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2nd 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 second 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.

Before we review our second quarter performance, I would like to update you on the three transformative actions we initiated last year. These include the divestiture of Grass Valley, the upsized $60 million cost reduction program, and the planned exit of approximately $250 million in undifferentiated copper cable product lines.

First, on July 2nd, subsequent to the end of the second quarter, we completed the sale of Grass Valley to private equity firm Black Dragon Capital. This is an important milestone for Belden. We were obviously pleased to complete this transaction, and we look forward to supporting the Black Dragon and Grass Valley teams during the transition.

Second, our SG&A cost reduction program is on track. We previously upsized the expected annual savings to $60 million, and communicated an expectation of delivering $40 million in 2020 and the full $60 million run rate in 2021. We have made considerable progress, and our teams delivered savings of $8 million in the second quarter, representing $32 million in annualized savings. As a reminder, these are permanent cost reductions that will not return as demand recovers.

Finally, we previously delayed the planned exit of $250 million in copper cable product lines due to the global pandemic. We intend to restart this process and engage with potential buyers in the second half of 2020.

Please turn now to slide 4 in the presentation.

We are extremely excited about the opportunities for Belden as we continue our transformation and align our portfolio of businesses around markets with favorable secular trends. Our key strategic priorities are Industrial Automation, Cybersecurity, Broadband & 5G, and Smart Buildings. We continue to believe that each of these markets offers compelling growth opportunities over the cycle. I'd like to briefly touch on each of them now.

First, the global pandemic is clearly impacting demand for Industrial Automation on a temporary basis, but we remain extremely optimistic longer-term. We see increasing levels of automation everywhere in our daily lives, from factories to restaurants to parking garages, etc. We absolutely see the secular tailwinds continuing, due in large part to increasing labor costs and enhanced productivity and quality needs. Social distancing and other new practices in the post-crisis environment 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 nascent Industrial markets, where we are particularly well positioned for success. Belden's truly unique offering provides critical cybersecurity protection for our customers.

Many of our Industrial and Enterprise customers delayed large IT projects, including Tripwire installations, in the first half of the year due to the COVID-related shutdowns. Importantly, however, we are not seeing project cancellations or market share loss, and we are encouraged by our robust recent order trends.

We continue to add new customers, expand existing deployments, introduce exciting new cloud-based and other products, and further penetrate international markets. As a result, we are gaining traction and driving strong growth with our Industrial cybersecurity and our software-as-a-service offerings. This provides further confirmation that the cybersecurity solutions we provide remain a critical area of investment for our customers, even in the midst of this pandemic.

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 legacy 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. Simply put, we are extremely well positioned to win in both.

Finally, in Smart Buildings, the increasing use of integrated networks to enable improved user experiences, efficiency, and data analytics drives increasing demand for our connectivity solutions. The outlook for some Smart Buildings markets has 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 reopens, we would expect healthy demand from these customers to partially offset the headwinds in other verticals within Smart Buildings.

Turning now to slide 5 in the presentation.

We view Belden as a very compelling investment opportunity, and I would like to reiterate our investment thesis for you now. We are significantly improving our portfolio of businesses, and positioning the Company for enhanced growth and profitability. As we successfully execute our strategic plans and deliver on our goals, we would expect this, in turn, to drive superior returns for our shareholders.

Key performance drivers include the portfolio moves that I just discussed, along with continued growth investment to capitalize on the opportunities in our strategic markets. To that end, we remain committed to our R&D investments. These investments are important to our customers and will enable us to provide a high level of product innovation in the future. We are successfully executing our $60 million SG&A cost reduction program, which represents approximately 300 basis points of incremental EBITDA margin expansion, and we continue to believe that the business has the potential to achieve EBITDA margins in the 20-22% range in time. However, it is important to note that we do not intend to achieve this by sacrificing R&D or other growth investments.

Finally, before moving on to our second quarter highlights, I would like to mention that I am extremely proud of the commitment and dedication of our workforce during these turbulent times. A recent survey of our teams confirmed that they continue to be highly engaged and productive. We implemented social distancing in our factories and remote and flexible working arrangements in our non-factory locations to allow people to work effectively from any location.

Further, we have enhanced our support for local communities by launching our Connect with Community Program. This new initiative allows all Belden employees to take up to one week of fully paid time off to support volunteer initiatives that can improve the lives of disadvantaged groups in their community. It is our sincere hope that this program will enable Belden employees to make a direct positive impact on the lives of others.

Please turn now to slide 6 in the presentation to review our second quarter highlights.

In the second quarter, we delivered revenues of $424.8 million and EPS of $0.46.

The quarter was highlighted by very robust demand in Broadband and 5G, with orders increasing by 20% on a year-over-year basis and 13% organically.

With broadband networks being stressed like never before, the products offered by this business are uniquely suited to address the issues presented by the global pandemic, such as new work from home practices.

Importantly, our strong balance sheet and ample liquidity provide the financial flexibility to successfully navigate this difficult economic environment.

We exited the quarter with cash on hand of $393 million. Recall that early in the second quarter and out of an abundance of caution, we proactively drew down $190 million under our revolving credit facility. We are very comfortable with our liquidity position at this point, and as a result we repaid $100 million of the $190 million revolver draw late in the second quarter.

Finally, free cash flow was $20 million in the quarter. We are encouraged by the positive free cash flow generation during a period of unprecedented global economic disruption.

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

Henk Derksen Belden, Inc. - CFO

Thank you, Roel. Before I review the second quarter financial performance, I'd like to discuss the details of the Grass Valley transaction.

The transaction included cash consideration plus various forms of deferred consideration. The gross cash consideration was $120 million, or approximately $67 million net of cash delivered with the business. Belden also made a short-term investment of $3 million for an equity interest in Grass Valley that we expect to convert into cash within 120 days of closing. The deferred consideration included a $175 million five-year seller's note, up to $88 million in PIK interest on the seller's note over its five-year term, and $178 million in potential earn-out payments. The earn-out payments are based on certain performance thresholds. Both the seller's note and the PIK interest are due to Belden after five years.

As Roel mentioned, we were very pleased to complete this transaction. Based on the terms of the deal, we continue to have a financial interest in the long-term success of the business and we look forward to supporting the Black Dragon and Grass Valley teams during the transition.

Please turn to Slide 7 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 $424.8 million dollars in the quarter, compared to $548.4 million in the second quarter of 2019.

Revenues decreased 21.7% organically from the prior-year period, as a $6.9 million favorable impact from acquisitions was offset by an $11.2 million negative impact from currency translation and lower copper prices. After further adjusting for changes in channel inventory, revenues decreased 15.6% organically from the prior-year.

Recall that we entered the second quarter with a planning assumption that our channel partners would pursue a reduction in channel inventory levels of $50 million during the quarter. The actual reduction was approximately $25 million. We now anticipate the remaining $25 million reduction will occur in the third and fourth quarters, and our expectation for channel inventory reductions for the full year 2020 is unchanged at $70 million.

Gross profit margins in the quarter were 35.4%, declining 220 basis points compared to 37.6% in the year-ago period. This decline was due to lower volumes and channel inventory reductions.

EBITDA was $49.1 million dollars, compared to $91.6 million in the prior-year period.

EBITDA margins were 11.6%, compared to 16.7% in the second quarter 2019.

Our SG&A cost reduction program is on schedule. Consistent with our commitment, we delivered savings of $8 million in the second quarter, representing $32 million in annualized savings. We also continued to fund our growth initiatives and R&D investments, and we remain committed to these important projects. Net interest expense increased by approximately $1 million dollars sequentially in the quarter due to the temporary borrowings under our revolving credit facility. At current foreign exchange rates, we expect interest expense in 2020 to be approximately $57 million dollars.

Our effective tax rate was 17.0% in the second quarter, as we benefitted from incremental discrete tax planning initiatives. We expect an effective tax rate of approximately 20% for the third quarter and 19% for the fourth quarter.

Net income in the quarter was $20.3 million dollars, compared to $58.8 million in the prior-year period.

Earnings per share was $0.46 in the quarter, compared to $1.26 in the year-ago period.

Turning now to slide 8 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 $221.4 million dollars in the quarter. Currency translation and copper prices had a negative impact of $7.5 million dollars. After adjusting for these factors and changes in channel inventory, revenues decreased 18% organically on a year-over-year basis. Within this segment, Industrial Automation revenues also declined 18% year-over-year after adjusting for changes in channel inventory levels. Not surprisingly, the declines were broad-based across our market verticals.

Revenues in our Cybersecurity business declined in the second quarter on a year-over-year basis, and were flat sequentially. More importantly, we secured a number of large strategic orders with new and existing customers. As a result, non-renewal bookings, our best leading indicator of revenues, increased 37% year-over-year overall and 70% in the Industrial vertical.

Industrial Solutions segment EBITDA margins were 11.9% in the quarter, compared to 18.4% in the year-ago period, primarily due to lower volumes.

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 and 5G and smart buildings.

Our Enterprise Solutions segment generated revenues of $203.4 million dollars during the quarter. A $6.9 million favorable impact from acquisitions was partially offset by a $3.7 million negative impact from currency translation and lower copper prices. After further adjusting for changes in channel inventory, revenues declined 13% organically on a year-over-year basis.

Revenues in Broadband and 5G increased 2% on an organic basis. Underlying demand was very robust, with orders increasing by 20% overall and 13% organically.

The global pandemic and the extreme stress on broadband networks is driving increasing investments in network infrastructure by our customers, supporting continued growth in our fiber optic and other outside-the-home products.

Further, our inside-the-home business is seeing strong demand for self-install kits as a result of social distancing and a reluctance to send technicians into consumers' homes. Revenues from self-install kits in the second quarter equaled the revenue generated for the full year 2019.

Revenues in the smart buildings market declined 21% on an organic basis excluding the reduction in channel inventory levels during the quarter.

Enterprise Solutions segment EBITDA margins were 10.9% in the quarter, compared to 14.5% in the prior year period, primarily due to lower volumes.

If you will please turn to Slide 9, I will begin with our balance sheet highlights.

Our cash and cash equivalents balance at the end of the second quarter was $393 million dollars compared to $294 million in the prior quarter and $295 million in the prior year period.

As Roel mentioned, early in the second quarter we proactively drew down $190 million under our $400 million revolving credit facility. This was done out of an abundance of caution during an exceedingly uncertain time.

We feel very comfortable with our current liquidity position, and as a result we repaid $100 million of the $190 million revolver draw late in the second quarter. We expect to repay the remaining $90 million later this year.

Working capital turns were 6.6 turns, compared to 6.8 turns in the prior quarter and 7.7 turns in the prior-year period.

Days sales outstanding of 65 days increased by 6 days sequentially and 8 days from the prior year.
Inventory turns were 4.5 turns, compared to 4.6 turns in the prior quarter and 5.2 turns in the prior year.

Our total debt principal at the end of the second quarter was $1.56 billion, compared to $1.40 billion in the first quarter. This reflects the additional $90 million in borrowing under the revolving credit facility and current foreign exchange rates.

Net leverage was 3.6 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 10. I will now discuss our debt maturities and covenants.

As a reminder, excluding the temporary revolver borrowing, 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 very comfortable with the quality of our balance sheet and our liquidity position at this point.

Please turn to Slide 11 for a few cash flow highlights.

Cash flow from operations in the second quarter was $39.9 million dollars, compared to $67.7 million in the prior year period.

Net capital expenditures were $19.8 million for the quarter, compared to $27.2 million in the prior-year period. The year-over-year difference is primarily related to project timing.

Free cash flow in the quarter was $20.1 million dollars, compared to $40.5 million in the prior-year period. We are encouraged by the positive free cash flow generation during a quarter of unprecedented global economic disruption.

On a trailing twelve months basis at the end of the second quarter 2020, free cash flow was $145.2 million dollars.

We implemented countermeasures to protect cash flows very early in this crisis, including upsizing our cost reduction program and other expense controls and working capital reductions. Following these actions and the positive free cash flow performance in the second quarter, we expect to remain solidly free cash flow positive for the full year 2020.

Before we open the call for Q&A, I'd like to make a few concluding remarks.

The COVID-19 pandemic continues to create significant economic uncertainty. Visibility into the eventual timing and magnitude of recovery in our global markets remains limited, making it difficult to accurately forecast near-term results. Given the wide range of potential outcomes, we are not providing specific revenue or EPS guidance for the third quarter or full year 2020 at this time.

That said, we are encouraged by our incoming order rates in July. Assuming no further material disruptions related to the global pandemic, our current expectation is that business conditions bottomed in the second quarter and we will see modest sequential improvement in the third and fourth quarters.
We look forward to resuming our normal guidance practices once visibility returns.

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