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Rockwell Automation, Inc. (ROK)

Q2 2020 Earnings Call – Prepared Remarks

Corporate Participants

Jessica Kourakos, *Head of Investor Relations, Rockwell Automation, Inc.*

Patrick Goris, *Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.*

Blake Moret, *Chairman & Chief Executive Officer, Rockwell Automation, Inc.*

Operator

Thank you for holding and welcome to Rockwell Automation's Quarterly Conference Call. I need to remind everyone that today's conference call is being recorded. Later in the call, we will open up the lines for questions. If you have a question at that time, please press *1.

At this time, I would like to turn the call over to Jessica Kourakos, Head of Investor Relations.
Ms. Kourakos, please go ahead.

Jessica Kourakos

Head of Investor Relations, Rockwell Automation, Inc.

Good morning and thank you for joining us for Rockwell Automation's second quarter fiscal 2020 Earnings Release Conference Call.

With me today is Blake Moret, our Chairman and CEO, and Patrick Goris, our CFO.

Our results were released earlier this morning, and the press release and charts have been posted to our website. Both the press release and charts include, and our call today will reference, non-GAAP measures. Both the press release and charts include reconciliations of these non-GAAP measures. A webcast of this call will be available at that website, for replay, for the next 30 days. For your convenience, a transcript of our prepared remarks will also be available on our website at the conclusion of today's call.

Before we get started, I need to remind you that our comments will include statements related to the expected future results of our Company and are, therefore, forward-looking statements. Our actual results may differ materially from our projections due to a wide range of risks and uncertainties that are described in our earnings release and detailed in all our SEC filings.

So with that, I'll hand the call over to Blake.

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Jessica, and good morning, everyone. Thank you for joining us on the call today.

Before I begin, let me say to everyone listening on this call, thank you for your interest and support, and I hope that you, and those close to you, are safe and healthy.

We are truly in unprecedented times, and our first priority is protecting employee health and safety. Our employees are doing outstanding work keeping our customers' operations up and running strong during this crisis. We are an essential business that supports critical infrastructure because our customers cannot build their products at scale without automation. So, thank you to our employees, our suppliers, our distribution partners, and everyone else who has been working hard to serve our customers and communities.

This pandemic will change how we live our lives and operate our businesses in the future. Rockwell's financial strength positions us well to overcome the current challenges and to be more valuable than ever as our customers learn to operate in this new environment.

With that, let me now review the topics for today's call. I'll first offer some color on how our people and our customers are effectively managing through this crisis, then provide a brief overview of our Q2 performance, including a status report on our operations and supply chain, and then focus more time on what we are seeing today and our outlook. Please turn to page 3 of the slide deck.

When I think about how our business is being conducted right now and how we are handling the current environment, I start with our employees and our customers. The safety of our employees is always our first priority. We closely follow U.S. CDC and World Health Organization guidelines. For our manufacturing workforce, we provide health screening, enhanced cleaning measures and use of safety equipment, and have implemented social distancing between workstations across our facilities. Our non-manufacturing workforce has been exercising social distancing and working from home for over a month now, and we have restricted non-essential business travel. Where we can, we are using our own technologies and services to keep our people productive and support our customers. For example, we now have 2,500 seats of Vuforia Augmented Reality activated internally to conduct witness testing as well as customer support and training.

Turning to our customers. This health crisis is bringing us even closer to our customers as everyone is rallying to help manufacture more necessary goods than ever before. For example, we have a strong partnership with 3M as they ramp up respirator production. And we recently collaborated with Heng Chang Machinery, a Chinese hygiene products machine builder, to increase the production capacity of their high-speed mask making machine. Our solution, based on Logix and our next-generation motion controllers, increased their output from 150 to 500 masks per minute.

We are also supporting Abbott Labs and other pharmaceutical companies to increase testing capacity, and with GE Healthcare and others to ramp up their production of ventilators. We're also supporting companies like Roche and Cytiva, who are working tirelessly to develop treatments and vaccines and are investing in manufacturing capabilities so that they are ready to scale up production as soon as possible. We're also helping companies who have repurposed manufacturing assets to now produce masks, ventilators, test kits and other equipment our communities desperately need. For example, Automotive and Mining OEMs are now making ventilators, and Food & Beverage machine builders are now making masks. Even the Jameson distillery, which is located near our offices in Ireland, has diverted some of their whiskey production lines to now produce alcohol sanitizing gels for hospitals and medical centers. These are just a few stories showcasing the innovation going on in these difficult times.

Let's now turn to Slide 4 for our Q2 performance and some key accomplishments in the quarter. Total sales grew slightly in the quarter, including a 3-point contribution from inorganic investments primarily related to our Sensia joint venture. Organic sales were flat versus last year and were in line with what we were expecting heading into the quarter, despite an 18% decline in China related to COVID-19.

Our organic sales performance benefited from strong sales of Logix, which grew 8% versus the prior year, led by strength in North America, particularly in Automotive and Food & Beverage. In addition to Logix, we continue to see strong growth in other core platforms like Independent Cart Technology for motion control and network infrastructure. Both of these grew double digits in the quarter, and we think we're taking share. We also had a number of important strategic wins in Automotive, Food & Beverage, Life Sciences, Mining, and Tire, where we were not the incumbent control platform.

Information Solutions and Connected Services, or IS/CS for short, was down slightly, largely due to a difficult comparison with major projects last year. That said, the pipeline for IS/CS remains strong. We built strong backlog in the quarter, and we still expect IS/CS sales to reach $400 million for the year.

Our IOT offering continues to differentiate itself in the marketplace. In the quarter, Rockwell was awarded the Industrial IoT Company of the Year by Compass Intelligence, which adds to our recent recognition in Gartner's annual Magic Quadrant survey as a leader in IOT software. We also saw very strong orders for Vuforia as we help customers expand their remote engineering capabilities during this pandemic.

Turning now to Q2 earnings. Adjusted EPS grew 19% and includes the release of our bonus accrual. And finally, Free Cash Flow grew about 90% in the quarter, underscoring Rockwell's solid financial health and strong balance sheet position.

Let's now turn to slide 5 where I will provide a few highlights of our Q2 organic end-market performance. Our Discrete market segment grew high single digits led by Auto, which grew by over 20% year-over-year and grew double-digits sequentially. Auto performed well above expectations in the quarter in almost every region. We continue to see very good growth in electric vehicle programs, and we also benefited from some traditional projects that we had been tracking. Our Hybrid market segment was flat in Q2. Our largest segment, Food & Beverage grew low-single digits, including growth at packaging OEMs. Life Sciences declined modestly due to the very tough comparison to last year.

Many of our customers, particularly those in consumer-focused hybrid industries, have been running their operations 24/7 to meet very high demand and have had little opportunity to implement projects that divert resources from current production. Process markets were down mid-single digits, with Oil & Gas also down mid-single digits. We'll talk more about our outlook for Oil & Gas in just a few minutes.

Turning now to slide 6 and our organic regional sales performance in the quarter. Growth in North America and Latin America was offset by an 18% decline in China, which accounts for about 6% of our global revenue. We saw growth in Asia Pacific, excluding China, led by EV battery. EMEA was down low-single digits, but with relative strength in Automotive, Food & Beverage, Life Sciences and Semiconductors.

Turning now to Slide 7. Let me take a few minutes here to discuss how we're navigating the current environment. I first want to say that I'm very proud of the efforts we have taken to build resiliency in our operations and supply chain over the years. Our plants are operational and meeting current demand. And while the many actions we had taken to mitigate tariffs over the last couple of years reduced the impact from COVID-19 on our Chinese supply chain, segments of our global supply chain are seeing some disruption. Among the biggest challenges have been reworking product flows to implement social distancing and managing shifts to limit the number of employees in a facility at one time. We are actively managing what is a very fluid situation. Patrick will have more details on our operations and supply chain.

As part of our actions to mitigate risk in our business and maintain our strong financial position, we announced earlier this month a series of temporary actions that better align our costs with a reduction in demand. The following principles are the foundation for our decision-making; keep our customer focus, protect employment as much as possible, protect our most important initiatives and investments to drive long-term differentiation, and position our company for success over the long term.

Balancing the near term with the long term is extremely important. This is why we have, and we intend to maintain, a strong balance sheet. Our capital deployment priorities remain in order, organic and inorganic investments, followed by dividends and repurchases.

Turning to slide 8, the acquisitions we announced last quarter, ASEM and Kalypso, are expected to close in the next couple of weeks, and we will continue to look for additional inorganic investment opportunities that advance our strategic objectives. We expect ASEM and Kalypso to contribute about half a point of revenue growth this year and over a point of growth on a full year basis. Together with our other inorganic investments, we expect total inorganic sales to contribute about 4 points of top line growth in fiscal 2020.

Turning now to our outlook on slide 9, we are focused on delivering value to all of our stakeholders through these rapidly changing market conditions. The path of recovery is difficult to predict. As we put together our forecast, we looked at a variety of inputs; our recent performance in China and Italy, near-term Industrial Production forecasts, our daily sales and orders intake through April, and what we are hearing from end customers and distributors. We expect that our fiscal third quarter sales will be down approximately 20% year-over-year, followed by sequential improvement in the fourth quarter. As a result, these are our expectations for the year. Organic sales down 8% at the midpoint. We continue to expect inorganic investments, now including ASEM and Kalypso, to contribute about 4 points of growth to the year. Adjusted EPS of $7.30 at the midpoint, and we're projecting Free Cash Flow to convert at over 100%.

As you can see, from our organic end-market projections for the second half and full year on slide 10, the midpoint of our projections assumes both Automotive and Oil & Gas will see particularly steep declines in the second half of the year. We are also modeling more modest declines in Food & Beverage and other industries. We expect most verticals, including Auto, to bottom in Q3 and gradually recover starting in Q4, with the exception of Oil & Gas, that we think will take longer to recover.

With that, let me now turn it over to Patrick who will elaborate on our second quarter financial performance and fiscal 2020 outlook in his remarks. Patrick?

Patrick Goris

Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.

Thank you, Blake, and good morning everyone. I will keep my remarks on second quarter results very brief, and then switch to comments about our strong financial position, what we see in our supply chain and operations, cost mitigation activities, and fiscal 2020 outlook.

I'll start on slide 11. For the second quarter, organic sales growth was down 0.2% compared to last year and acquisitions contributed 3% to total growth. Currency translation was a larger headwind than expected due to a stronger US dollar, and decreased sales by 1.5 points. Within the quarter, organic sales were up low single digits through February, with very weak performance in China, again through February – down about 30% - more than offset by better than expected North America product sales. Global organic sales weakened in March and were down a little less than 4% for the month compared to last year.

Overall, company backlog, including for products, and for solutions and services, increased both sequentially and on a year-over-year basis for the quarter. Segment operating margin was 22.1%, up 80 basis points compared to last year, primarily due to lower incentive compensation expense. Our incentive programs are highly correlated to financial performance of the company. We no longer expect an incentive compensation payout to be earned for fiscal 2020, and we therefore released our incentive accruals. This represents a little over 200 basis points of segment margin tailwind, which is partially offset by margin headwinds related to currency at a little over half a point of margin, and the impact of acquisitions at about half a point. General Corporate – Net expense was lower compared to last year, mainly as a result of favorable mark-to-market adjustments related to our deferred and non-qualified compensation plans. I'll cover the Adjusted EPS bridge on a following slide.

The Adjusted Effective Tax Rate for the second quarter of 12.4% was lower than we expected, due to several discrete items. Free Cash Flow in the quarter of about $200 million included a $31 million tax payment, which represents the second installment on the repatriation tax that is owed as a result of Tax Reform.

Slide 12 provides the sales and margin performance overview of our operating segments.

Architecture and Software had good organic growth in the quarter, with strong Logix performance. Lower incentive compensation was a margin tailwind of about 200 basis points for this segment, and currency was about a 100 basis point headwind.

Organic sales of the Control Products & Solutions segment decreased 3.6%, with the products in this segment down 3%, and the solutions and services down about 4%. Sensia represents almost all of the 5.8% revenue growth from inorganic investments in this segment.

Second quarter organic book-to-bill for our solutions and services businesses was 1.10. As I mentioned earlier, we built backlog in the quarter including for solutions and services, but starting in March, we have seen an increase in project delays initiated by customers. Operating margin for the Control Product and Solutions segment was down 70 basis points compared to last year.

The next slide, 13, provides the Adjusted EPS walk from Q2 fiscal 2019 to Q2 fiscal 2020. As you can see, core performance was up a little less than $0.05 despite no organic revenue growth in the quarter. Large tailwinds related to incentive compensation and a lower tax rate were partially offset by the impacts of currency. As expected, the impact of acquisitions was about neutral.

I'll switch gears now and will provide some comments about our balance sheet and liquidity. Please move to slide 14. We continue to be in a strong position with regard to our capital structure and liquidity. At March 31, cash on the balance sheet was about $640 million, and our total debt was about $2.1 billion. Our net debt to adjusted EBITDA ratio was 1.0.

Last week, we executed a $400 million term loan, which provides us the funds to close two previously-announced acquisitions – ASEM and Kalypso, as well as funds for other general corporate purposes. The two acquisitions are expected to close in the next few weeks, with a combined purchase price of approximately $300 million. We expect both acquisitions to add about half a point of revenue to fiscal 20 sales, and expect the fiscal 20 Adjusted EPS impact, including one-time costs, to be about a $0.05 headwind.

From a liquidity perspective, in addition to our strong balance sheet and free cash flow generation profile, we have access to the commercial paper market for our operating needs. Our single-A credit ratings provide us good access to the capital markets. And finally, our liquidity is also supported by our existing $1.25 billion credit facility which expires in November 2023. This credit facility remains available and undrawn. The only financial covenant we have in our debt agreements is an EBITDA to Interest Expense covenant in our credit facility and the new term loan. We have plenty of room under that covenant, which we have pressure tested in our scenario analyses.

As you know, we have a history of generating solid free cash flow, and we expect, just like in prior downturns, working capital reduction to be a source of cash. We are also deferring non-critical capital expenditures, and now expect fiscal 2020 capital expenditures to be closer to $130 million compared to $160 million prior guidance. Finally, as we have mentioned in the past, we do not expect to have any mandatory U.S. pension contributions in the next few years, and we have no long-term debt maturities till 2025. In a nutshell, we continue to be in a strong financial position, and are focused on maintaining it.

Next, I'll make some comments about what we are seeing in our supply chain, manufacturing and distribution operations, as well as our solutions and services businesses on slide 15. We have a global supply chain, including a network of suppliers and manufacturing and distribution facilities. Our supply chain team is closely managing our end-to-end supply chain, with a particular focus on all critical and at-risk suppliers and supplier locations globally. In late January and early February, we proactively increased inventory levels of certain, mostly China-sourced components and products. We are currently experiencing some isolated supply and cross-border transit disruptions, and do see some increased supply chain costs, particularly related to reduced air freight capacity. We are implementing freight surcharges to help mitigate the impact of these higher input costs.

All of our manufacturing facilities and distribution centers are operational at this time. We have implemented additional safety and hygiene processes - including separation of shifts and social distancing between workstations - to keep our employees safe. Some of the operational changes implemented, as well as some unplanned employee absenteeism are driving some inefficiencies in our operations, which we are in the process of addressing.

Our solutions and services businesses include thousands of domain experts. They understand our customers' challenges and priorities, and design and implement solutions and provide services through a combination of domain expertise and our technology. Physical access to customer facilities is often important as we deliver those solutions and services.

As a result of COVID-19, access to customer facilities in some instances has been difficult, for example for on-site commissioning. While we have been leveraging our technology and that of our partners to deliver certain services and solutions remotely, decreased access has led to some project delays, as well as inefficiencies due to lower labor utilization. We intend to protect our domain experts as much as possible during this period.

Moving to slide 16, overview of cost actions. In early April, we announced several actions to address the current and anticipated business conditions as a result of the pandemic. I won't go through all of these but will point out that all these actions are expected to yield over $150 million of savings for fiscal 20. As the salary reductions take effect May 1st, we expect most of the savings to be realized in our fourth quarter. We have identified additional cost actions to implement if business conditions require, or to reallocate resources to our highest priorities. Finally, note that while our overall cost structure is coming down, we have maintained and in some cases are selectively increasing investments in some of our highest priority areas in order to increase differentiation and create long-term value for customers and shareowners.

This takes us to slide 17. This slide presents an overview of the business conditions we saw in China and Italy, two of our larger end markets which were impacted by COVID-19 before other geographies. Note that the China and Italy charts provide an overview of the year-over-year growth in order intake for our product businesses only. Products are about two thirds of our business and represent our shorter-cycle book and bill business.

As you can see, the impact in China was severe in January and February, followed by a very strong, V-shaped recovery in March that has continued in April through Friday of last week. In Italy, we saw year-over-year product orders growth through January, followed by a weak February and March. Order intake in Italy remains weak in April, but it's up about 10% sequentially when compared to March order rates. Using our product order trends in China and Italy as leading indicators, we expect most of our other geographies to be down significantly in the third quarter and expect a more gradual recovery starting late in the third quarter into our fourth quarter. Directionally, we expect solutions and services to also follow this trend. Moving to the right side of the slide, this represents total company sales, including solutions and services. Our guidance midpoint assumes that Q3 overall Company organic sales will be down about 20% year-over-year, followed by a sequential improvement in our fourth quarter, which we estimate to be up about 10% sequentially but still down over 10% compared to last year.

Let's move on to the next slide, 18, guidance. Incorporating the expected revenue contributions from ASEM and Kalypso, as well as updated currency forecasts, we now expect full year fiscal 2020 reported sales of about $6.35 billion and project organic sales to be down between 9.5% and 6.5% compared to last year. Segment margin is expected to be in a range of 18.5% to 19.5% compared to 21.5% prior guidance, mostly as a result of lower volumes, partially offset by our cost actions. The lower Adjusted Effective Tax rate mainly reflects some of the discrete benefits we recorded in the second quarter.

Slide 19 represents the full year fiscal 2020 Adjusted EPS bridge, midpoint of January guidance to midpoint of April guidance. Core performance includes the large unfavorable impact of volume and mix as well as some of the inefficiencies in our supply chain, operations, and solutions and services I referred to. These are partially offset by our cost reduction actions, including lower incentive compensation. A headwind from currency and acquisitions is mostly offset by a lower tax rate. On a year-over-year basis, our guidance at the midpoint assumes full year core earnings conversion, which excludes the impacts of currency and acquisitions, of a little over 35%.

We expect a particularly challenging third quarter. This is the quarter during which we project our sales to trough, with the weakest performance in our higher margin product business, and we won't have full run rate savings of all the actions we implemented. We expect fiscal third quarter Adjusted EPS to be a little over $1 per share.

A few additional comments, General Corporate – Net is now expected to be closer to $95 million. Purchase accounting amortization expense for the full year is expected to be about $45 million, up $30 million compared to last year. Net interest expense for fiscal 2020 is still expected to amount to about $100 million. We expect Non-Controlling-Interest now to be about neutral, given lower expected sales and earnings at Sensia. Average fully diluted share count is now expected to be $116 million for fiscal 2020.

With respect to repurchases, we are currently in the market, but are monitoring business conditions closely to inform the level of repurchases going forward. Finally, we expect continued strong free cash flow performance, with free cash flow conversion over 100% of Adjusted Income as we liquidate working capital, particularly in the fourth quarter.

With that, I'll hand it back to you, Blake, to for some closing remarks before Q&A.

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Patrick.

We're managing our costs and protecting our balance sheet against the current reality of unprecedented volatility, but we're also considering long-lasting changes that are being accelerated by the pandemic. We remain optimistic about a world that learns to reduce the human toll from COVID-19, and about Rockwell's role in increasing business resilience.

Here are some thoughts about that future, starting with industries that we think will be especially important. It's clear that countries like the U.S. want to increase local manufacturing capability for medicines and medical devices, and we continue to grow share and capabilities in life sciences. I've spoken earlier about some of the ways we're helping pharmaceutical and medical device companies scale up the production of critically needed products during this crisis.

Packaged food and beverages are critically important when going out is not an option. Rockwell's food & beverage business is roughly 70% retail for grocery stores and home delivery, and 30% food service for restaurants. End users as well as machine builders depend on Rockwell for the speed, flexibility, and support that we can provide. Electric vehicles are going to continue to increase their share. Our Q2 growth in Auto had a significant EV and battery component, and while we expect a tough road for the Auto industry over the next few quarters, our investments in motion technology and software for these applications will continue to bear fruit. The oil & gas industry is going to be focused on lower-cost production, not capex-driven capacity. Our focus on new technology that lowers ongoing production costs from existing assets will be most important for operators for the foreseeable future. Innovation will be necessary to lower the breakeven point for a barrel of oil.

With respect to manufacturing footprint, we expect companies to reduce single points of failure in their supply chain and plant capacity. We are increasing the resilience of our own worldwide system, and we know our customers have plans to do the same. We are already seeing some manufacturers' plans to return manufacturing to North America, where we have higher share. Remote support of operations will be important across many industries, to provide expertise virtually when being physically on-site isn't possible. We're already doing this for hundreds of companies. To ensure the highest quality and safety of products, product traceability is becoming more important, which is an application we know very well from our life sciences experience. Flexibility is one of the biggest benefits of automation. Rapidly ramping up output, designing lines to run multiple products, and changing packaging to meet evolving demand is likely to be even more important in the future. Software that simulates throughput under different conditions and optimizes production is a part of this flexibility, and we have a strong and growing offering in this area. Finally, we're seeing diverse companies come together to solve tough problems quicker than we ever thought possible. This is about the power of partnerships, and the humility to recognize that no one company can do it all. Partnering is a fundamental part of our culture. For all of these reasons, we believe we are well-positioned for a bright future.

With that, I'll turn it over to Jessica to start Q&A.