

3rd Quarter 2020 Earnings Transcript

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CORPORATE PARTICIPANTS

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PRESENTATION

Kevin Maczka Belden, Inc. – VP, Treasurer & Investor Relations

Thank you, operator. Good morning, everyone, and thank you for joining us today for Belden's third quarter 2020 earnings conference call.

My name is Kevin Maczka, I'm Belden's Vice President of Investor Relations and Treasurer. With me this morning are Belden's President and CEO Roel Vestjens and CFO Henk Derksen. Roel will provide a strategic overview of our business, and then Henk will provide a detailed review of our financial and operating results, followed by Q&A.

We issued our earnings release earlier this morning, and we have prepared a slide presentation that we will reference on this call. The press release, presentation, and transcript of these prepared remarks are currently available online at investor.belden.com.

Turning to slide 2 in the presentation. During this call management will make certain forward looking statements in reliance upon the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. For more information, please review today's press release and our annual report on Form 10-K. Additionally, during today's call management will reference adjusted or non-GAAP financial information. In accordance with Regulation G, the appendix to our presentation and the investor relations section of our website contain a reconciliation of the most closely associated GAAP financial information to the non-GAAP financial information we communicate.

I will now turn the call over to our President and CEO Roel Vestjens. Roel?

Roel Vestjens Belden, Inc. – President & CEO

Thank you, Kevin, and good morning, everyone.

As a reminder, I'll be referring to adjusted results today.

Please turn to Slide 3 in our presentation for a review of our third quarter highlights.

Business conditions improved during the third quarter, and I am pleased to report solid double-digit sequential increases in revenue, EPS, and free cash flow.

Third quarter revenues increased 12% sequentially to $475.8 million, with both of our segments delivering organic growth on a sequential basis in the quarter.

EPS increased 57% sequentially to $0.72, and free cash flow increased 78% sequentially to $35.7 million.

I am extremely proud of the way our global workforce has responded to the unprecedented challenges this year. The teams remain highly engaged and committed to supporting our valued customers while maintaining the safest possible working conditions. These significantly improved results demonstrate the continued dedication of our associates around the world.

During the quarter, we made further significant progress with our $60 million SG&A cost reduction program. We expect to deliver $40 million of these savings in 2020 and the full $60 million in 2021. Our teams delivered $12 million in savings in the third quarter as expected, and we intend to deliver the full $15 million quarterly run rate savings in the fourth quarter. When fully realized, this represents approximately 300 basis points of incremental EBITDA margin expansion on an annual basis. As a reminder, these are permanent cost reductions that will not return as conditions normalize.

As we successfully execute our cost reduction plans, we continue to make strategic investments to accelerate growth and capitalize on the opportunities in our key markets.

To that end, R&D spending increased 26% year-over-year in the quarter, with over 60% of this investment now dedicated to software development. This includes standalone software and embedded software within various hardware products.

We are making targeted investments in compelling growth opportunities across the portfolio to drive further innovation in Industrial Automation and enhance our best-in-class Cybersecurity cloud platform.

Innovations are important to our customers and our shareholders, as they will further strengthen our product offering, enhance our competitive advantage, and drive growth. We are seeing a return on prior investments in broadband fiber in the form of outsized growth in those products. Similarly, we expect our current investments in Industrial Automation and Cybersecurity to drive accelerating growth in those solutions going forward.

Our strong balance sheet and ample liquidity provide the financial flexibility to make these important investments as we successfully navigate this economic downturn and position the Company to fully participate in the recovery.

We exited the quarter with cash on hand of $391 million after repaying all remaining short-term revolver borrowings. We are comfortable with our liquidity position at this point.

Finally, demand trends and visibility in our business are improving. As a result, we are resuming our traditional guidance practices.

We expect modest sequential improvement in underlying demand during the fourth quarter. However, we expect our channel partners to pursue incremental reductions in channel inventory levels during the fourth quarter after only modest reductions in the third quarter. This will partially offset the sequential growth in underlying demand that we expect, and it is contemplated in our guidance.

Please turn now to slide 4 in the presentation.

Looking out beyond the quarter, we remain very excited about the opportunities for Belden as we continue our transformation. We are aligning our business around markets with favorable secular trends,

and our key strategic priorities are Industrial Automation, Cybersecurity, Broadband & 5G, and Smart Buildings.

We believe that each of these markets offers compelling growth opportunities over the cycle. I'd like to briefly review each of them now.

First, the global pandemic clearly impacted demand for Industrial Automation on a temporary basis, but we remain extremely optimistic longer-term, due in large part to increasing labor costs and enhanced productivity and quality needs. The secular tailwinds remain fully intact, and social distancing and other new health and safety practices represent yet another incremental demand driver for automation on the factory floor and elsewhere.

In Cybersecurity, increasingly sophisticated and costly attacks are driving the need for advanced cyber solutions. We are especially excited about the Industrial markets, where we are particularly well positioned. Belden's truly unique offering provides critical cybersecurity protection, and this remains an important area of investment for our customers during this pandemic. We are clearly gaining traction with our new cloud-based and other products, and we are encouraged by robust recent orders for our Industrial cybersecurity and software-as-a-service offerings.

In Broadband & 5G, demand for more bandwidth and faster speeds is ever-increasing, and the COVID-19 pandemic is only accelerating the demand for our fiber optic and other products. We continue to expand our fiber product portfolio and capacity through organic and inorganic investments, including five bolt-on broadband fiber acquisitions completed in the last few years.

We are extremely well-positioned to support our MSO customers as they upgrade existing networks in response to record demand levels and new competitive threats from 5G. We also support Telco customers as they build out new 5G infrastructure.

Finally, in Smart Buildings, the increasing use of integrated networks drives increasing demand for our connectivity solutions. The outlook for some Smart Buildings markets clearly changed due to COVID-19, but we continue to see growth opportunities in certain market verticals, such as government, healthcare, and data centers. As the economy recovers, we would expect healthy demand from these customers to partially offset the headwinds in other verticals within Smart Buildings.

I will now ask Henk to provide additional insight into our third quarter financial performance. Henk?

Henk Derksen Belden, Inc. - CFO

Please turn to Slide 5 for a detailed consolidated review.

I will start my comments with results for the quarter, followed by a review of our segment results and a discussion of the balance sheet and cash flow performance. As a reminder, I will be referencing adjusted results today.

Revenues were $475.8 million dollars in the quarter, compared to $533.1 million in the third quarter of 2019.

Revenues decreased 10.7% on a year-over-year basis and increased 12.0% sequentially. After adjusting for a $4.9 million favorable impact from acquisitions and a $5.2 million favorable impact from currency translation and higher copper prices, revenues declined 12.6% organically on a year-over-year basis. After adjusting for a $12.3 million favorable impact from currency translation and higher copper prices, revenues increased 9.1% organically on a sequential basis.

Recall that we entered the third quarter with a planning assumption that our channel partners would pursue a reduction in channel inventory levels of $25 million during the second half of the year and $70 million for the full year 2020. Our expectation for the full year is unchanged, but we now expect most of the second half reduction to occur in the fourth quarter after experiencing only modest reductions of approximately $3 million in the third quarter.

Gross profit margins in the quarter were 35.3%, declining 210 basis points compared to 37.4% in the year-ago period. This decline was primarily due to lower volumes.

EBITDA was $65.3 million dollars, compared to $49.1 million in the prior quarter and $90.0 million in the prior-year period.

EBITDA margins were 13.7%, compared to 11.6% in the prior quarter and 16.9% in the prior-year period. As Roel mentioned, we made further significant progress with our $60 million SG&A cost reduction program. Consistent with our commitment, we delivered savings of $12 million in the third quarter, representing $48 million on an annualized basis. We expect to deliver the full $15 million quarterly run rate savings in the fourth quarter.

As we streamline our cost structure, we remain committed to our important growth initiatives. During the quarter, we increased our R&D investment by $6 million, or 26%, from the prior year.

Net interest expense increased by approximately $1 million dollars sequentially in the quarter due to changing foreign exchange rates. At current foreign exchange rates, we expect interest expense in 2020 to be approximately $58 million dollars.

Our effective tax rate was 17.7% in the third quarter, as we benefitted from incremental discrete tax planning initiatives. We expect an effective tax rate of approximately 19% for the fourth quarter and 18% for the full year 2020.

Net income in the quarter was $32.2 million dollars, compared to $20.3 million in the prior quarter and $54.4 million in the prior-year period.

Earnings per share was $0.72 in the third quarter, compared to and $1.19 in the year-ago period. Earnings per share increased 57% sequentially from $0.46 in the second quarter.

Turning now to slide 6 in the presentation for a review of our business segment results.

I will begin with our Industrial Solutions segment.

As a reminder, our Industrial solutions allow customers to transmit and secure audio, video and data in harsh industrial environments. Our key markets include discrete manufacturing, process facilities, energy, and mass transit.

The Industrial Solutions segment generated revenues of $246.7 million dollars in the quarter. Currency translation and copper prices had a favorable impact of $3.3 million dollars year-over-year and $8.1 million dollars sequentially. After adjusting for these factors, revenues decreased 15% organically on a year-over-year basis and increased 8% sequentially.

Within this segment, Industrial Automation revenues declined 16% year-over-year and increased 8% sequentially. Not surprisingly, the trends were consistent across our market verticals in the quarter.

Cybersecurity revenues declined 8% in the third quarter on a year-over-year basis, and increased 6% sequentially. We continue to secure large strategic orders with new customers, and significantly expand our engagements with existing customers. As a result, non-renewal bookings, our best leading indicator of future revenues, increased 18% year-over-year overall and 42% in the Industrial vertical. Further, we continue to gain significant traction with our software-as-a-service offerings. SAAS offerings represented nearly 20% of non-renewal bookings in the quarter, compared to only 5% a year ago.

Industrial Solutions segment EBITDA margins were 15.6% in the quarter, compared to 11.9% in the prior quarter and 19.2% in the year-ago period. The year-over-year decline primarily reflects lower volumes and increased R&D investments in Industrial Automation and Cybersecurity.

Turning now to our Enterprise segment. As a reminder, our Enterprise solutions allow customers to transmit and secure audio, video and data across complex enterprise networks. Our key markets include broadband, 5G and smart buildings.

Our Enterprise Solutions segment generated revenues of $229.1 million dollars during the quarter. After further adjusting for a $4.9 million favorable impact from acquisitions and a $1.9 million favorable impact from currency translation and higher copper prices, revenues declined 10% organically on a year-over-year basis. After adjusting for a $3.9 million favorable impact from currency translation and higher copper prices, revenues increased 11% sequentially.

Revenues in Broadband and 5G increased 4% organically on a year-over-year basis and 7% sequentially. The ever-increasing demand for more bandwidth and faster speeds is driving increasing investments in network infrastructure by our customers. This supports continued robust growth in our fiber optic products, which increased 17% year to date on an organic basis.

Revenues in the Smart Buildings market declined 21% organically on a year-over-year basis and increased 16% sequentially.

Enterprise Solutions segment EBITDA margins were 11.5% in the quarter, compared to 10.9% in the prior quarter and 14.5% in the prior year period. The year-over-year decline primarily reflects lower volumes.

If you will please turn to Slide 7, I will begin with our balance sheet highlights.

Our cash and cash equivalents balance at the end of the third quarter was $391 million dollars compared to $393 million in the prior quarter and $297 million in the prior year period.

Recall that we proactively drew down $190 million under our $400 million revolving credit facility early in the second quarter. This was done out of an abundance of caution at the outbreak of the global pandemic.

We are comfortable with our current liquidity position, and as a result we repaid all remaining revolver borrowings during the third quarter.

Working capital turns were 7.5 turns, compared to 6.6 turns in the prior quarter and 6.9 turns in the prior-year period.

Days sales outstanding of 63 days was consistent with the prior quarter and prior year.

Inventory turns were 5.0 turns, compared to 4.5 turns in the prior quarter and 5.4 turns in the prior year. Our total debt principal at the end of the third quarter was $1.52 billion, compared to $1.56 billion in the second quarter. This reflects the repayment of the borrowing under the revolving credit facility and current foreign exchange rates.

Net leverage was 3.8 times net debt to EBITDA at the end of the quarter. This is temporarily above our targeted range of 2.0 to 3.0 times, and we expect to trend back to the targeted range as conditions normalize.

Turning now to slide 8. I will now discuss our debt maturities and covenants.

As a reminder, our debt is entirely fixed at an attractive average interest rate of 3.5% with no maturities until 2025 to 2028. We have no maintenance covenants on this debt, so we are not at risk of an event of default caused by worsening economic conditions.

As I mentioned previously, we are comfortable with our liquidity position and the quality of our balance sheet.

Please turn to Slide 9 for a few cash flow highlights.

Cash flow from operations in the third quarter was $50.8 million dollars, compared to $67.9 million in the prior year period.

Net capital expenditures were $15.1 million for the quarter, compared to $23.3 million in the prior-year period. The year-over-year difference is primarily related to the Grass Valley divestiture, which we completed in July 2020.

Free cash flow in the quarter was $35.7 million dollars, compared to $44.6 million in the prior-year period. Free cash flow increased 78% sequentially from $20.1 million in the second quarter. We are encouraged by the robust sequential improvement during a period of continued economic disruption related to the global pandemic.

On a trailing twelve months basis at the end of the third quarter 2020, free cash flow was $136.4 million dollars.

Consistent with our typical seasonality, we expect the fourth quarter to be the strongest quarter of the year for free cash flow generation. We expect to remain solidly free cash flow positive for the full year 2020.

That completes my prepared remarks. I would now like to turn this call back to our President and CEO, Roel Vestjens, for the outlook. Roel?

Roel Vestjens Belden, Inc. – President & CEO

Thank you, Henk.

Please turn to Slide 10 for our outlook.

As I mentioned previously, demand trends and visibility in our business are improving. As a result, we are resuming our traditional guidance practices.

Assuming no further material disruptions related to COVID-19, we expect modest sequential improvement in underlying demand in the fourth quarter, partially offset by the incremental reduction in channel inventory levels that we discussed.

We anticipate fourth quarter 2020 revenues to be between $460 million and $485 million, and EPS of $0.63 to $0.78.

For the full year 2020, we expect revenues to be between $1.824 billion and $1.849 billion, and EPS of $2.47 to $2.62.

Before we conclude, I would like to reiterate our investment thesis. We view Belden as a very compelling investment opportunity, as we are significantly improving our portfolio and aligning around the favorable secular trends in Industrial Automation, Cybersecurity, Broadband & 5G, and Smart Buildings. Throughout this challenging period, we continue to invest in our business to positon the Company for improving growth and robust margin expansion.

As we successfully execute our strategic plans and deliver on our goals, we would expect this to drive superior returns for our shareholders.

Finally, I would like to inform everyone that we will be hosting Belden's 2020 Investor Day event virtually on Tuesday, December 15th.

At this event, we will provide a detailed update on the Company's strategy for creating shareholder value. We hope you will be able to join us for the live webcast.

That concludes our prepared remarks, operator, please open the call to questions.