THOMSON REUTERS

EDITED TRANSCRIPT

Q2 2018 NCI Building Systems Inc Earnings Call

EVENT DATE/TIME: JUNE 06, 2018 / 1:00PM GMT

CORPORATE PARTICIPANTS

Donald R. Riley *NCI Building Systems, Inc. - President, CEO & Director*
K. Darcey Matthews *NCI Building Systems, Inc. - VP of IR*
Mark E. Johnson *NCI Building Systems, Inc. - Executive VP, CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

Brent Edward Thielman *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*
Lee M. Jagoda *CJS Securities, Inc. - Senior MD & Analyst*
Matthew Adrien Bouley *Barclays Bank PLC, Research Division - VP*
Reuben Garner *Seaport Global Securities LLC, Research Division - Associate Analyst*
Scott Evan Schrier *Citigroup Inc, Research Division - Senior Associate*

PRESENTATION

Operator

Greetings, and welcome to the NCI Building Systems' Second Quarter Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It's now my pleasure to introduce your host, Darcey Matthews, Vice President of Investor Relations for NCI Building Systems. Thank you, Ms. Matthews. You may begin.

K. Darcey Matthews ***NCI Building Systems, Inc. - VP of IR***

Good morning, and thank you for your interest in NCI Building Systems. Joining me today for the call are Don Riley, our CEO; and Mark Johnson, our CFO.

Please be reminded that comments regarding the company's results and projections may include forward-looking statements that are subject to risks and uncertainties. These risks are described in detail in the company's SEC filings, earnings release and supplemental slide presentation. The company's actual results may differ materially from the anticipated performance or results expressed or implied by these forward-looking statements.

In addition, management will refer to certain non-GAAP financial measures. You will find a reconciliation of these non-GAAP financial measures and other related information in the earnings release and our supplemental presentation located on our website.

Our second quarter 2018 earnings were released last night. A copy of both the release and our supporting supplemental presentation can be found in the Investors section of our website.

This morning, Don will make a few comments about the quarter and some of our initiatives and then turn the call over to Mark for more specific financial commentary before we open up the call for your questions.

And now I'd like to turn the call over to Don.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

Thanks, Darcey. Good morning, everyone. Thank you for joining us today to review our 2018 second quarter results. I am proud of the NCI team and our customers' performance in Q2. It is through their efforts in support we achieved solid results in a period of macroeconomic headwinds. Year-over-year for Q2, NCI revenues and adjusted EBITDA were up 9% and 7%, respectively, and adjusted earnings per share were up 56%.

We successfully increased pricing to offset the recent inflation in material and labor costs. We had gross margin percent expansion in our Buildings and Components businesses versus prior year and, sequentially, for NCI as a whole, and our total backlog was up 11%, reaching historic levels. This solid performance has positioned us well for Q3.

As we stated last quarter, we expect low-rise nonresidential construction starts will continue to grow mid-single digits with the addressable markets for our legacy businesses growing 2% to 4%. IMP, based upon increasing market penetration, should continue to grow at low double-digit rates. Our current backlog and incoming order rates for Buildings and IMP continues to support these base assumptions.

In the second quarter, the NCI team maintained a strong focus on managing costs, driving operating efficiency and ensuring commercial discipline. Based upon these areas of focus, we were able to successfully manage through this period of expanding inflation. We are currently expecting a strong third quarter, and as anticipated, some of the strengths will be due to portions of work advancing into Q3 from Q4 with customers trying to get ahead of inflationary prices.

As noted on our Q1 call and as demonstrated in our Q2 performance, we have dealt with these periods of rising inflationary costs before and are confident in our ability to manage through them. We anticipate that this may create a less pronounced seasonal step-up between the third and fourth quarter. But when evaluated as first half, second half, we continue to have the view that 2018 will be a meaningfully better year than 2017 for NCI.

As we have discussed, the 3 key areas of our long-term strategy are, first, the implementation of advanced manufacturing, where investments in automation and process innovation will further drive down our operating costs, improve margins, quality and service and enhance our long-term operational flexibility.

A key element of this initiative is the implementation of an automated frame line for the Buildings business. The frame line is in place and operational per our plan and will be fully up to speed by the end of Q3. We gave our board a tour of the line last month, and the board and the entire NCI team are excited about the potential this project holds for us. This has been our largest investment to date in automation, and I'm pleased that the team has accomplished this key initiative on time and ahead of schedule. It will greatly add to the company's flexibility in terms of scaling up for peak seasons.

Second, we're making strides with our continuous improvement initiative, where we're taking advantage of the great work that has been done in manufacturing to deliver cost reductions with Lean and Six Sigma initiatives across our entire business. We continue to be ahead of our implementation plans for 2018, having trained over 350 employees in Lean and Six Sigma principles and are working on tripling the number of continuous improvement projects compared to 2017. I am proud of the commitment the NCI team has made to these efforts and is also positive to see the results showing up on our ESG&A numbers and product line gross margins.

Third, NCI solutions, our growth strategy around insulated metal panels and our ability to drive adjacent products across our legacy distribution channels, is progressing in line with our expectations. IMP grew 10% year-over-year in Q2, where the prior year was an incredibly strong quarter with an unusually high architectural mix. For Q2, IMP represented 33% of NCI's consolidated EBITDA.

As we've noted, the impact of these 3 elements by 2020 will be $40 million to $50 million, yielding margin and EBITDA expansion and a reduction in our overall ESG&A. We continue to remain confident in these ranges and have direct line of sight for hitting these targets. The team is focused on these 3 critical areas, and I believe there are more opportunities for further cost reductions and operational efficiencies at NCI as we increase our competencies in advanced manufacturing and continuous improvement.

Our overriding objective remains: establish a business platform that enables NCI to outperform our addressable market within the low-rise nonresidential market while allowing expansion of our operating margins. We enter the second half of 2018 positioned well with a focus on commercial discipline and operational excellence while staying true to our long-term growth strategies around IMP, stores and product adjacencies. We're confident 2018 will be a better year than 2017. We finished half one strong with EBITDA 15% ahead of prior year and on our way to a positive start for half 2 with our backlog up 11%.

I want to close again with a thank you to the NCI team and our customers, and I look forward to answering your questions at the end of the call. I will now turn the call over to Mark to comment on our second quarter financial results and third quarter guidance.

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Thank you, Don. As in past earnings announcements, we have provided both a press release discussing our results and additional analysis in the supplemental information posted on our website. I'll therefore streamline my comments to add some additional color on our financial results for the quarter.

Our consolidated revenues were up 8.7% year-over-year as a result of gains in both pricing and volume. Commercial discipline was the foremost driver behind our improvement this quarter as we achieved broad-based pricing increases in all 4 of our business segments. In fact, of the $37 million year-over-year increase in our revenues, roughly $27 million of the increase was attributable to the successful management of higher raw material costs, which positively impacted both our revenues and gross profits.

We have been able to proactively stay ahead in the midst of an inflationary environment in which we've seen many of our input costs rise. These include not only raw material costs, such as steel, chemicals and paint, but also transportation costs and labor costs. We have more work to do with transportation costs in the IMP business and are focused on continuing to drive commercial discipline as certain costs continue to rise in the second half of 2018.

In terms of volume growth, external gains primarily came from the Components and IMP segments, which [continued] in Q1. In the Components business, volume gains were achieved across most commercial products and were particularly strong in overhead roll-up doors. While insulated metal panel volumes saw solid gains, product mix was less favorable than a year ago as cold storage and commercial and industrial sales made up a larger proportion relative to the higher-margin architectural products. In contrast, last year's second quarter had an unusually large proportion of architectural panel sales, which made for difficult comparison at the margin line this quarter.

Gross margins at 22.8% were just above the midpoint of our guidance and increased 100 basis points sequentially. Nevertheless, we are comping to an unusually strong margin period in the second quarter of 2017 and, as expected, saw a year-over-year gross margin decline. The decline is reconciled in our supplemental information and relates to the product mix shift within IMP combined with lower manufacturing utilization in Buildings and Components -- sorry, Buildings and Coaters and higher transportation costs in IMP.

Looking at our adjusted operating margins. We saw roughly 40 basis points of improvement over last year's second quarter. The increase in our operating margins were mostly driven by controlling and leveraging our ESG&A costs, which has been a focus in our cost reduction efforts.

Before turning to our outlook, I'll comment on our cash flow and working capital. During the second quarter, we generated nearly $47 million in cash flow from operations with just under $9 million of CapEx spend. On a year-to-date basis, our operating cash flow grew from less than $8 million last year to nearly $40 million this year. This improvement was achieved despite the inflation and material costs due to better year-over-year working capital metrics and lower tax and interest rates. As we stated during our first quarter call, we anticipate generating meaningful operating cash flow enhanced by lower interest costs and lower effective tax rates for fiscal 2018.

Turning now to our outlook. Consolidated backlog is up 10.8% year-over-year to $632 million. Based on key leading indicators and incoming order rates across our businesses, we continue to expect our combined Buildings and Components businesses to track in the range of 2% to 4% volume growth for the addressable portion of low-rise starts for fiscal 2018. And for our IMP product line, we expect revenue to continue to grow at low double-digit rates, thanks to greater market penetration and our ability to accelerate sales of these products through our buildings and components channels.

We continue to anticipate net capital expenditures in the range of $45 million to $55 million for the year to be funded from operating cash flow. Of this amount, almost half represents growth or productivity investments. We expect to see the usual seasonal pattern of stronger construction activity in the second half, driving volume, plant utilization and earnings during that period.

The rising cost environment is motivating certain customers to take delivery as soon as possible to avoid further price increases when available. This is true during the second quarter, and we expect it will continue in the third quarter, which, depending on pricing activity, may result in a less pronounced step-up in activity levels from the third quarter to the fourth.

With these considerations in mind, we currently estimate consolidated revenue for the third quarter will range between $525 million and $545 million with adjusted EBITDA ranging between $56 million and $66 million. As a reminder, we have provided additional guidance for the third quarter in the supplemental presentation posted on our website.

And now we'll open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Lee Jagoda with CJS Securities.

Lee M. Jagoda ***CJS Securities, Inc. - Senior MD & Analyst***

So just focused on the leading indicators that have been kind of forecasting this low single-digit, low-rise nonres gain for some time. The Buildings volume has been declining on a third-party basis for you for the last several quarters. And is there some mix issue or some other thing that's causing the volumes in Buildings to be lower than what the leading indicators would suggest?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Thanks, Lee, for the question. The Buildings group is very, very focused more, I would say, than they ever have of being a leader in the pricing environment as raw material costs have been increasing so dramatically. Normally, at this time in a cycle like this, while for the whole company we may get ahead of cost increases, the Buildings group may be lagging. They're actually ahead along with our other divisions during this period. So very aggressive pricing and favoring project profitability over volume. And the other comment I would add is that in the second quarter of last year, we had very, very strong volume growth in the Buildings segment. We had over 13% volume growth year-over-year, and so you're comping against a much stronger volume period with strong growth in it.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

And I would echo Mark's comments around the commercial discipline as well as we're really pleased with where the backlog is for Buildings right now and the quality of that backlog.

Lee M. Jagoda ***CJS Securities, Inc. - Senior MD & Analyst***

Perfect. And then just as a follow-up, the IMP backlog within Engineered Building products was up 21% year-over-year. Can you comment on how far that backlog looks out and the mix of that backlog in terms of high value versus low value compared to what you shipped this quarter?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Yes. So I would say that it's very representative of the product that we shipped this quarter. Products that go to the Buildings group tend to be in that midrange ICI type of product. Very satisfied with the margins on that product, and the time line for those typically will ship anywhere in the 90- to 120-day range.

Operator

Our next question is from Matt McCall with Seaport Global Securities.

Reuben Garner ***Seaport Global Securities LLC, Research Division - Associate Analyst***

It's actually Reuben on for Matt. You guys mentioned some pull-forward in the Q3 guide. Can you quantify how much and maybe which of the segments we'd expect to see near-term boosts from?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Yes. It's really difficult to quantify that. It's just a behavioral element of what occurs when you see rapid price increases like this. We've seen similar events in the past. If you go back to the fourth quarter of 2016, there was a somewhat similar environment, maybe not quite as dramatic, but you saw a much flatter seasonality between Q3 and Q4.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

And it would be across -- especially the single skin and Buildings businesses. And then you would also see some within IMP, but probably not quite as much.

Reuben Garner ***Seaport Global Securities LLC, Research Division - Associate Analyst***

Okay. And then maybe following up on the last questions. The Buildings backlog growth of 14%, that's -- the last several quarters, it's been tracking well above revenue growth. And you mentioned you like the -- I think you said the visibility that the backlog provides. Can you talk about the differences between the backlog growth we've seen over the last year and the revenue growth? And what gives you confidence that maybe you'll see an acceleration in the Buildings segment moving into the back half and into next year?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Yes. The backlog has been going at a faster rate than revenue for somewhat, I don't know, last several quarters, and what that relates to is the types of projects that are incoming and the amount of site work that needs to get done before those projects are ready to be delivered. And so we've seen a predominance of that type of project coming into the backlog right up until this most recent quarter. And then in the most recent quarter, we saw a reversal of that to where projects that are ready for immediate or fairly rapid delivery are the predominant items in the Buildings backlog now.

Reuben Garner ***Seaport Global Securities LLC, Research Division - Associate Analyst***

Okay. And then if I could sneak one more in. Can -- did -- can you quantify the volume versus the price breakdown in your backlog, whether it's the Buildings or consolidated?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Sure. On a consolidated basis, there's not a precise measurement of the underlying volume, but approximately somewhere around 7% to 8% underlying volume growth.

Operator

Our next question is from Scott Schrier with Citigroup.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***

First, I -- Mark, I wanted to kind of clarify the comment about the less pronounced seasonal step-up from 3Q to 4Q. So just to be clear, you're still expecting a step-up from 4Q to 3 -- from 4Q versus 3Q.

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Generally speaking, we have almost always seen a step-up from the third quarter to the fourth quarter. The only period of time where that's not been the case is when the economy in general has been decelerating. So just based on that historical pattern, yes. But how pronounced it would be and how notable it would be, we'll be able to provide guidance on that when we're a little bit closer to it.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***

Okay. And based on some of your conversations with some of this pull-forward in demand trying to get in front of the steel costs, at this point, is there any potential for a slowdown in '19 because a lot of this has just all pushed into '18?

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

Yes. Right now, based on our leading indicators, we don't see a slowdown in '19. As you know, we have 90 to 180 days in Buildings and 6 to 9 months in IMP view. So our current indicators don't show a slowdown in the horizon we have visibility to.

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Yes. And that horizon he's referring to is our internal indicators. The external indicators we looked at give us more of a 9- to 14-month view, and those do not show a slowing indication either.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***

Great. So cash flow looks good. You improved your cap structure this quarter. Noticed that you had a little bit of an increase in some biz dev expenses in the quarter. So if you could talk about how you're thinking about acquisitions or potentially where some of those targets might be and what you're seeing in terms of seller expectations.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

Sure. So as we've consistently shared, our priorities for capital allocation have been our internal projects and initiatives where we see a high rate of return, and we have a history -- demonstrated history of delivering on the results associated with that. The prime example is the one I referenced today around advanced manufacturing, getting that line in place and operational. We then see as a second priority is the debt paydown and managing our debt to the ratios we anticipate. And then as I have shared, we see that there's an 18-month horizon where we are very strongly focused on our internal initiatives and the impact those are going to have, and we see being more aggressive after that 18-month horizon on looking at adjacencies, so other aspects associated with the envelope. And as we've also said, that doesn't mean that if there are opportunistic items that come into play in that period, we would absolutely look at those, assuming that they fit in the portfolio and are accretive for us.

Operator

(Operator Instructions) Our next question is from Brent Thielman with D. A. Davidson.

Brent Edward Thielman ***D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst***

Don, the comments on the Buildings segment and sort of focused on price over volume to some degree, has competition been slower to respond to the cost environment than you would've expected? And if that's the case, is that starting to change?

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

I think in the Buildings segment, I would say we've had a reasoned environment, especially amongst the top players. I would say if we've seen aggression, it's more in the smaller regional players. They're probably very dependent upon where their steel positions were, what inventory costs were and how they were managing through that. So I would say we are seeing general positive pricing discipline as the -- across the top of the big 3 players that have about 73% to 75% share and more competition at the lower level.

Brent Edward Thielman ***D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst***

Okay. And I know you're sort of reiterating the mid-single-digit growth, the low-rise. But is there anything you see out there or at least beginning to develop that might suggest that pace is accelerating?

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

I think the areas that we continue to see as high are mini storage. It continues to run very well for us. The other areas that are very strong for us is cold storage, and there is -- our food FDA regulations out there that are starting to come into play that people have to -- are getting to the end of the life cycle where they have to comply with. But then you also have the local fresh food phenomenon where you require local distribution in order to meet those food services, that same day delivery. So we see very strong growth on that front. We have seen very strong growth on the ICI front in that world and at the regional, some of the regional, smaller regional players, which we view is very positive. And the slower front continues to be the ag front for us.

Operator

Our next question is from Matthew Bouley with Barclays.

Matthew Adrien Bouley ***Barclays Bank PLC, Research Division - VP***

The Q3 guidance for gross margins, you're calling for effectively flat year-over-year, which is an improvement versus Q2. Can you break out, I guess, kind of what the pieces of that you have the most visibility into, whether that's kind of IMP mix or better manufacturing utilization? And then what factors maybe kind of less in your control? So I guess what are just the wildcards that could drive that margin to the upper or lower end of the range?

Mark E. Johnson ***NCI Building Systems, Inc. - Executive VP, CFO & Treasurer***

Great question. So the visibility we have into the fourth -- or, sorry, the third quarter really comes from what we can see in our backlog in the near-term schedules that we have. The phenomenon we saw in the IMP product mix was very pronounced in the second quarter. We still expect to see less favorable year-over-year mix in the products, based on what's in backlog right now relative to the insulated metal panel business. So that's a restraining impact on our margins. If you note, at the midpoint of our guidance, we're just below where prior year margins came in, and the primary driver for lower margins is that mix of business in the IMP world. We're -- we have additional cost increases that we're continuing to pass through in our price increases. We've taken into account how we price work going into the backlog. We expect to continue to be ahead of the material input costs in the third quarter and relatively excited about where we see margins going from here for the last half of the year.

Matthew Adrien Bouley ***Barclays Bank PLC, Research Division - VP***

Okay, got it. Second question, specifically in the Buildings segment. Strong year-over-year margin performance, improving sequentially. It sounds like you're attributing that to pricing and ESG&A, and correct me if I'm wrong there. But then -- I guess just how sustainable would you say is that type of margin improvement as we look to the second half of the year, again focusing on the things that are kind of in your control, particularly ESG&A?

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***

I would say at a macro level, we feel that we're positioned very well. As Mark has said, we've been able to pass on inflation and continue to expect to be able to do that. And we expect sequentially to have improvement quarter-to-quarter in our gross margins, and we expect to have sequential improvement in our ESG&A. And we attribute that not only to the commercial discipline, but also to the initiatives continuing to come into play across all the organization.

Operator

Ladies and gentlemen, there are no further questions. I would like to turn the conference back over to Darcey Matthews for closing comments.

K. Darcey Matthews ***NCI Building Systems, Inc. - VP of IR***

Sherry, thank you. On behalf of Don, Mark and I, we appreciate your interest in NCI, and we look forward to speaking with everyone soon. Have a nice day.

Operator

Ladies and gentlemen, thank you for your participation. This does conclude today's teleconference. You may disconnect your lines, and have a wonderful day.