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Rockwell Automation, Inc. (ROK)

Q3 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 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.

I would now 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 third 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 will 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 we begin discussing our results and outlook, I'd like to make just a few opening remarks.

While we, as a company, are managing well in this environment, we are highly sensitive to the toll this is taking on our employees during this time. Beyond the fear of a loved one getting sick, racial injustice is on our minds as we develop actions as a company, and as individuals, that will help put a permanent end to the denial of fundamental human rights.

Additionally, thousands of our employees continue to work under very difficult conditions, including the temporary pay cuts we implemented in May. These pay cuts were necessary to better align our costs to current business conditions while preserving jobs, but there is a limit to how long they can remain in place. I had hoped we would be in a position to announce a firm end-date to the temporary pay reductions by now, since our goal has always been to reverse them as soon as possible. However, business conditions remain weak and the recent surge of COVID-19 infections has worried all of us, and nobody can predict with accuracy when a combination of social distancing practices, therapeutic medicines, and eventual vaccines will turn the tide. We do intend to reverse the temporary pay reductions by the end of December and hopefully sooner. In addition, this quarter we will make another special payment to our manufacturing associates worldwide, who are on the front lines of maintaining our essential operations.

There are many reasons to be optimistic, and I am immensely proud of all of our employees and the great work they are doing. Our Environmental, Health, and Safety team is working around the clock to keep employees safe, and our technology is crucial to projects that are increasing mask and respirator production to far higher levels than four months ago. Candidate therapeutics and vaccines are being produced and packaged with the help of our innovation and expertise around the world. In short, our employees are having a direct impact on protecting the health of millions of people around the world, and I want to thank them all for their dedication.

Turning now to our results on slide three. While business conditions remain difficult, and results in Q3 were down year-over-year, earnings were higher than we expected for the quarter, primarily driven by better organic sales. Total sales declined by 16% versus the prior year, including a three-point contribution from inorganic investments. Organic sales were down about 17.5%, and better than the 20% decline we were expecting heading into the quarter. Product sales outperformed our expectations, and were driven by better performance in Logix, Motion and Network and Security Infrastructure.

We also had a number of new strategic wins in process applications against major process competitors. These wins spanned several industries this quarter, including Life Sciences, Food & Beverage and Oil & Gas. One of the more notable wins was with Companhia Cacique de Café Soluvel, the largest exporter of instant coffee in Brazil and one of the largest in the world. They are building a new, technologically advanced coffee plant to expand production capacity. This was a highly competitive greenfield win, and we beat our biggest competitors based on our technology and track record with the customer. This win includes a broad suite of Rockwell technology: FactoryTalk Innovation Suite software, drives, Connected Services, as well as newly-released process control technology within Logix that enhances our differentiation against traditional DCS systems.

Turning to Information Solutions and Connected Services. Sales were down slightly, partly due to travel restrictions and limited access to customer sites. However, IS/CS orders grew double digits over the prior year and showed strong growth in both software as well as connected services.

Turning now to earnings. Adjusted EPS was $1.27, and our strong cash flow performance further reinforces our already-strong balance sheet and liquidity position.

Let's now turn to slide four, where I will provide a few highlights of our Q3 organic end-market performance. Our Discrete market segment declined approximately ~20% with Automotive performing better than we projected in April, based on the factory closures at that time. Semiconductor saw positive growth in the quarter, up mid-single digits, and continues to benefit from secular tailwinds in 5G, datacenters, and the Internet of Things. We also see ecommerce as an important emerging driver of our discrete business, due to the excellent fit of our technology with fulfillment center applications.

Our Hybrid market segment declined about 10% with Food & Beverage and Life Sciences performing in line with our expectations. Food & Beverage customers continued to experience extremely high demand and as a result, we are helping them focus their resources on maximizing production. These customers continue to show strong interest in digital transformation solutions that will improve their resiliency and flexibility. Although timing around these projects has been delayed as a result of the pandemic, we would expect Food & Beverage to begin to improve over the coming months. One meaningful indicator for the Food & Beverage vertical continues to come from Packaging OEMs, which showed positive growth in the quarter.

Turning to Life Sciences. We continue to expect Life Sciences to have a strong finish to the year, due to the industry's strong focus on digital transformation, as well as our involvement with the leading companies making significant investments in COVID-related vaccines and treatments.

Process markets were down approximately 25% with Oil & Gas a little weaker. In general, process markets are more solutions-based and require more hands-on interaction, both at the front-end of a new project as well as at the back-end for final commissioning and delivery. We saw physical restrictions and continuing lack of access to plants due to COVID having a more significant impact on these industries.

Turning now to slide five, and our organic regional sales performance in the quarter. North America declined by 20% with weaker process industries partly offset by better resiliency in discrete and hybrid industry segments. In this region, product sales performed better than our solutions and services.

EMEA sales outperformed our expectations and benefited from PPE production and double-digit growth in Information Solutions and Connected Services. Asia Pacific sales declined 10% with year-over-year positive growth in Automotive and Semiconductor. China sales declined mid-single digits, but saw orders return to positive growth in the quarter. Broad-based Latin America declines were led by very weak Automotive performance.

Turning now to our outlook on slide six. Last quarter, we forecasted that our fiscal third quarter sales would be down approximately 20% followed by sequential improvement in the fourth quarter. We came in slightly better than that in Q3, and our mix of product was also more favorable. However, the rate of recovery in our solutions and services business is slower than we anticipated, due to the continued restricted movement of people. In addition, the COVID-19 pandemic, and global efforts to respond to it, are rapidly evolving. Our projections assume that a gradual recovery continues, with no increase in pandemic-related facility closures or disruptions to the supply chain.

Based on all the information we have available at this time we expect organic sales to decline approximately 8% for the fiscal year. No change from our prior full year guidance midpoint. We expect inorganic investments to contribute about four points of growth to the year, and Adjusted EPS to reach $7.50 at the midpoint. That's up from the guidance midpoint of $7.30 we set in April. We continue to target Free Cash Flow conversion at over 100 percent

With that, let me now turn it over to Patrick who will elaborate on our third 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'll start on slide eight, Third Quarter Key Financial Information.

For the third quarter, organic sales were down 17.6% compared to last year, and acquisitions contributed just over 3 percent to total growth. Currency translation was a larger headwind than expected due to a stronger US dollar, and decreased sales by 1.9 points. Orders performed better than sales, and were down mid-teens year-over-year.

Overall, company backlog increased year-over-year for the quarter. Segment operating margin was 16.5%, down 730 basis points compared to last year's record high, primarily due to lower sales. General Corporate – Net expense is up slightly compared to last year, mainly as a result of unfavorable mark-to-market adjustments related to our deferred and non-qualified compensation plans.

Adjusted EPS of $1.27 was better than expected. During April's call, I mentioned that we expected Adjusted EPS to be a bit over $1 dollar, based on an organic sales decline of about 20%. Organic sales performance at - 17.6% was better than expected, as was product mix, and discrete tax items were about a $0.05 benefit to our results in the quarter.

Our results include about $15 million or $0.10 of Adjusted EPS of restructuring charges, which are offset by a gain on an asset sale. From an operating earnings perspective, both items are evenly split between the two segments.

On the statement of operations on page ten of our press release, the gain on sale is included in Other Income and the restructuring charges are included in SG&A. You will note that SG&A is up about $9 million year-over-year, reflecting not only the restructuring charges, but also the incremental SG&A from acquisitions made this fiscal year. The combined impact of these two items is a year-over-year increase of over $30 million in SG&A expense. I'll cover a year-over-year Adjusted EPS bridge on a later slide.

The Adjusted Effective Tax Rate for the third quarter of 13.5% was lower than we expected, due to a benefit from option exercises. Free Cash Flow in the quarter of $311 million was a strong result in this environment, with over 200% conversion on Adjusted Income – further enhancing our liquidity.

Slide nine provides the sales and margin performance overview of our operating segments. I will just point out that the main driver of segment margin reduction is lower sales. The book to bill for our solutions and services businesses was 1.05 for Q3, with continued project delays impacting these businesses rather than project cancellations.

The next slide, ten, provides the Adjusted EPS walk from Q3 fiscal 2019 to Q3 fiscal 2020. As you can see, core performance was down significantly on the large organic revenue decline in the quarter. Our temporary cost reduction actions, and a lower tax rate, partially mitigated the impact of the large sales decline. The restructuring charge and the gain on the asset sale pretty much offset each other. The Adjusted EPS impact of acquisitions was about $0.05 dilutive, including intangible amortization. Core earnings conversion in the quarter, that is, excluding the effects of acquisitions and currency, was about 50% roughly in line with the outlook comments that I shared with you in April.

Before I move on, I want to mention that we continue to be in a strong position regarding our capital structure and liquidity. At June 30, cash on the balance sheet was over $900 million, and our total debt was about $2.4 billion. You can find a current update of our Balance Sheet and Liquidity slide in the Appendix.

Moving to slide eleven, Product Order Trends. This slide shows our global daily order trends for our product businesses. Our product businesses represent about two-thirds of our overall sales, and include our shorter-cycle, book and bill businesses. Within the quarter, daily product orders troughed in April followed by sequential improvement in May, June, and continuing into July through Friday of last week. Our updated guidance assumes this improving trend continues at a gradual pace.

Moving to slide twelve. I'll provide a brief update on a few things that we discussed on our last earnings call with respect to COVID-19. Our first priority remains employee and customer safety. Access to customer sites improved throughout the third quarter, but remains a challenge for our solutions and services businesses. This affects not only our utilization rates and creates associated inefficiencies, but also project timing. We continue to experience project delays in our solutions and services businesses, and the rate of improvement is slower than we expected in April. We are however not seeing a pickup in cancellations, just project pushouts.

Regarding our own manufacturing operations and supply chain, our plants continue to be operational and meet current demand. Supply disruptions have generally been mitigated, but we continue to incur higher freight costs and inefficiencies in our operations as we focus on the safety and well-being of our employees.

During the quarter, we approved incremental investments to increase the resiliency of our supply chain and operations. For example, we are in the process of making investments to provide us more flexibility to produce products in multiple locations around the world. This includes capital investments in some of our US facilities.

Finally, the temporary cost actions we implemented during Q3 remain in place. The temporary cost actions and absence of a bonus earned are tailwinds for us in fiscal 20 compared to fiscal 19. As these items are reversed, they will present a headwind for fiscal 21. We intend to neutralize that headwind through the structural cost actions we have taken this year, additional cost savings identified, and by maintaining lower levels of discretionary spending.

Let's move on to the next slide, thirteen, Updated Guidance. We now expect full year fiscal 20 reported sales to be down approximately 5.5%. We continue to project organic sales to be down about 8% compared to last year. Segment margin is still expected to be about 19.5%. The lower Adjusted Effective

Tax rate mainly reflects the discrete items we benefited from in the third quarter. Our updated Adjusted EPS guidance range is $7.40 - $7.60. At the midpoint, this is $0.20 higher than prior guidance, reflecting our third quarter performance and a lower tax rate for the full year. 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 about 35%.

General Corporate – Net is still expected to be around $95 million. Purchase accounting amortization expense for the full year is expected to be about $40 million. Net interest expense for fiscal 2020 is still expected to amount to about $100 million. We expect Non-Controlling-Interest to be slightly positive, given lower earnings at Sensia. We expect continued strong free cash flow performance, with free cash conversion of over 100% of Adjusted Income.

Finally, with respect to repurchases, we spent about $50 million in the third quarter. Our guidance does not assume any additional share repurchases for the remainder of fiscal 20. Average fully diluted share count is now expected to be 116.6 million for fiscal 20.

Our capital deployment priorities remain the same. Our first priority is organic growth. After that, we focus capital deployment on inorganic activities. Then we focus on capital returns to shareowners, through our dividend and then share repurchases.

With that, I'll turn it back over to you Blake to for some additional remarks before we start Q&A.

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Patrick. Let's turn now to slide fourteen. While the pandemic has disrupted our normal course of business in the short term, we believe it is also accelerating the need for industrial automation and digital transformation solutions that address manufacturing safety, as well as operational flexibility and resiliency. To better align us with the evolving needs of our customers, we are very excited to announce our three new operating segments, simplifying our structure around essential offerings, leveraging our sharpened industry focus, and adding software talent, which will play a larger role in our future value. This is the next step toward accelerating the profitable growth strategy that we discussed last year at Investor Day.

It is also no coincidence that these operating segments map very closely to how our customers think about technology. If you recall, this is a similar technology stack to the one we reviewed at Investor Day last November.

To begin with, the products included in our Intelligent Devices segment are every bit as important as they have always been. Intelligent Devices are the inputs and outputs for industrial processes, and they are also where the data is born. Moving up, Control is at the heart of automation, and customers continue to demand high reliability and safety in their processes. We also see the growing role software can play to increase flexibility and insight across global customer operations. We're focusing on these crucial, integrated capabilities, and adding additional talent in our new Software and Control segment. And finally, the domain expertise provided by our Lifecycle Services ensures the positive business outcomes that give our customers a faster return on their automation investment.

The three segments will continue to share a common sales organization and supply chain. Having a single sales force, knowledgeable in their customer's applications, simplifies the way customers interact with us. This is just one way in which simplification delivers efficiencies for both us and our customers.

Our leadership will continue to blend experienced Rockwell leaders with fresh perspectives. Fran Wlodarczyk will lead the Intelligent Devices segment; Frank Kulaszewicz will lead the Lifecycle Services segment, and we will begin an external search for the leader of Software & Control. In the interim, Chris Nardecchia, our current Senior Vice President of Information Technology and Chief Information Officer, will serve as the leader for that segment. In addition, to accelerate the evolution of our culture, Becky House has become Chief Administrative and Legal Officer, which includes leadership of our talent, legal, ethics and compliance, and Environmental, Health & Safety teams.

Our culture is the foundation for accelerated growth under this new structure. It reflects a willingness to compare ourselves to the best alternatives our stakeholders have; a focus on increasing the speed of decision-making; ensuring we have a steady stream of fresh ideas; and, of course, our strong culture of integrity and inclusion. A more detailed view of what is included in each segment can be found on slide fifteen.

Turning to slide sixteen. These segments create clear focus for each of these essential offerings, and they all have plenty of room to gain share and profitably accelerate our growth in expanding markets. This new structure positions us well to deliver value to customers in what is being called the new normal.

Turning to slide seventeen, I'll make some additional comments on the secular changes we're seeing in our market. As you may recall, last quarter we talked about the increasing need for customers to build resiliency and flexibility in their operations and supply chains. That includes the need for life sciences companies to increase their local manufacturing capability for medicines and medical devices in the U.S.; and the need for innovative technologies to drive higher levels of productivity, flexibility, sustainability, traceability, and safety. In the last 3 months, we have seen examples of all of these trends.

Many life sciences companies recently announced they are in the process of expanding their North American manufacturing footprints and supply chains, and other companies in discrete industries are planning to do the same. In the quarter, we also won business with Johnson & Johnson to deliver technology for their new Universal Machine, which represents the epitome of flexible manufacturing. The Universal Machine is a collaborative, mobile robot that will be deployed in response to the Covid-19 crisis, and can be repurposed to do machine loading and unloading, end of line packaging and inspection activities, or warehouse material handling activities where social distancing is needed. We think many companies will be interested in adding this type of flexible automation technology to their manufacturing environments in the future.

And evidence continues to build for the need for more remote capabilities. In the quarter, we had a key win in EMEA with a major oil company that is making investments in Sensia technology to significantly increase their remote monitoring capabilities. In addition to our remote monitoring capabilities, the value of our Augmented Reality offering with PTC is very compelling to customers as they increasingly look for alternative ways to operate their plants efficiently and safely, and to reskill their workers as quickly as possible.

These trends are unfolding now, and as you can see from many of the offerings on this slide, we are well aligned to customers' needs as they manage through this new normal. Nobody is better positioned to bring Information Technology and Industrial Operational Technology together than Rockwell and our partners. Our customers' efforts to increase resilience and agility have the potential to provide meaningful tailwinds for years to come.

With that, let me pass the baton back to Jessica to begin the Q&A session.

Q&A Session

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Jessica. To summarize, we remain focused on the well-being of our employees, we are managing prudently through a gradual recovery, and we are taking steps to accelerate long-term profitable growth.

Nobody is better positioned to bring Information Technology and industrial Operational Technology together than Rockwell and our partners. We wish you all good health and thank you for your interest and support.