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Rockwell Automation, Inc. (ROK)

Q2 2021 Earnings Call – Prepared Remarks

Corporate Participants

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

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

Steven W. Etzel, *Senior Vice President, Finance, Rockwell Automation, Inc.*

Jessica Kourakos, *Head of Investor Relations, 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.

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 2021 Earnings Release Conference Call.

With me today is Blake Moret, our Chairman and CEO, Nick Gangestad, our CFO, and Steve Etzel, our Senior Vice President of Finance.

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. Supplemental information related to our new business segments can be found in the investor relations section of our corporate website.

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. Let's begin by reviewing our results on slide 3.

The strong orders momentum we saw last quarter accelerated and broadened across verticals in fiscal Q2. Total orders surpassed $2 billon, which is a new record, and organic orders grew double digits from last year's orders. As you may recall, COVID did not significantly impact our business until the June quarter of last year.

Total reported sales grew 6%, including a 2-point contribution from recent acquisitions, including ASEM, Kalypso and Fiix.

Organic sales grew a little over 1% versus prior year, despite significant supply chain constraints. The manufacturing supply chain continues to be stressed by sharply increased demand, along with various well-publicized events around the world that have reduced output and narrowed freight lanes. We will continue to navigate these challenges in the coming months and take measures to continue increasing our supply chain resiliency.

I'll now comment on our top line performance by business segment. Intelligent Devices organic sales increased 6%, led by strong, broad-based demand for our automation products. Our motion control offering continues to shine and was up double digits, as CPG companies continue to add packaging flexibility.

Software & Control organic sales also grew 6%, led by strong demand across the segment. We saw growth in Logix control, visualization hardware and software, network and security infrastructure, and across the balance of our FactoryTalk software portfolio. Reported sales growth was over 12% for the segment in the quarter. Orders for the Intelligent Devices and Software & Control business segments both grew strong double digits year-over-year and sequentially.

Turning to Lifecycle Services, organic sales declined 11% versus the prior year, primarily impacted by weaker performance in Oil & Gas. On a sequential basis, revenue and orders grew mid-single digits, and we expect continued sequential sales improvement in this segment through the balance of the year.

In Information Solutions and Connected Services, we had another strong quarter, with organic sales and orders growing double digits, with contribution across a variety of end markets. This quarter's orders also included a number of meaningful software and infrastructure-as-a-service multi-year wins with some of the world's largest Food & Beverage manufacturers. This included Kraft Heinz, where we actively monitor their industrial network and cybersecurity environments. These wins also contribute to ARR, which grew double digits year-over-year. Total backlog grew strong double digits on an organic basis, both year-over- year and sequentially.

Turning to profitability, segment operating margin of 22% and Adjusted EPS of $2.41 were above expectations and overcame headwinds from the reinstatement of the bonus and higher costs related to supply chain constraints. Stronger volume, favorable business mix, and the timing of spending all contributed to our strong profit performance in the quarter as we continue to increase our business resiliency.

Let's now turn to slide 4, where I'll provide a few highlights of our Q2 end-market performance. Figures are for organic sales. We had very good growth in our Discrete industry segment, with high-single-digits sales growth significantly above our expectations.

Within this industry segment, Automotive sales were in line with expectations, declining mid-single digits versus a strong prior-year period when auto grew by over 20%. We continue to estimate 10% organic sales growth for the year in this vertical, as MRO continues to grow and as an increasing number of capital projects are expected to launch in the second half of the year. Despite chip shortages impacting automotive production, we are not seeing related delays in capital or operational spending for our products.

The Semiconductor vertical significantly outperformed our expectations this quarter, growing about 15%. We believe strong secular tailwinds, increasing capital spend, and broadening share of wallet with customers are all driving our growth and share gains in this vertical. As a result, we are raising our Semiconductor growth outlook to approximately 15% for the year, up from our original November guidance of mid-single digit growth.

Another highlight within Discrete was our performance in eCommerce, with sales growing over 70% versus prior year. Once again, our differentiated offering, featuring our Independent Cart Technology, is enabling eCommerce applications at a growing number of marquis accounts. This vertical has significant secular tailwinds, of course, and has become a bigger growth driver for our overall Discrete industry segment.

Turning now to our Hybrid industry segment. These verticals also had a terrific quarter.

Food & Beverage grew over 10%, as our strong product portfolio enables these customers to efficiently add SKUs as they seek to differentiate their offering and maximize their growth. We saw increased capital spending by Food & Beverage customers in the quarter. Not surprisingly, packaging OEMs are also very busy, and they contributed another quarter of double-digit growth versus the prior year.

Life Sciences grew about 15% in Q2, led by strong demand in North America and Asia Pacific. We won an important MES project in Korea during the quarter, helping the Dong-A ST pharmaceutical company face the challenge of exporting products that need to comply with FDA regulations. Dong-A ST is expecting production efficiency and quality to improve by going paperless through their choice of Rockwell's PharmaSuite MES. Based on the broad-based increase in Life Sciences demand and the share gains we are seeing in this market, we are raising our view on Life Sciences and expect it to grow about 20% in fiscal 21.

Process markets were down approximately 10% and were weaker than expected, led by larger declines in Oil & Gas. Process verticals typically lag our discrete business by about half a year. That said, we saw sequential improvement again in North America for Oil & Gas during Q2. Mining customers are also becoming more active, and we saw low-single-digit growth in the quarter.

Turning now to slide 5, and our Q2 organic regional sales performance.

North America organic sales grew by 2% versus the prior year, primarily due to strong growth in Food & Beverage, eCommerce, and Life Sciences.

EMEA sales declined 7%, driven by Oil & Gas, Metals and Auto, partially offset by strength in Food & Beverage.

Sales in the Asia Pacific region grew 16%, with broad-based growth led by Semiconductor, Chemicals, and Life Sciences. Asia Pacific backlog reached another record high in the quarter and we expect strong sales growth in the region for both the upcoming quarter and full year.

In China, we saw over 30% organic growth driven by strong growth in all three industry segments, including particular strength in EV and Semiconductor in Discrete, Tire, Life Sciences and Food & Beverage in Hybrid, and Mining and Chemical in Process. We expect growth in China will exceed the company average for the year, as our longer cycle businesses kick in.

Let's now turn to slide 6 to review highlights for the full year outlook.

Orders momentum in the first half of the year is expected to drive strong sales growth in the balance of the year, especially as we enter a period of easier comps. Higher top line guidance is driven by improvements during the quarter in our Discrete and Hybrid industry segments that more than offset incremental declines in Process.

Our new outlook for total reported sales is over 10% year-over-year growth at the midpoint, including 7% organic growth. Core automation is not the only driver of growth this year, as we also expect double-digit sales growth in Information Solutions and Connected Services. We're seeing good contribution from both organic and inorganic sources, and we also expect double-digit ARR growth in fiscal 21.

We expect margins to stay relatively flat with last year, despite the reinstatement of our bonus and the incremental one-time investments we spoke about last quarter that will largely impact the second half. Our new adjusted EPS target of $9.15 at the midpoint of the range represents over 16% growth compared to the prior year.

A more detailed view into our outlook by end market is found on slide 7. I won't go into the details on this slide, but as you can see, we continue to expect broad-based organic sales growth this year, with Oil & Gas lagging. Our diversification across higher-growth end markets is one aspect of the increasing business resilience that we talked about during Investor Day in November.

With that, let me now turn it over to Nick who will elaborate on our second quarter performance and updated financial outlook for fiscal 21. Nick?

Nicholas Gangestad

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

Thank you, Blake, and good morning everyone.

I'll start on slide 8, second quarter key financial information. Second quarter reported sales were up 5.6% year-over-year. Organic sales were up 1.3%, slightly better than our expectations. Acquisitions contributed 1.9 points of growth, and currency translation increased sales by 2.4 points.

Segment operating margin was 22%, flat compared to Q2 of last year. This represents strong underlying improvement considering a $60 million headwind from the year-on-year change in the bonus.

Corporate and Other expense of $30 million was $12 million higher than last year, primarily due to mark-to-market adjustments related to our deferred and non-qualified compensation plans.

The Adjusted Effective Tax Rate for the Second quarter was 16.7% compared to 12.6% last year. Last year's rate benefited from several larger discrete items.

Second quarter Adjusted EPS was $2.41, well above our expectations. I'll cover a year-over-year Adjusted EPS bridge for Q2 on a later slide. Free Cash Flow was $224 million in the quarter. Year to date, Free Cash flow conversion was 97%.

One additional item not shown on the slide, we repurchased 363,000 shares in the quarter at a cost of $92 million. Through the first half of the year, we are on track to our full year repurchase expectation of approximately $350 million. At March 31, $674 million remained available under our repurchase authorization.

Slide 9 provides the sales and margin performance overview of our three operating segments.

The Intelligent Devices segment had organic sales growth of 5.8% in the quarter. Segment margin was 23.8%, 80 basis points higher than last year, mainly due to higher sales and lower spend, partially offset by the reinstatement of incentive compensation.

As Blake highlighted earlier, we once again had strong orders performance in the quarter, particularly in our Products businesses. Intelligent Devices orders grew approximately 20% both year-over-year, and sequentially.

Software & Control segment organic sales grew 5.6% in the quarter. Acquisitions contributed 4 points to growth. Segment margin was 29.8%, which was 70 basis points below last year's strong margin performance. The margin benefit from higher sales was offset by the reinstatement of incentive compensation. Software & Control orders also grew mid-teens both year-over-year and sequentially.

Organic sales of the Lifecycle Services segment declined 11% year-over-year, as the recovery in this segment continues at a slower pace than our products businesses. Acquisitions contributed 3.3% to growth. Operating margin for this segment declined 310 basis points to 9% versus 12.1% a year ago, primarily due to lower sales and the reinstatement of incentive compensation partially offset by favorable mix and cost savings from actions taken in the prior year. Second quarter book to bill performance for the Lifecycle Services segment was 1.19.

The next slide, 10, provides the Adjusted EPS walk from Q2 fiscal 2020 to Q2 fiscal 2021.

Starting on the left, Core performance had a positive impact of approximately $0.45, driven by higher sales, favorable mix, and productivity. Currency contributed about $0.05.

Incentive compensation was a year-over-year headwind of approximately $0.45. This reflects a $0.35 impact from the reinstatement of the bonus as well as a $0.10 impact from improved FY21 performance.

Tax was a headwind of about $0.10, primarily due to favorable discrete items last year. Although not shown on the chart, the EPS impact from acquisitions was breakeven.

Moving to slide 11, quarterly product order trends.

This slide shows our average daily order trends for our products. The trends shown here account for two-thirds of our overall sales. Order intake for products improved again this quarter, as the recovery continued. Q2 product order levels grew year-on-year as well as sequentially and are at an all-time high, particularly strong areas were in Motion, Visualization, and Logix.

Orders for the Lifecycle Services segment also improved in the quarter sequentially, though at a slower pace than our Product order growth. The overall strong order performance resulted in record company backlog, growing over 30% year-over-year and double digits sequentially.

This takes us to slide 12, updated guidance.

We are increasing our organic sales growth outlook by 1 point across the range – the new range is 5.5% to 8.5%, with a mid-point of 7%. We expect currency translation to now contribute about 2% to growth. We still expect acquisitions to contribute 1.5%. In total, the mid-point of our reported sales guidance range is 10.5% or about $7 billion.

We have also updated the Adjusted EPS guidance to a new range of $8.95 to $9.35. I'll review the bridge from the prior guidance mid-point to the new $9.15 mid-point on the next slide.

Segment operating margin is expected to be approximately 19.5%. This is unchanged from prior guidance and primarily reflects strong Q2 margin performance and the higher sales guidance offset by higher supply chain costs, bonus expense, and less favorable currency. As a reminder, the second half includes higher spend as well as the incremental one-time software development and sustainability investments that we discussed on last quarter's call. The one-time investments will primarily affect the Software & Control segment.

Our Adjusted Effective Tax Rate is still expected to be about 14%, the same as prior guidance. As previously mentioned, this includes a 300-basis point benefit related to discrete items which we expect to realize late in the fiscal year. We continue to project free cash flow conversion to be approximately 100% of Adjusted Income.

A few additional comments on fiscal 2021 guidance.

Corporate and Other expense is expected to be about $110 million. Total purchase accounting amortization expense for the full year is expected to be about $50 million. Net interest expense for fiscal 2021 is still expected to be between $90 and $95 million. Finally, we're still assuming average diluted shares outstanding of about 117 million shares.

This takes us to slide 13.

This slide bridges the mid-point of our January Adjusted EPS guidance range to the mid-point of our new guidance. Starting on the left. There is a higher contribution from core operating performance, primarily due to the higher organic sales guidance and favorable mix, partially offset by higher supply chain costs.

The contribution from currency is now expected to be $0.10 lower compared to prior guidance. Next, given the increase in guidance, there is about a $0.15 impact from higher bonus expense. Which brings the new midpoint of the guidance range to $9.15. Finally, a quick comment regarding the second half. We do expect second half year-over-year organic sales growth of about 20%.

With that, I'll hand it back to Blake for some additional comments.

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

Thanks, Nick.

With a solid first half under our belt, we look at the remainder of fiscal 21 with optimism. Strong order trends and record backlog underpin a robust top line outlook, and we have confidence in our team's ability to navigate the supply chain challenges.

Looking to our future, we continue to invest in software capabilities, including development, sales resources, and infrastructure. These investments support strong growth in our software business and ARR in fiscal 22 and beyond.

Our momentum would not be possible without the tremendous efforts of our employees. I'd like to thank everyone at Rockwell, and particularly our Integrated Supply Chain organization, which has done a great job managing pandemic challenges and now mitigating our sourcing and logistics constraints. We're leveraging our own manufacturing expertise to help customers be more resilient, agile and sustainable. Nobody is better positioned to help our customers deal with these increasingly complex manufacturing challenges and opportunities than Rockwell and our ecosystem of best-in-class partners.

With that, let me make some final remarks about Steve Etzel, who is participating in his final earnings call. Steve stepped up during a critical period for us, as we pivoted into the early stages of this recovery and accelerated our transformation. His experience, dedication, and caring for fellow employees was exactly what we needed. Nick and I join thousands of employees in wishing Steve and Michelle all the best in a happy retirement full of adventure and time with their growing family.

Let me now 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. In summary, we are very pleased with our strong performance in the quarter. The recovery in manufacturing is accelerating at a much faster pace than we initially expected. Rockwell is extremely well-positioned in this recovery, and we're especially excited about the new product introductions and services that we will bring to market over the next couple of years.

It is an exciting time to be a part of the Rockwell journey, and we thank you for your interest and ongoing support.