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Rockwell Automation, Inc. (ROK)

Q2 2022 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.*

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 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.

Thanks, Rob. Good morning, and thank you for joining us for Rockwell Automation's second quarter fiscal 2022 Earnings Release Conference Call.

With me today is Blake Moret, our Chairman and CEO, and Nick Gangestad, 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 on our 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. Additional information and news about our company can also be found on Rockwell's investor relations Twitter feed using the handle @InvestorsROK, that's @Investors R-O-K.

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 of 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 today.

Before providing detail on second quarter results, which were below our expectations, I want to provide general comments on the business environment. Through the first half of our fiscal year, two themes stand out. The first is broad-based demand growth across industries, geographies, and offerings. Substantial backlog in all three business segments, low cancellation rates, and detailed component supply forecasts give us confidence that we will achieve double-digit revenue growth this fiscal year and reach \$9 billion of profitable sales in the next couple of years.

The second theme is persistent supply-chain constraints and associated cost inflation, which put particular pressure on Q2 sales and earnings. Since our last earnings release in January, we've seen supplier pushouts and de-commits for electronic component shipments, the impact of unexpected COVID-related shutdowns in China, and Russia start a war in Ukraine. These have had an impact on our results and guidance, so let's get into the detail on our quarter, the outlook, and what we are doing to maximize Rockwell's business performance and long-term value.

Our second quarter results are summarized on slide three. Total orders grew by 37%, once again reflecting very strong demand across our portfolio of core automation and digital transformation solutions. Total revenue grew 2% year-over-year in the quarter. Organic sales grew a little over 1% versus prior year, worse than our expectations due to the supply chain challenges.

Through six months, Rockwell's organic top line has grown 9% year-over-year. Orders momentum was broad-based across all three business segments. However, product shipments and solutions with significant hardware content were limited by multiple component shortages.

In the Intelligent Devices business segment, organic sales declined 3% versus prior year, a sharp reversal from the 25% growth in the first quarter, reflecting volatile component supply. Within this segment's Motion business, sales of our Independent Cart Technology grew strong double digits, and our orders more than doubled from a year ago.

Software & Control organic sales grew a little less than 1%, also reflecting component shortages. We continue to see strong order growth in this business, led by Logix and Visualization. In Lifecycle Services, organic sales increased 11% versus the prior year, led by 24% growth at Sensia. Demand is broadly increasing in Lifecycle Services, as demonstrated by a 1.34 book-to-bill. Information Solutions & Connected Services grew strong double digits in both orders and revenue.

Industrial Cybersecurity demand was strong in the quarter with orders up 90% year-over-year, as customers in Life Sciences, Food and Beverage, Mining and many other end markets are increasingly relying on us to provide the robust network technology and real-time domain expertise to keep their critical operations secure and resilient.

In the quarter, one of our Plex wins was with Ree Automotive, an automotive technology company and EV platform maker headquartered in the EMEA region, where our cloud-native smart manufacturing platform will enable their state-of-the-art plant with real-time production monitoring, inventory and quality management, creating an agile manufacturing system needed for customized electric vehicles. You will recall that globalizing market access for Plex's software was an important synergy to be realized through this deal. Last month Plex also became available on Microsoft's Azure cloud in Europe, and we're partnering with Microsoft to promote this new capability.

At Fiix, we had another great quarter, with ARR growing over 40%. We continue to win new logos including our first wins in Asia.

Our partnership with PTC continues to grow, and in the quarter, we booked software subscriptions for Digital Performance Management based on ThingWorx. This new solution helps identify, prioritize, and act on de-bottlenecking opportunities that have the greatest potential P&L impact in manufacturing sites. We combine great technology and domain expertise to create a very strong value proposition for our customers. In the quarter, organic ARR grew by 17%.

Let's turn to slide four. Our usual Q2 end-market performance slide is in the appendix. It's important to understand that this quarter sales growth or decline in specific industry verticals is primarily based on the particular products being shipped into these verticals and the degree they were impacted by component shortages rather than underlying demand.

Working left to right on the slide Auto and eCommerce, two very important verticals we serve within our Discrete industry segment, were down in the quarter, with the resulting single-digit decline for the Discrete segment. The majority of sales to these verticals are in products, which were heavily impacted by component shortages that impacted our ability to ship to these customers. In contrast, orders for Auto and eCommerce remain very strong.

We continue to see large competitive wins with our Independent Cart Technology for motion control in battery applications, and about a third of our total Auto business is expected to be for Electric Vehicle applications in the full year.

We also had an important sustainability win this quarter at Electra Battery Materials, a leading provider of low-carbon and sustainable metals to the EV automotive sector. Rockwell was chosen to provide a turnkey solution for North America's first integrated and environmentally sustainable battery materials plant.

In eCommerce and Warehouse Automation, we continue to win expansion projects with our flexible material handling technology and digital twin software. And in Semiconductor, our offerings can be found in chip-making machinery, material handling equipment, and building management systems at the largest semiconductor and semiconductor capital equipment companies in the world. It is clear we are playing a critical role in this industry's plans for multi-billion-dollar capacity expansion.

We continue to see strong broad-based demand in Food and Beverage with particular focus on digital transformation projects. Life Sciences sales were up double digits, as two-thirds of our Life Sciences business is in software, solutions, and services that are less dependent on electronic components. Oil and Gas sales were up double digits led by improving trends in upstream and midstream. Our Sensia joint venture had strong orders and ships in the quarter and is expected to grow strong double digits for the year. In summary, multi-year capital investments across many end markets, coupled with higher automation and digital transformation intensity, have created high backlog and a continuing strong order funnel to support growth in each industry segment we serve.

Turning now to slide five and our Q2 organic regional sales performance. North America organic sales declined by about 3% versus the prior year due to the higher mix of Intelligent Devices in this region. The Intelligent Devices segment was more heavily impacted by component shortages this quarter. We continue to expect more balanced sales growth across regions for the full year and expect North America to be the fastest growing region in fiscal 2022.

Latin America sales were up 13%, EMEA sales increased 6%, and Asia Pacific grew 9%, due in part to the higher solutions content in this region. In China, we saw high single-digit growth driven by strength in Mass Transit, Life Sciences, Tire, and Oil and Gas.

Let's turn to slide six, which is a new slide we thought would be helpful this quarter. The high backlog we've been building over the last few quarters and continued low cancelation rates, set the stage for strong revenue growth in the second half of fiscal 2022 and beyond. We do expect lead times and backlog to stabilize over the next year, and at that point orders and shipment levels will begin to converge, which is a good thing. In the near term, the primary limiting factor to growth is component availability.

So, as we turn to slide seven, let's go a bit deeper into some of the actions we are taking to improve semiconductor chip availability and our overall resiliency. We expect component shipments to increase in the coming quarters due to several factors. The first is improved material flow from key suppliers over the next couple of quarters. Where we are seeing improved flow from existing suppliers, several factors are contributing, such as the addition of incremental capacity, improved allocation

percentages, opportunistic broker buys, and some of these suppliers' recovery from discrete events like fires and floods.

We have also re-engineered certain products to utilize components with better supply resiliency. For example, the new series of PanelView operator interface has enabled us to double the shipment quantity in the last two months.

We have significantly accelerated our manufacturing capacity investments in our Twinsburg and Singapore facilities over the last year, which will benefit production and resiliency in the second half of fiscal 2022.

We continue to qualify new and additional semiconductor chip vendors to create redundant sources for individual components and to diversify our supplier base, and we expect to see the benefit in fiscal Q4. We continue to invest in diversifying our portfolio and see continued double-digit growth in our Information Solutions and Connected Services, which are less dependent on hardware supply chains.

Price is also a meaningful contributor to our growth and our resiliency in mitigating inflation. We have very strong pricing power in the market thanks to our highly differentiated offerings. We are seeing good price realization as annual customer agreements renew, and we are taking action to get quicker realization of future price increases. In the last year, we have announced several price increases totaling 17% materially benefiting the later portion of this fiscal year and even more so in fiscal year 2023.

However, as you know, there are risks that cannot yet be accurately quantified, which is one of the reasons we have widened our range for growth expectations for the full year. These risks include the duration and potential escalation of the war in Ukraine. We have suspended the small amount of business we do in Russia and Belarus, less than half of 1% of total sales. We are seeing logistics cost increases due to higher energy costs, as well as constrained and lengthened air freight lanes.

Another source of risk is the widespread shutdown of businesses in China due to COVID infection outbreaks. Our plants have partially re-opened due to the critical role our products and services play in industries such as Semiconductor, but the bigger risk is from upstream suppliers with operations in the area. We have built in some risk for China shutdowns, but it is difficult to quantify this risk in the next two quarters.

Let's now turn to slide eight to review highlights for the full year outlook. Orders for the year are expected to approach \$10 billion. At some point we expect orders to moderate, as lead-times for our

products return to more normal levels. However, orders are expected to remain well-above pre-pandemic levels given the amount of capital projects underway in industries we serve.

We continue to expect double-digit reported sales growth, but we've reduced the midpoint and widened the range, in part given the volatility of component supply that we saw in the second quarter. April component supply and total sales are tracking well with our forecast.

Acquisitions are expected to do well and contribute over two points of profitable growth. We continue to expect double-digit growth in both Core automation as well as Information Solutions and Connected Services.

We continue to expect another year of double-digit Annual Recurring Revenue growth, which makes up over 8% of our total revenue. I'm pleased with the impact both acquisitions and organic investments are having in these new lines of business.

We have reduced our margin expectation and Adjusted EPS target range for the year. The midpoint of the Adjusted EPS range represents a point of increase over the prior year and a 13% increase without the impact of last year's lower tax rate and benefit from a one-time legal settlement. And, as noted on the slide, the board authorized an additional \$1 billion of share repurchases.

Nick will now add detail to our Q2 results and financial outlook for fiscal 2022. Nick?

Nicholas Gangestad

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

Thank you, Blake, and good morning, everyone. I'll start on slide nine, Second Quarter Key Financial Information.

Second quarter reported sales were up 2% over last year. This is below our expectations and was directly linked to electronic component availability in the quarter. Q2 organic sales were up 1.3% and acquisitions contributed 2.3 points to total growth. Currency translation decreased sales by 1.8%.

Segment operating margin was 15.7%, approximately 300 basis points worse than we expected and primarily impacted by lower-than-expected sales volume and higher input costs. Versus last year, our margins declined 630-basis points mostly due to negative price/cost and higher investments in key growth areas. I will comment further on price/cost on the next page.

Our Adjusted EPS in the quarter was \$1.66 and 31% down from the prior year. As we said last quarter, we expected Q2 to be the most impacted by negative price/cost, as the benefits from prior price actions will be more heavily weighted to the second half of fiscal year 2022 and into fiscal year 2023. I'll cover a year-over-year Adjusted EPS bridge on a later slide.

The Adjusted Effective Tax Rate for the second quarter was 16.0% and in line with the prior year. Free Cash Flow was \$46 million in the quarter and down compared to the prior year due to lower pre-tax income and higher income tax payments. Income tax payments were in line with our expectations and higher year-over-year due to payments made in the current quarter in the US related to fiscal year 2021 discrete tax transactions. Free Cash Flow results were lower than expectations driven by lower pre-tax income and higher working capital as we continue to build our sub-assemblies for more rapid conversion into finished goods as we receive critical components.

Turning to page 10. This is a new slide we added this quarter. This slide shows the actual impacts for quarter one and quarter two and what we included in our projections for the second half for both price and input costs. First on pricing.

From our three price increases since last summer, we expect those actions to provide about \$400 million of cost recovery once fully implemented. Less than 10% of this benefit was realized in the first half of fiscal year 2022. The ramp to achieve the pricing impact occurs because much of our pricing is set by pricing agreements we have with our customers. Once we announce a price increase, these customers will not see the increases until their current annual agreements renew. We are implementing actions to accelerate realization on future price increases. The price growth projected here is only from previously announced price increases, and factors in higher inflationary costs not yet seen. If inflation forecasts for fiscal 2023 worsens more than expected, we will take further price actions to offset these costs.

On input costs, we did see a higher year-over-year and sequential increase in input costs in Q2. These increases were driven by increased logistics costs and a higher level of broker buys. We anticipate these elevated cost levels to continue increasing for the balance of the year. For fiscal 2022, we expect input costs to increase over \$200 million primarily due to higher electronic component costs and higher freight. On a net price/cost basis, we are negative in the first half and positive in the second half. We now expect full year price/cost to be slightly negative in fiscal 2022.

Slide 11 provides the sales and margin performance overview of our three operating segments.

Total reported sales were up mid-to-high single digits in both our Software & Control and Lifecycle Services segments. Intelligent Devices was down 5% as this segment was impacted more by supply chain constraints.

Intelligent Devices organic sales were down 3% in Q2 and up 10% in the first half. Compared to last year, Intelligent Devices margins declined 920 basis points to 14.6%, driven by negative price/cost, investment spend, and lower volumes. This segment accounted for the vast majority of the miss to our internal expectations in both sales and margins. We expect the second half margins in this segment to expand by 200 to 300 basis points sequentially on higher volumes and higher price from earlier implemented price actions.

Software & Control organic sales were up less than one point and 4% in the first half. Segment margins were up sequentially for this segment and declined 520 basis points compared to last year, mostly due to higher year-over-year investment spend, negative price/cost and the impact of acquisition integration costs. We expect the second half margins in this segment to expand by over 600 basis points sequentially on higher sales and higher price from implemented price actions.

Lifecycle Services grew organic sales by 11%, including more than 20% growth from Sensia. Demand remains strong across all businesses and end markets. Book to bill was 1.34 for Q2. Segment margin was up sequentially for this segment and declined 170 bps compared to the prior year, driven by lower labor utilization caused by supply chain constraints, partially offset by higher sales volume and lower incentive compensation. Margin is expected to grow through the balance of the year with strong sales growth and a higher margin backlog.

The next slide, 12, provides the Adjusted EPS walk from Q2 fiscal 2021 to Q2 fiscal 2022.

Starting on the left, core performance was down about \$0.75 on a 1.3% organic sales increase as we continue to make growth related investments. We also were impacted by the timing of merit increases and lower labor utilization. As previously discussed, price/cost had a negative \$0.25 impact in the quarter. Given our updated guidance, we lowered our estimate for fiscal year 2022 incentive compensation. On a year-over-year basis, incentive compensation was about a \$0.25 tailwind. This brings us to our total EPS of \$1.66.

Let's move on to the next slide, 13, guidance for fiscal 2022.

We are updating our sales guidance to a new range of approximately \$7.8 to \$8.0 billion in fiscal 2022, up 11% to 15% for the year. We expect organic sales growth to be in a range of 10% to 14%. We expect currency translation to be a headwind of 1.5 points, and about 2.5 points of growth coming

from acquisitions. Our wider sales guidance range reflects the volatility we see in the component supply and uncertainty of the full impact of Covid related shutdowns in China.

As Blake mentioned earlier, we are forecasting an increase in sales in the second half in line with improved material flow from key suppliers. From a calendarization perspective, we are forecasting improved sequential performance over the balance of the year with a heavier weighting in Q4 driven by the resiliency actions Blake mentioned as well as the timing from higher price realization.

We expect full year segment operating margin to be about 20%. This is a 150-basis point reduction from our prior guide and is the result of our volume decrease. The impact from higher input costs since our January guidance is expected to be more than offset with reduced spending levels including lower incentive compensation. We will continue to prioritize our growth and resiliency investments.

We expect second half margins of around 22%, up 4 percentage points from first half levels primarily driven from higher sales volume and a 250-basis point improvement from price/cost.

The first half impact of price/cost on margins on a year-over-year basis was dilutive by approximately 250 basis points and the margin impact in the second half from price/cost will be accretive by over 100 basis points.

We expect margins to improve sequentially 300-400 basis points in the third quarter and another 400-500 basis points in the fourth quarter. We now expect full-year core earnings conversion of between 20% to 25%, with second half core conversion of approximately 40%. We continue to expect the full year Adjusted Effective Tax Rate to be around 17%. We do not anticipate any material discrete items to impact tax in fiscal 2022.

We are decreasing our Adjusted EPS guidance range to \$9.20 to \$9.80. At the midpoint of the range, this is up about 1 point compared to the prior year. Finally, we expect full-year fiscal 2022 Free Cash Flow conversion of about 85% of Adjusted Income. The decrease from our prior guide of 90% is driven by higher working capital where we continue to have high inventory levels in order to support our increased demand.

A few additional comments on fiscal 2022 guidance. Corporate and Other expense is projected around \$120 million. Net Interest expense for fiscal 2022 is expected to be about \$115 million. We're assuming average diluted shares outstanding of about 117 million shares. Finally, on capital deployment, our capital allocation priorities for this year remain the same, including our focus on de-leveraging.

As Blake mentioned earlier, the Board authorized another \$1 billion of share repurchases. Board and management are committed to using our capital deployment framework to drive long-term shareholder value, including opportunities for increased share repurchases.

Turning now to page 14. 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 lower contribution from core operating performance, due to the lower organic sales guidance, partially offset by lower spend. We now expect price /cost to be negative for the full year or a \$0.25 negative impact versus our January guidance. Currency is expected to be a \$0.20 headwind

Next, given the decrease in our forecasted performance, there is about a \$0.35 impact from a projected lower bonus expense. Which brings the new midpoint of the guidance range to \$9.50. Although not on this page, we continue to expect our acquisitions including Plex to be about neutral this year including incremental interest expense or a year-over-year benefit of about \$0.15.

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

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Nick.

This was a tough quarter, but we are aggressively working to temper the impact of persistent and volatile supply chain shortages. We have provided guidance that reflects a detailed view of expected component availability and actions we are taking to increase the flow of product and solutions to the market. We are beginning to see increases in some of the semiconductors we use, we continue to qualify new sources, and important new capacity is being built for the technology we use in many of our products. For example, the incremental fab capacity a major supplier is planning to bring on-line will directly benefit a number of our product families in early 2023. While we do not anticipate supply chain challenges to end soon, we do expect gradual sequential improvement over the coming quarters.

I want to thank our suppliers for their recognition of the critical role we play in U.S. manufacturing and industrial applications around the world. We are on track with our manufacturing capacity expansion to

ensure that internal equipment and processes support our revenue growth in fiscal year 2022 and beyond.

Despite these challenges, we are also on offense. We continue to introduce new differentiated technology and services, including the January opening of our Israeli Cybersecurity Operations Center to support worldwide customers. Later this year we will release new FactoryTalk operator interface and design software at our annual Automation Fair. We have reduced spending plans in response to the higher costs, but we are prioritizing programs that will generate new revenue in the coming years and we are increasing investments that strengthen our resiliency.

We continue to focus on accelerating profitable growth within the long-term financial framework that has served us and our investors well. We complement internal investment with a disciplined capital allocation that is focused on creating value.

The capabilities and dedication of our people continue to set us apart. From our manufacturing associates in plants around the world, to our salespeople working together with supply chain professionals to meet our customer's most critical needs, to our development engineers balancing the simultaneous demands of building component resiliency and launching new products, to the teams who are focused on keeping our people safe and productive, we're confident that our extra effort will be remembered as we help manufacturers feed, clothe, protect, and move the world.

Jessica will now begin the Q&A session.

Jessica Kourakos

Head of Investor Relations, Rockwell Automation, Inc.

Thanks, Blake. Operator, we will now begin the Q&A.

Q&A Session

Jessica Kourakos

Head of Investor Relations, Rockwell Automation, Inc.

Thanks, everyone. That concludes today's call.