improve inventory dates on hand that I think could drive improving cash flow later on this year? Thank you.

Ashish Agrawal
Chief Financial Officer and Vice President

Yes. So as you saw, we mentioned that the working capital sequentially increased very slightly. And, you know, our plants have been reducing our purchases and just the impact of the sudden drop in sales, we were not able to fully correct that situation, but we expect that we should be able to make good progress as we go forward here in Q3 and into Q4.

And in terms of receivables and payables, those components of the working capital remain in good shape and we are managing those carefully and the quality of the receivables remains good as far as we can see so far.

Karl Ackerman
Cowen

Thank you.

Operator
Thank you. And we will take our last question and its from Hendi Susanto from Gabelli Funds.

Hendi Susanto
Gabelli Funds

Good morning, Kieran. Good morning, Ashish.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Good morning, Hendi.

Ashish Agrawal
Chief Financial Officer and Vice President

Hi, Hendi. How are you?

Hendi Susanto
Gabelli Funds

Good. Kieran, if I see the sales of your automotive to transportation market, the sales decline seems weaker than the overall automotive market. Some companies believe that the second quarter was the trough. Can you share your insight into those?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

So, Hendi, when we look at the commercial vehicle side of it, we think the second quarter with the trough as well. We think we see improvements there. When you look at it, and if you look at some of our bigger customers in that space, they had declines of about 55% so much steeper than what you see in the light vehicle side of things.

So we think that will recover steadily,. Some of those products go into the mid-range, which may do a little bit better in the heavy-duty side of it. We're not sure exactly yet, if that's one or two quarter cycle or more, but that's something we are monitoring closely.

Hendi Susanto
Gabelli Funds

Got it. And then, Kieran, you also mentioned that the premium brand in automotive should rebound faster. Could you remind us what kind of exposure CTS has with regard to premium versus non-premium?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

So in North America, we've got good exposure. In Europe, we're a little lighter on the premium side of it, and we're good with the Japanese transplants on the premium side as well. But Europe was a little weaker for us.

Hendi Susanto
Gabelli Funds

And then, Ashish, with regard to the new $12 million of restructuring costs between now and yearend 2022, what is the linearity of the $12 million cost?

Ashish Agrawal
Chief Financial Officer and Vice President

Hendi, as Kieran mentioned, we are expecting a small impact in 2020. We expect a bigger impact towards the end of 2021. And then obviously by the end of 2022, we should be able to realize all of those targeted savings.

Hendi Susanto
Gabelli Funds

I mean the costs associated with the benefit like...

Ashish Agrawal
Chief Financial Officer and Vice President

Okay. Sorry. I misunderstood your question.

Hendi Susanto
Gabelli Funds

No problem.

Ashish Agrawal
Chief Financial Officer and Vice President

The cost should be generally in line as we get improvements, maybe leading by a quarter or two quarters. But the timing of some of those projects is still being finalized. And we will articulate a little bit more on that as we go forward, Hendi.

Hendi Susanto
Gabelli Funds

And then Kieran, the QTI acquisition contribution was stronger than my expectation. Where did you see strength in QTI business in the second quarter and whether or not you expect to see those strength to continue? Some companies have mentioned the benefit of let's say, like outdoor activities and then outdoor equipment. I'm wondering whether CTS did benefit from those in the second quarter?

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

We've been very pleased with the performance both on a top line, on the margin perspective with the QTI acquisition. Mostly our improvements have been coming in industrial and on the medical side. And we're focused on expanding in both of those areas on the hot and cold side, we want to expand.

We also want to go deeper into the medical and leverage some of the channels that we have from existing customers at CTS. And then obviously expand into the regions, which is part of our plan as we go forward as well in Europe and Asia.

Hendi Susanto
Gabelli Fund

Thank you, Ashish. Thank you, Kieran.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Thanks Hendi.

Ashish Agrawal
Chief Financial Officer and Vice President

Thanks, Hendi.

Operator

And it looks like there are no further questions. I'd now like to turn the call back over to Kieran O'Sullivan for any closing remarks.

Kieran O'Sullivan
Chairman, Chief Executive Officer and President

Thank you, (Celestina), and thank you all for your participation on today's call. And be safe. We're getting back to work here. We have much to do, and we look forward to updating you again in October . Thank you very much.

Operator
Thank you. And that does conclude today's call. Thank you for your participation and you may now disconnect.