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Astec Industries, Inc.

Second Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Steve Anderson, *Senior Vice President of Administration and Investor Relations*

Barry Ruffalo, *President and Chief Executive Officer*

Becky Weyenberg, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Stanley Elliott, *Stifel.*

Brian Sponheimer, *Gabelli Equity Trust*

PRESENTATION

Operator

Good morning, my name is Dennis, and I will be your conference operator today. At this time, I would like to welcome everyone to the Astec Second Quarter 2022 Earnings Conference Call.

After the speakers' remarks, there will be a question-and-answer session.

I would now like to turn the conference over to Steve Anderson, Senior Vice President of Investor Relations. Please go ahead.

Steve Anderson

Thank you and welcome to the Astec second quarter 2022 earnings conference call.

Joining me on today's call are Barry Ruffalo, Chief Executive Officer, and Becky Weyenberg, Chief Financial Officer. In just a moment, I'll turn the call over to Barry to provide his comments and then Becky will summarize our financial results.

Before we begin, I'll remind you that our discussion this morning may contain forward-looking statements that relate to the future performance of the Company, and these statements are intended to qualify for the Safe Harbor liability established by the Private Securities Litigation Reform Act. Any such statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions. Factors that could influence our results are highlighted in today's financial news release, and others are contained in our filings with the SEC. As usual, we ask that you familiarize yourself with those factors.

In an effort to provide investors with additional information regarding the Company's results, the Company refers to various U.S. GAAP, which are generally accepted accounting principles, and non-GAAP financial measures, which management believes provides useful information to investors. These non-GAAP financial measures have no standardized meaning prescribed by U.S. GAAP, and therefore are unlikely to be comparable to the calculation of similar measures for other companies.

Management of the Company does not intend these items to be considered in isolation or as a substitute for belated GAAP measures. Management of the Company uses both GAAP and non-GAAP financial measures to establish internal budgets and targets, and to evaluate the Company's financial performance against such budgets and targets. A reconciliation of GAAP to non-GAAP results are included in our news release and the appendix of our slide deck.

All related earnings materials are posted on our website at www.astecindustries.com, including our presentations, which is under the Investor Relations, Presentations tabs.

Now, I will turn the call over to Barry.

Barry Ruffalo

Thank you, Steve. Good morning everyone and thank you for joining us.

I will begin with a brief overview of the quarter followed by highlights of progress made on our continued strategic evolution and key messages from the quarter. I will then share what we are seeing in terms of demand and current market dynamics. Then Becky will share details on our financial results and capital deployment, and we will then open the call for Q&A.

We are a well-diversified industrial company as shown on Slide 4 with two segments providing valued equipment, parts, and digital solutions to our customers in Infrastructure and Materials markets. As a leader in our space, we have significant coverage across the rock to road value chain, allowing us to provide a wide range of our customers' needs.

I began with a brief overview of our business because I believe it is a helpful backdrop to understand the strong demand we are seeing as described in our key messages on Slide 5.

Second quarter revenue grew nearly 15% year-over-year with strong growth across both of our segments as robust end market demand for our products and services continued. Customer sentiment and economic drivers in the markets we serve generally remained positive. Strong market demand has resulted in record backlog positions.

Despite strong sales, I'm disappointed we are not able to deliver better profitability. Second quarter financial results were negatively impacted by several factors that reduced our margins. Among them were continued inflation and manufacturing inefficiencies associated with industrywide supply chain and logistics constraints and the temporary absorption of expenses in order to support customer needs.

Based on our demand outlook for the rest of 2022 and into 2023, we believe the long-term benefit of taking care of our customers outweighs these short-term costs, and we are confident the investments we are making will generate a positive return. We continue to make progress in battling supply chain challenges but the fight continues. At the point when macro headwinds normalize, our actions to align costs with revenue and employ our OneASTEC operating model will ensure we are truly adding value to our shareholders.

Despite financial results that were below our expectations, we maintained a strong balance sheet that remains able to support our growth initiatives and facilitate investments in operational excellence. In addition, our balance sheet can support our business in times of potential economic recession.

Given market demand, a strong balance sheet, and a company united around OneASTEC operating model, it positions our business to pursue profitable growth to drive long-term stakeholder value, guided by our Simplify, Focus, and Grow strategy. This focus provides a stable framework to address the near-term macro-driven headwinds we continue to face.

Turning to Slide 6, I would like to review current business dynamics and how Astec is responding. In response to industry-wide strong demand, we are implementing strategic actions to expand capacity and increase throughput. One action is capital investment. This quarter, Capex is $7 million, bringing our total year-to-date Capex to $19 million.

As a reminder, the Full Year 2021 capital spend was $20 million. The incremental spend in 2022 is driven by automation and additional cost-efficient capacity. In addition to capital investments, we are successfully hiring and training employees to position our workforce for higher levels of production. Unfortunately, this is creating a near-term headwind as we work through supply chain challenges.

We believe, however, these will pay off longer term as we deliver solutions to our customers. It's worth noting that today’s strong demand environment is not fully impacted by the Federal Highway Bill, and we are not relying solely on this for our optimistic outlook. We do believe this will be an added benefit and currently expected to begin seeing demand for funded projects beginning in 2023.

Disruptions in supply chain logistics continue to be a source of focus for us as we were impacted during the second quarter. Our OneASTEC operating model and focus on operational excellence are helping us mitigate these challenges. We expect cost inflation to impact commodity purchase logistics expenses for the rest of 2022. Our focus on pricing is better positioning us to offset inflation, and we are successfully leveraging our pricing power to pass through higher costs and capture value we offer to customers. We expect to unrealize (phon) price in the backlog to be recognized in the second half of the year.

I would also like to note, we continue to execute our strategy to Simplify, Focus, and Grow, that was initiated in 2019. The Company is transitioning from a decentralized business model to a OneASTEC approach where systems and processes are consistent across the Company. This approach leverages the scale of the Company, better meets the needs of our customers, and creates better career opportunities for our employees.

The Company has invested to build capabilities in product management, engineering and operations, and sales while maintaining resources in the business to ensure continued focus and support to serve our customers. You can see our growing and record backlog on Slide 7. This is a true testament to the strength of our end markets and our customers’ desire for our solutions. However, it is also a challenge in that we want to ensure our customers are satisfied, which means we are striving to convert these orders into deliveries.

I've already spoken about a number of these initiatives, including Capex investments for facility expansion and automation, and additional headcount. We're also beefing up our manufacturing and engineering group to allocate project management skills to help ensure we are effectively and efficiently solving the most pressing needs. In addition, cross-site manufacturing better utilizes our capacity.

The OneASTEC business model shown on Slide 8 is the guiding framework for our Company and it enables us to better address industry headwinds. This helps focus our efforts and unites us with our core values. Though challenges are present, I'm confident the OneASTEC business model is the key to moving forward and instilling a true performance culture. Building on the model, we follow our SFG's growth strategy on Slide 9. Simplify the business, Focus on excellence in everything that we do, and

Grow across the rock to road value chain. This is an ongoing process for us and we are always striving to improve.

I'm proud of the progress we have made and I'm confident that the strategy is the right one for us. By staying focused on critical objectives and effectively managing these things within our control, I'm confident we are heading in the right direction and I remain optimistic that 2022 will be a positive year for Astec, our customers, and our shareholders.

With that, I will now turn the call over to Becky to discuss our detailed financial results.

Becky Weyenberg

Thank you, Barry and good morning everyone.

As shown on Slide 11, sales increased to $318.2 million in the second quarter, up 14.6% compared to the same period as last year. Equipment and parts sales increased 18.5% and 9.1% respectively. A 23.3% increase in domestic sales was partially offset by an 8.4% decline in international sales.

As Barry mentioned, demand remained strong and we maintained record backlog, increasing 92% from the second quarter of 2021 to $837.4 million. Backlog increased in both segments with Infrastructure Solutions surging 161% and Materials Solutions growing 22.5%. Activity remains robust globally with our commercial teams connecting with customers and matching their needs with our solutions.

Second quarter Adjusted EBITDA decreased 36.5% to $13.2 million compared to the prior-year period. Adjusted EBITDA margin decreased to 4.1% as cost inflation more than offset volume, pricing, and mix this quarter, inclusive of $2.7 million unfavorable foreign exchange. We do expect this to improve in the second half of the year as previously price backlog continues to work through the system and pricing actions are realized.

Adjusted SG&A expenses decreased 1.3%, driven primarily by leveraging solid top line growth and controlling expenses. Adjusted earnings per share was $0.19, down $0.27 from the second quarter of 2021, and excludes $10.6 million or $0.47 of transformation, restructuring, and other costs, including $6.4 million of costs associated with our ongoing Simplify, Focus, and Grow transformation program. Our adjusted net effective tax rate for the quarter was 27.1% due to the mix of international income relative to domestic income.

Moving on to Slide 12. Infrastructure Solutions sales increased 16.6% to $209.6 million in the quarter, primarily due to favorable net volume, pricing, and mix. Domestic sales were up 26.8% while international sales fell 13.6%. Equipment sales were up 20% and parts sales grew 11%. Segment gross profit was essentially flat at $38.4 million and gross margin decreased 330 basis points to 18.3%, driven by the negative impact of inflation, supply chain, and logistics challenges, and manufacturing efficiencies. The Infrastructure Solutions backlog at the end of the quarter increased 161% to $568.3 million as we continued to see strong and increasing demand for highway and road building construction products globally.

Turning to Slide 13. Our Materials Solutions sales increased 9.8% to $107.4 million compared to the same period a year ago, driven by increased domestic demand and favorable net volume, pricing, and mix. Equipment sales grew 14.4% and parts sales were up 5.8%. Domestic sales were up 16.2%, while international sales fell 4.2% versus the second quarter of 2021. Segment gross profit decreased 19.8% to $21.9 million, and gross margin decreased 750 basis points to 20.4% due to the combination of a strong comparison in Q2 of 2021, cost inflation, and manufacturing inefficiencies. Materials Solutions backlog at the end of the quarter increased 22.5% to $267.5 million, driven by a strong demand environment.

On Slide 14, we highlight the key drivers of our year-over-year Adjusted EBITDA decline to $13.2 million from $20.8 million. The negative impact from inflation offset positive contribution from volume, pricing, and mix. You can also see the impact for manufacturing efficiencies and higher SG&A. SG&A, excluding research and development cost, was higher in dollars. It declined as a percentage of sales from 16.5% in Q2 '21 to 14.6% in Q2 '22. We expect further leverage in SG&A as sales continue to grow. We also expect our price-to-cost position to improve as we move forward. The steps we're taking to improve profitability should begin to reap benefits in the second half of 2022.

Turning to Slide 15, our cash position was lower as we are investing in growth, including an increase in working capital. Our balance sheet, however, remained solid and we expect cash position to improve during the balance of 2022. We have available liquidity of $195.4 million and essentially no debt at the end of the quarter, enabling us to withstand a variety of economic situations. Should we need to incur higher debt levels in the future, we will strive to operate between 1.5 times to 2.5 times net debt to EBITDA.

Slide 16 highlights our disciplined capital deployment framework. We are following a targeted capital deployment approach within the context of our long-term strategic objectives to maximize shareholder value. This includes identifying internal investments that meet our 14% return on invested capital hurdle rate, complemented by a strategic approach to acquisitions that align with growth, objectives, and financial criteria.

In addition to capital expenditures of $40 million to $50 million for the year, we are focused on the ERP implementation with an estimated $25 million to $30 million of spend in 2022. This will replace much of our existing disparate core systems, allowing for standardized processes and integrated technology solutions that enable us to better leverage automation and process efficiency.

We believe that, given our long-term growth prospects, that the year-to-date downturn in our stock price implies a discounted valuation of our real worth and therefore, we remain committed to delivering returns to shareholders through funding our $0.12 per share quarterly dividend and conducting opportunistic share repurchases, subject to market conditions, under the 2018 authorization of which $126 million remains available.

With that, I will now turn it back over to Barry for his closing comments.

Barry Ruffalo

Thank you, Becky.

We remain committed to achieving our long-term goals as shown on Slide 17. This builds on Becky's last slide. It's a disciplined approach to investing our capital as a key driver to achieving these goals. In addition, we must remain focused on operational excellence in the OneASTEC operating model to drive consistent and sustainable profitability across the organization.

Finally on Slide 18, you can see a summary of our key investment highlights that begins with our leadership positions within attractive markets that are aligned with secular growth trends, enabled by innovation, high quality products, and a superior customer service.

Our established position in the market and the global installed base drives a predictable and recurring revenue stream for high margin aftermarket business. Our strong balance sheet enables us to withstand macro challenges and further create shareholder value. All of this supports our team's progress towards our Simplify, Focus, Grow strategy, which leads to profitable growth.

In closing, we serve strong markets with solutions our customers want. Their sentiment has been positive, leading to strong order flow, and record backlog. We continue to invest in our business. At the same time supply chain challenges have been a headwind this quarter. We believe positive results will be generated as we deploy operational excellence through our OneASTEC operating model and further realize pricing actions taken to offset the impact of inflation. I'm confident we will be able to achieve our long-term targets and build sustainable long-term shareholder value.

With that, Operator, we are now ready to open the call for any questions.

Operator

Your first question is from the line of Stanley Elliott with Stifel. Please go ahead.

Stanley Elliott

Hey, good morning everyone. Thank you guys for taking the question.

Can we start off on the margin side? With 4Q we had the margin miss, and it felt a little bit like there were some of the—getting manufacturing and labor up to speed in addition to the inflation seemed to have kind of right sided itself in the first quarter and then kind of we're back here again in the second quarter. Maybe talk I guess to start off, what happened sequentially from the first quarter to the second quarter? I know it's seasonally a bit of a weaker quarter, but I would love to hear kind of what drove the downside on the margins.

Barry Ruffalo

Hey, good morning, Stanley. This is Barry. Yes, good question. Thank you.

I think that when we look at the sequential progress we've made from Q1 to Q2, obviously we did see inflation spike up a little bit higher in Q2 versus Q1. The good news there is that we were able to offset pretty much the spike in inflation with pricing. From our pricing volume mix to inflation ratio, we were able to maintain that. The manufacturing variances, we've had supply chain issues, that actually drove more manufacturing inefficiencies in the quarter.

As I said before, when you think about the supply chain, I would say generally the supply chain has shown some improvement for us, but the things that we're left with, Stanley, are very complicated. There are things that our supplier can't get rectified on their side. Therefore, the things that we're driving to improve that with them sometimes includes re-engineering of different components or trying to test other brands and configurations in order to put on our equipment, so it takes us a little bit longer and a little bit more work to actually get those things in place. I think that when we look at the quarter-over-quarter, those are the things that are really different.

I would just also remind you that in Q4, the thing that really drove the Q4 performance was really COVID. We saw a huge spike in COVID cases which ultimately impacted our labor in Q4. The things that were dealt with in Q4, really to Q2 are different in that COVID was not really impacting our labor but the supply chain and some of that inflation is really what's driven this.

Not alone, as we've called out the currency fees, which is also a thing that we've dealt with now in Q2, which in the past has been more of a good guy for us, as we went through 2021. So that's it. It's a little bit in the quarter as well.

Stanley Elliott

Yes, and probably for the rest of the year too would be my guess.

Drill down to the segments, so looking at kind of the differences with the Material Solutions business down, let's call it 800 basis points, with that having more of a distribution kind of bend versus the infrastructure side, has something changed there? I understand you have a lot of retail orders and you can't really move price, but you were certainly under the impression that you had a little more flexibility to push price and that you wouldn't necessarily see a margin delta of that, and would expect it to have been a little more stable quarter to quarter.

Barry Ruffalo

Yes. Thank you, Stanley.

I'd point out that Q2 of 2021 was a really great quarter for the Material Solutions business. As you pointed out, we did see that gross margin drop. When I think about that, there's elements of pricing and inflation or inflation to go with that. In the manufacturing variances, an area that also due to the supply chain issues that have impacted us in that part of the group. As much as we've seen the Company, our absorption, actually improve Q4 to Q1 to Q2, that still is a driver for us in the business. We have had a lot of success in pricing. We've taken recent pricing actions within that part of our business.

I think that we've shown good pricing power in our Materials Solutions segment, and as you've mentioned, Stanley, that's where we have the best ability because mostly in the IPS side of the business, the infrastructure business, it's really a lot of direct order. So there we're dealing directly with the customers and that becomes a little bit harder. Obviously, with the dealer organization with Materials Solutions, some of those orders are stocked and they stock the orders for sure. We've been working with our dealers to continue to take prices up.

Stanley Elliott

Then lastly, Barry, you mentioned some unrealized price in the backlog in the second half and some benefits you'd expect to see. How should we think about the second half of the year versus the first half, either price-cost or absolute pricing? Anything there that could help us.

Barry Ruffalo

Yes. Thanks, Stanley.

As we talked about in Q1 as well and as mentioned in our opening, we see that the price-cost situation will continue to improve as we go through the rest of the year, and that's still where we stand today. From Q1 to Q2, we stick with that statement that we'll continue to see that. As we go through the rest of the year, we should see that parity continue to stay where it is and improve across Q3 and Q4.

Stanley Elliott

Perfect. I'll turn it over. Thanks, guys. Best of luck.

Operator

Your next question is from the line of Brian Sponheimer with Gabelli. Please go ahead.

Brian Sponheimer

Good morning, Barry. How are you?

Barry Ruffalo

I'm good, Brian. How are you?

Brian Sponheimer

I'm good.

I want to talk a little bit further down the road. You mentioned some revenue coming in 2023 from the Federal Highway Bill. I'm just curious what those conversations are like with your customer base, given maybe some of the volatility that they're seeing as far as just within their own businesses and what from a project standpoint is more concrete that you're going to be able to within 12 months see your equipment being put into play for?

Barry Ruffalo

Yes. Hi, Brian, thanks for the question.

I've spent a lot of time here in the last months with customers, and most of our customers have a backlog today that takes them at least a year out and many of them more than a year out. They are dealing with margin pressures, just like everyone else is, and that's impacted them in different ways. Where they have projects in states where there's indexed bidding, that they're able to maintain their margins in some states, where there's not, they've actually taken a margin hit as they've gone through their cycle.

Generally, though, I would tell you, Brian, that the customer sentiment is still very positive. They see work being bid and let, and as we talked about, we really haven't seen any money really flow from the Infrastructure Bill yet, and we also know that when that's passed, it's typically about 18 months before we start to see work naturally flow. We're still within that timeframe in regards to where we would naturally expect a little bit of a pause before some of that starts to flow to the market.

Generally, I would say, Brian, that our customers really across the board, whether that's in different parts of the United States or really globally, are generally very positive. Obviously, in the European region, it's a little bit of concern but that's really a small part historically of our revenue stream, Brian, so we don't necessarily see those types of impacts having an adjustment on our performance as we move forward in time.

Brian Sponheimer

I appreciate that color.

I'm also curious as to the permitting and start to finish timeframe that—is it truly easier with this Federal Highway Bill to actually get a project with shovels in the ground and moving along?

Barry Ruffalo

Yes, good question.

I know as you probably read as well, Brian, the federal government is working on permitting and regulations to try and allow these types of projects to become more shovel ready looking forward, but I would say in today's environment, it hasn't really changed very much from our customers historically realized. I would say that's not really had any type of impact yet on our customers' ability to perform work.

Brian Sponheimer

Okay. I appreciate the color and best wishes for a successful back end.

Barry Ruffalo

Thank you, Brian.

Operator

At this time, there are no further questions. I will now turn the call back to Steve Anderson for any closing remarks.

Steve Anderson

All right. Thank you, Dennis. Again, we appreciate your participation in this conference call, and thank you for your interest in Astec.

As today's news release indicates, today's conference call has been recorded. A replay of this conference call will be available through August 17, 2022, and an archived webcast will be available for 90 days. The transcript will be available under the Investor Relations section of the Astec Industries' website within the next seven days. All of this information is contained in the news release distributed earlier this morning.

This concludes our call but I'm happy to connect if you have additional questions. Thank you all. Have a good day.

Operator

This does conclude the Astec second quarter 2022 earnings conference call. Thank you all for participating. You may now disconnect.