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NCI Building Systems, Inc. (NCS)

Q2 2016 Earnings Call

CORPORATE PARTICIPANTS

K. Darcey Matthews
Vice President, Investor Relations

Norman C. Chambers
Chairman and Chief Executive Officer

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

OTHER PARTICIPANTS

Robert Wetenhall
RBC Capital Markets LLC

Michael G. Dahl
Credit Suisse Securities (USA) LLC (Broker)

Lee Jagoda
CJS Securities, Inc.

Steven Michael Fisher
UBS Securities LLC

Alex J. Rygiel
FBR Capital Markets & Co.

Brent Edward Thielman
D.A. Davidson & Co.

Scott Schrier
Citigroup Global Markets, Inc. (Broker)

Reuben Garner
BB&T Securities LLC

Drew Lipke
Stephens, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Greetings. Welcome to the NCI Building Systems' Second Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Darcey Matthews, Vice President of Investor Relations. Thank you, Ms. Matthews, you may now begin.

K. Darcey Matthews
Vice President, Investor Relations

Thank you, Rob. Good morning, and welcome to NCI Building Systems call to review the company's results for the second quarter of fiscal 2016. The company's second quarter results were issued last night in a press release that was covered by the financial media.

In keeping with SEC requirements, I'd like to advise that, during this call, we will be making forward-looking statements that involve risks and uncertainties. Actual outcomes may differ materially from those expected or implied. For a more detailed discussion of the risks and uncertainties that may affect NCI, please review our SEC filings including the 8-K that we filed last night. We undertake no obligations to update any forward-looking statements beyond what is required by applicable securities laws.

In addition, our discussions of operating performance will include non-GAAP financial measures. A reconciliation of these measures with the most direct comparable GAAP measures are included in the earnings release and the CFO commentary, both of which are available on our website.

At this time, I'd like to turn the call over to NCI's Chairman and Chief Executive Officer, Norm Chambers.

Norman C. Chambers

Chairman and Chief Executive Officer

Thanks, Darcey. Good morning, everyone. As you know, our second quarter earnings were released last night. I will provide a few brief comments before I turn the call to Mark, who will offer more details on our second quarter financial performance. After that, we'll be happy to take your questions.

So, I'll start by sharing with you key highlights from our second quarter. First, I'm pleased to report our value chain of commercial, manufacturing, and supply chain management delivered meaningful year-over-year improvement in gross profit margin and earnings in our second quarter. Gross profit margin expanded 290 basis points, and adjusted EBITDA increased over 60% year-over-year.

Because CENTRIA is now fully included in both our current year and prior year comparable quarter, our results more clearly demonstrate the continued year-over-year improvement in operating performance. Our teams did a very good job, managing steel cost volatility and quite extensive flooding in the Central U.S. The commercial team has ratcheted up our commercial pricing discipline as we face rapidly rising steel costs, something that we have dealt with successfully many times in our business, most notably in fiscal 2004, fiscal 2006, fiscal 2008, fiscal 2011.

Second, and not unlike the past several quarters, our performance was a result of our focused and integrated execution across our commercial, manufacturing and supply chain activities. As a result of our restructuring efforts and our organizational changes over the last 18 months, our supply chain management focus has enabled us to collect, analyze, take data-driven actions with better clarity and speed to enhance our commercial opportunities to improve margins.

Third, our year-over-year volume increased by 15.8%, far exceeded the 3.4% growth in revenue as lower year-over-year steel costs prevailed during the second quarter. While all three of our segments performed well relative to our internal expectations, our Components business was particularly strong due to increased demand for both our legacy single skin components and insulated metal panel products.

Likewise, the Coatings segment continues to benefit from the base loading of the coating plants with internal volume. Our Buildings segment also had strong year-over-year improvement in gross profit. We remain focused on taking advantage of our operating leverage created by volume increases that drive greater manufacturing capacity utilization. Manufacturing was a significant contributor to improve margins by lowering total manufacturing cost per ton by 6% on a quarterly year-over-year basis.

Last but not least, we continued to generate above market growth in insulated metal panels, IMP, in large part, we believe, driven by substitution from traditional building products resulting from strict energy code throughout much of North America. Demand for CENTRIA proprietary architectural form panel has led to good growth of this high-value product as a percentage of its bookings and backlog.

Additionally, external and internal intercompany demand from the large market segments, industrial, commercial and institution, which is called ICI, and cold storage, has driven 25% growth at Metl-Span's bookings, which has added nicely to its impressive backlog during the first half of fiscal 2016. We accomplished all of this against a background of uneven, but modestly strengthening growth in non-residential construction markets.

Our Buildings group's bookings in April and May have shown encouraging year-over-year improvement with high-single digit growth in April, followed by double-digit growth in May. We believe part of this increase likely resulted from a rising steel price cost and concerns about restricted steel supply.

Now, a word about the immediate future. The leading indicators that correlate most closely to actual volumes of low-rise new construction starts are the residential single family starts, ABI mixed-use index, and Leading Economic Indicator. Taken together, these indices continue to suggest a 4% to 6% growth for low-rise construction starts of fiscal 2016, with the majority of that growth occurring in the second half of our fiscal year and consistent with the slow growth economy.

In closing, our overriding objectives continue to be, one, take advantage of the market-leading positions in our legacy businesses, while accelerating the higher growth IMP through our multi-sales channels; and two, expand our gross margins through our internal initiatives around commercial discipline, manufacturing efficiencies and supply chain management.

Now, Mark will take you through the second quarter financials.

Mark E. Johnson

Chief Financial Officer, Treasurer & Executive VP

Thank you, Norm. As usual, we have provided a review of our 2016 second quarter financials in both the earnings press release issued yesterday and the CFO commentary posted on our website. I'll now take a few minutes to add some additional insight to those results.

Overall, the second quarter results came in at the top-end of our guidance ranges and slightly above consensus expectations. Our business segments are collectively benefiting from the past two years of improvement initiatives as well as our manufacturing and operational restructuring efforts.

The key drivers of our second quarter performance continue to be both volume growth and margin improvement. As Norm mentioned, our gross margin expanded by 290 basis points to 24%, which was at the upper end of our guidance range. Our improved margins point to the positive results of optimizing our manufacturing footprint and enhancing our supply chain management, while at the same time, remaining focused on our commercial discipline.

We have continued to refine our raw material sourcing strategies and practices, which is serving us well as we navigate through notable swings in cost for our primary raw material steel. We are purchasing steel with more precision and managing our inventory quite well. In addition, we have progressed our manufacturing reorganization plans, which we have previously said are expected to result in annual cost savings and in efficiency improvements of between $15 million and $20 million annually that will be phased in through the end of fiscal 2018.

Production and other logistic efficiency improvements resulted in an estimated 80-basis point improvement in our gross margin during the second quarter versus the prior year comparable period. As part of our plan, we also recognized a $900,000 gain on the divestiture of an idled manufacturing plant, which increased our gross margin by 25 basis points versus the prior year period. Partially offsetting these items, we also incurred costs and inefficiencies in ramping up our recently acquired Canadian insulated panel plant, as well as closing and relocating operations at another of our insulated panel facilities. These incremental costs associated with our manufacturing and restructuring reduced our gross margin during the period by an estimated 65 basis points.

Our adjusted EBITDA rose by 60.8% or about $9.6 million during the quarter from the same period last year. About $7 million of this increase was attributable to underlying volume growth and about $4 million resulted from margin expansion. Offsetting these positive items were approximately $2 million of costs and inefficiencies from the previously mentioned transitions in our insulated panel facilities.

Now, I'll turn to our operating results. In the 2016 second quarter, our consolidated revenues increased by approximately $12 million or 3.4%. The year-over-year revenue improvement was primarily driven by volume growth across all three business segments, but particularly strong growth in our Components and Coaters segments. Total external sales volumes measured in tons on a consolidated basis rose by a total of almost 16%, including a 16.4% increase in Components external volumes, a 26.3% increase in Coaters external volumes, and a 2.8% increase in Buildings external volumes.

Notably, the Components group not only saw increased demand for insulated panels, but also a strong demand across virtually all of our legacy metal component products. The Coaters group benefited from not only strong external demand, but also saw similar increases in internal volumes to support the Components and Buildings segments.

Our Buildings segment, which has historically seen more activity in industrial and manufacturing end markets than the other two segments, has experienced more subdued growth rates as a result of weaknesses in those end markets.

Despite these volume increases, lower steel prices also impacted our revenues during the quarter. As you probably know, steel prices have declined over 20% from the second quarter of last year. And the pass-through of these lower costs to our customers reduced our revenue by approximately $17 million to $20 million compared to last year's second quarter. Steel costs are now increasing steadily. And the negative impact on our revenues will lessen significantly in our third quarter and will likely not be a negative factor on our fourth quarter revenues.

ESG&A expenses increased slightly by approximately $1.6 million during the second quarter from the same period last year, primarily because of higher underlying volumes and incremental incentive compensation costs on higher earnings.

Overall, we remain pleased with the level of bookings and quoting activity across our three segments so far this year. And we've seen no discernible trend to change our expectations for moderate new non-residential growth for fiscal 2016. Our consolidated backlog stands at $533.4 million, which is up 5.7% versus the comparable period of the prior year and is up 11.6% sequentially.

Now, let's take a brief look at some items on our balance sheet. We ended the quarter with a cash balance of $77.9 million compared with $73.8 million at the end of the first quarter. Free cash flow for the second quarter, defined as adjusted EBITDA minus net CapEx and net changes in working capital, was approximately $31 million for the quarter compared with only $2 million in the year ago period.

During the second quarter, we paid down another $10 million of long-term debt, which takes us to $20 million repaid in the first half of 2016. And we continue to anticipate paying down a total of $40 million in fiscal 2016. Our net debt leverage ratio at the end of the second fiscal quarter was 2.3 times, so we are getting very close to the pre-CENTRIA acquisition level of 2.2 times. In addition, as previously reported, we spent $7.4 million during the second quarter as part of our stock repurchase plan.

Turning to our third quarter outlook, we continue to outperform the low-rise construction markets as reported by Dodge in terms of volume growth and have delivered material year-over-year improvements in both gross margin and adjusted EBITDA in the first two quarters of fiscal 2016.

More importantly, our ongoing restructuring and reorganization efforts over the past two years are beginning to contribute to our earnings growth. Over the remainder of this year, we will continue to further these initiatives and look for opportunities to trim costs, eliminate redundancies, identify synergies, and align our capabilities with our customers' needs.

In the third quarter, we estimate consolidated revenue will range between $435 million and $455 million with gross margins ranging between 23% and 25.5%. As per our normal seasonal cycle and consistent with past patterns, we expect our revenue and adjusted EBITDA in the second half of fiscal 2016 will exceed the first half. Further, as we have previously stated, we continue to expect that for the full year, fiscal 2016 will be a better year than 2015 in terms of both gross margin and adjusted EBITDA.

Finally, as a reminder, we have provided additional financial guidance for the third quarter in the CFO commentary posted on our website.

Now, operator, I will turn the call back over to you for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Thank you. Our first question is from Bob Wetenhall of RBC Capital Markets. Please proceed with your questions.

Robert Wetenhall
RBC Capital Markets LLC
Q

Hey. Good morning. Very nice quarter.

Norman C. Chambers
Chairman and Chief Executive Officer
A

Thank you, sir.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

Thank you.

Robert Wetenhall
RBC Capital Markets LLC
Q

Hey. Norm, I wanted to jump into insulated metal panels. I think IMP is probably a quarter of sales and more than 40% EBITDA. You've got a year essentially under your belt. So, it's clearly a big piece of the business. I wanted to ask, is the business lived up to your expectations in the past 12 months? And what are your expectations for revenue growth for IMP specifically during the balance of the year?

Norman C. Chambers
Chairman and Chief Executive Officer
A

So, I think that the opportunities that we have with insulated metal panels across our product offering that CENTRIA has on the high-end, and Metl-Span has in terms of the industrial, commercial and cold storage, is unprecedented. And we continue to see opportunities to improve our distribution through our network of builders, through our components, sales channels and, frankly, through the great customers that both CENTRIA and Metl-Span have. So, we really like what we have going on there, Bob. We like it even more. We've got a great leadership team in both companies. Manufacturing is doing very well. And our focus on maximizing the value we can bring to our customers by being disciplined about our sales channels is another kind of fundamental thing we're doing. So, we're really happy with the role it's playing in our growth and expect that to continue.

Robert Wetenhall
RBC Capital Markets LLC
Q

Any view on growth rate for that as well?

Norman C. Chambers
Chairman and Chief Executive Officer
A

I think it's going to continue to grow at a pace that's greater than the market. And that's largely driven by the substitution of products driven by energy codes. That's a great opportunity for us to expand our penetration into markets and replacing more traditional kinds of building products. And that's a great opportunity for us.

Robert Wetenhall
RBC Capital Markets LLC
Q

That's very exciting. I mean, it's a good tailwind. Mark, I was hoping on steel prices, if you could just spend a minute. It sounds like the headwind from steel prices declining is going to recede as you go into the back part of the year. Can you walk us through segment-by-segment how higher steel prices will impact revenue performance and segment profitability?

And also, just in conjunction, Norm spoken about a natural hedge, how should we think about revenues and margin performance in each segment, in concert with this natural hedge commentary in a rising steel price environment?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

Sure. Great question. The first and foremost thing to understand about our business, in particular, is that everything we sell, everything we make is made to order by a customer. So there is no manufactured product just sitting on our shelves and wait for a customer to buy it. The customer is determining the price point well before we ever start manufacturing it.

So, steel price changes, steel price volatility flows through very rapidly in our industry. And we have the advantage of having three separate business segments that all react differently as steel prices move. And those three reactions tend to fall 50% on one side of the equation and 50% on the other, where as rising steel prices – or as steel prices rise, we tend to be able to expand margins at some parts of our business. And as steel prices decline, we tend to see some challenges in other parts of our business. But on a consolidated basis, we tend to see a very consistent gross margin produced by the consolidated company. So, that is a unique advantage we have by the three integrated business segments that we have.

Robert Wetenhall
RBC Capital Markets LLC

Q

So, if prices rise, can you walk me through Coatings, Components and Buildings, what's going to happen in top line and what's the margin impact just so we can kind of get a more specific view as we go into 2H?

Norman C. Chambers
Chairman and Chief Executive Officer

A

So, the most important thing to take away from this is that our Coatings and Components group are able to, by the short sale cycle, to stay in stride with steel price increases. And they will largely be advantaged from steel price increases. The Buildings group will ultimately be advantaged, but there will be a period of compression of their margins because of the longer sale cycle that they have, okay? And that is a very normal occurrence. So, we would expect to see some pressure to the Buildings' growth in their margins in Q3 and Q4.

Robert Wetenhall
RBC Capital Markets LLC

Q

But you're going to get a tailwind on Coatings and Components that will offset the weakness you get in Buildings. Is that the right way to think about it from a margin standpoint?

Norman C. Chambers
Chairman and Chief Executive Officer

A

Yeah. [ph] So, consolidated (21:36), as Mark said, it really balances out.

Robert Wetenhall
RBC Capital Markets LLC

Q

Good. Well, congrats on terrific execution. You guys have made big progress in a pretty short amount of time, and I think you deserve to be recognized for that. And good luck with next quarter.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Well, thank you very much. I appreciate that.

Operator: Our next question is from the line of Mike Dahl with Credit Suisse. Please go ahead with your question.

Michael G. Dahl
Credit Suisse Securities (USA) LLC (Broker)

Q

Hi. Thanks for taking my questions. Norm, just wanted to start out with maybe a high-level question for you, because while you're still talking about it being a somewhat slow and uneven recovery, I think some of – first of all, the revenue growth this quarter or volume growth this quarter, the guide for the third quarter, and then some of the bookings numbers you gave for April and May, it does sound like there may be a bit of an upgrade in your expectations for end markets. Can you kind of – or is that the case? And can you walk us through kind of where the puts and takes have been relative to maybe earlier this year?

Norman C. Chambers
Chairman and Chief Executive Officer

A

Yeah. So I tried to [indiscernible] (22:44) in the press release to actually talk about that in terms of end markets that are showing growth and areas of the country that are showing growth on a year-over-year basis. And I think that, by virtue of choosing those, and not choosing others, you can kind of tell that that isn't the case in some other areas.

Certainly, when we think of the broad definition of manufacturing, that has clearly been slow in the last six months on a year-over-year basis, driven both by oil and gas and a number of other things that are going on. So, when we look at our shipments and our bookings, our industrial, commercial side are still the biggest part of our business, but manufacturing has been slower. That has been countered though by commercial, by healthcare, and by – I'll use a broader term kind of in the amusement, in entertainment areas. So, for instance, we do a lot of work in sports arenas from a community to an NFL team. And those have been very good to us.

So, again, as you know, we're very diversified. We don't have an end market that's greater than 5% of our sales, we don't have a customer that's 2% of our sales. So, that really is an advantage at times when we see certain places where there is – the headwind [ph] we've seen in (24:17) manufacturing.

Michael G. Dahl
Credit Suisse Securities (USA) LLC (Broker)
Q

Got it. That's helpful. And then, Mark, shifting gears, the progress around deleveraging has been pretty tremendous over the past year and you're back at that what's more of a comfort level around or just over 2 times. Can you just talk about, as you get past the $20 million of additional debt repayment this year, how you are thinking capital allocation?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

Sure, I would describe it as being very committed to the debt reduction plans that we've spoken to and continuing those and maintaining the right amount of flexibility and focus on returning value to all the stakeholders of the company and balancing that through all types of cycle, all types of periods. So, maintaining optionality, maintaining flexibility is really our current stand.

Michael G. Dahl
Credit Suisse Securities (USA) LLC (Broker)
Q

Okay. And any thoughts specifically relating to executing on the remaining buyback?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

That's something that's definitely been approved by our board of directors and remains firmly in view.

Michael G. Dahl
Credit Suisse Securities (USA) LLC (Broker)
Q

Okay. Thank you.

Norman C. Chambers
Chairman and Chief Executive Officer
A

Thank you.

Operator: Our next question comes from the line of Lee Jagoda with CJS Securities. Please proceed with your question.

Lee Jagoda
CJS Securities, Inc.

Q

Hi. Good morning.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Good morning, Lee.

Lee Jagoda
CJS Securities, Inc.

Q

So, Norm, just want to start with the Coatings segment. Obviously, volumes were up 26% and it was the first time in, I think, six quarters the segment showed some year-over-year revenue growth. I guess the question is, what portion of that is a function of just the increased demand versus you internally getting past some of the operational issues and taking on more business from your customers?

Norman C. Chambers
Chairman and Chief Executive Officer

A

Hey. I got to tell you that's – I'm glad you asked that question, because Don Riley and Dan Happel have really done an incredibly solid job of putting that business back together on a footing that is consistent with our very successful past and being selective and thoughtful about the customers that we wish to work with and taking advantage of the internal demand and just doing it in a really solid methodical way, and it's taking us a year or more to kind of get back to the position that we prefer to be in and we're there and I will say that the team is still very focused on some growth opportunities, but are very mindful of the kind of customers that we need to work with.

Lee Jagoda
CJS Securities, Inc.

Q

And do you think we're at the point yet where we can say the business is back to a place where we can kind of see the historical margins from two years, three years ago come back?

Norman C. Chambers
Chairman and Chief Executive Officer

A

Yes, I do.

Lee Jagoda
CJS Securities, Inc.

Q

Okay. But just one more for me. In terms of the slope of steel prices, since the quarter has ended, it seems like the increase has been pretty steep in a lot of the steel products. Are you seeing any problem in terms of either managing your customer orders with regard to steel price or customers kind of backing away temporarily, saying they may want to wait for steel prices to come in a little bit?

Norman C. Chambers
Chairman and Chief Executive Officer

A

So, there's two things going on there, and one is what we normally experience and one is not. So, the first, what we normally experience is, in fact, the reality of costs going up in a really short and intermediate term and having to work with our customers to kind of get that. In the past years, and as you could tell by my script, I mean, we've done this a lot, Lee, over the years, as you know.

And at the end of the day, what's different about this one is that I can't remember, in my tenure here, where we had outside forces like the tariff laws having such an immediate and dramatic impact on the reduction of the availability of alternative steel during a domestic steel price increase. And I'll tell you, that is a different deal because what happens is that the, if you will, safety valve that a lot of our competitors have had to reach out to foreign steel just simply isn't there. And if it's there, it's at a much higher cost because of tariffs.

So, I'm very encouraged, and frankly, I find myself firmly in a camp that says higher steel prices are good for the industry and are good for our suppliers, steel companies, and are a good thing for our customers, because our pricing compared to other materials is still very, very low and competitive. So, there is room to grow.

Lee Jagoda
CJS Securities, Inc.

Q

So, I think that's a key point. Thanks very much. I'll hop back in.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Thank you.

Operator: Our next question comes from the line of Steven Fisher with UBS. Please proceed with your question.

Steven Michael Fisher
UBS Securities LLC

Q

Thanks. Good morning.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Good morning.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Good morning.

Steven Michael Fisher
UBS Securities LLC

Q

I wonder if I could just follow up on Lee's question there on the Coatings group and the third-party volumes. If you could just clarify kind of what really did drive the volume there. I know you said you're sort of getting that organizationally back on track. But was there a particular end market? Was there a particular region? And would you expect this kind of growth to kind of be sustained? Or is there maybe any kind of one-time benefit in the quarter that might not repeat?

Norman C. Chambers
Chairman and Chief Executive Officer

A

No, there was no one-time benefit. It really is the result of hard work and realizing that, in many instances, for the customers we wish to work with, frankly, there is a trial period of which we are on trial to produce materials at the quality that they want, at the time that they want, at the price that they want. And Dan and the team have been going through that in a yeoman-like way, and have really kept their patience and discipline. And Don has been husbanding that and making sure that the guys don't get anxious to try to get more work. And the net result is we're ending up with a customer base that is much more keeping with our traditions.

So, one of the advantages that we have is we have the Middletown facility, and that's a new facility that is new from a standpoint of not – we didn't have that facility during the last recovery. I'm talking about a very long time ago, 2003 to 2008. And that extra capacity, coupled with, frankly, more intelligent supply chain management that we have, really gives us an opportunity to satisfy our internal needs, which are hugely important to us, and to grow our business modestly with third-party sales. So I think we got a good hand to play yet there.

Steven Michael Fisher
UBS Securities LLC

Q

Okay. That's helpful. And I wonder if you could just kind of give us your big picture thoughts on the cycle in this sort of a slow growth economy, but kind of where are we now for kind of the low-rise products? What visibility do you have to the growth in 2017 at this point? And are there any particular place where you think the market is still undersupplied?

Norman C. Chambers
Chairman and Chief Executive Officer

A

So, let me just start, then, Mark, I think, can add more detail. But the – one of the things that's still clear and you hear us talking less about it is that I'm not sure we've crossed 1 billion square feet yet, right? I mean, we've had relatively weak to slightly negative growth. And that has largely been driven by the fact that low-rise construction really has followed the normal pattern since 2011 of growing in line with the economy.

What has been different is the mid-rise and high-rise is growing at a more rapid pace. It appears to me by looking at the numbers that that is still a very big part of the market, but that rate of growth is decreasing some. So my point is that we still see frankly a lot of market left. We don't see any impending reduction in the slow growth economy, particularly when we look at the relationship of low-rise non-res construction with single-family starts. And, man, that still looks real good to us.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Yeah. I was going to add to that, we've done some work with our own teams on leading indicators for low-rise construction starts to something we're very tied to. And that gives us 12 months to 14 months of visibility, which extends into next year. And we continue to see that moderate growth continuing into next year, so that visibility that we do have.

Steven Michael Fisher
UBS Securities LLC

Q

Okay. Terrific. Thank you.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Thank you.

Operator: Our next question comes from the line of Alex Rygiel with FBR Capital Markets. Please proceed with your question.

Alex J. Rygiel
FBR Capital Markets & Co.

Q

Thanks. Good morning, Norm and Mark.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Good morning, Alex.

Alex J. Rygiel
FBR Capital Markets & Co.

Q

Could you comment a little bit on capacity utilization rates right now? And then, secondly, could you comment on gross margins in the quarter up kind of 290 basis points, obviously, at the high end of your range, so theoretically inside your range, but any anomalies, any kind of positive or negative surprises relatively to kind of what you're expecting coming in?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Sure. First, with respect to the capacity utilizations, we're, of course, higher than we were at this time last year by 4 basis points to 10 basis points in each of our divisions. Our Components group is approaching a 50% capacity utilization, our Coaters group is just over 50% and our Buildings group in this last quarter was just under 30% utilization. So, still have significant amounts of capacity. With respect to our gross margins coming in at the higher end of our range, really the big reason for that is that the volumes came in at the high end of our range or just actually outside the top end of our range, and that drove the increased operating leverage across all three of our segments.

Alex J. Rygiel
FBR Capital Markets & Co.

Q

Very helpful. And, Norm, you sort of addressed it without addressing, but clearly it sounds like sort of the South Central, Southwest, Texas/oil patch market, a little soft. I know it's a smaller component of your revenue stream, but any color or thought, views there?

Norman C. Chambers
Chairman and Chief Executive Officer

A

Yeah. So, it's interesting. We look at the seven production areas that are gas and fracking, and actually saw a pickup in Marcellus, I believe. And so, at the end of the day, though, from my perspective, anything to do with upstream oil and gas is going to struggle for quite some time to come. So, we're pleased. We're seeing manufacturing opportunities increase. And it's interesting, the automotive side looks particularly interesting to us. And that's both good for insulated metal panels as well for our – sorry – as well as it is for our Building group. So, we're seeing some brightness there.

And the other thing is distribution centers. We really do very well in those. And we're seeing that not only from the bricks-and-mortar economy, but from the dot-com economy as well.

Alex J. Rygiel
FBR Capital Markets & Co.

Q

That's great. Thank you very much.

Norman C. Chambers
Chairman and Chief Executive Officer

A

You're welcome.

Operator: Our next question comes from the line of Brent Thielman with D. A. Davidson & Company. Please proceed with your question.

Brent Edward Thielman
D.A. Davidson & Co.

Q

Hi. Good morning. Nice quarter.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Good morning. Thank you very much.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Good morning.

Brent Edward Thielman
D.A. Davidson & Co.

Q

Hey, Mark, you mentioned steel likely wouldn't have an impact on overall revenue by Q4. Should the lower steel prices still weigh on Buildings group sales into the end of the year given the longer lead times?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

They should not have an impact in the fourth quarter. We do still expect some moderate level of impact in the third quarter.

Brent Edward Thielman
D.A. Davidson & Co.

Q

Got it. Okay. And then, Norm, of those end markets you mentioned, where internal bookings are gaining, is there something specific about those markets in your product offering that might be allowing you to take some share there? Or do you look at these gains as sort of consistent with the underlying growth of those markets?

Norman C. Chambers
Chairman and Chief Executive Officer

A

So, what I am seeing that would be a reflection of a change is that we are expected, when we invested as heavily as we have in insulated metal panels, that we would be pushing those products through our builder network and through our Components group in addition to the existing great sales channels that CENTRIA and Metl-Span have.

And what we're finding now is that push is still there, but we are getting a pull. What do I mean by that is that because of our presence in insulated metal panels, we are being brought into some larger types of projects that we frankly wouldn't have seen before. And in these cases, our insulated metal panels are providing us the opportunity to provide the whole building envelope. And that's a kind of an exciting change. Now, we'll see how that plays out. It's still early days. But we really like what we're seeing there.

Brent Edward Thielman
D.A. Davidson & Co.

Q

Okay. Great. Congrats, again.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Thank you.

Operator: Our next question comes from the line of Scott Schrier with Citigroup. Please go ahead with your question.

Scott Schrier
Citigroup Global Markets, Inc. (Broker)

Q

Hi. Good morning. Thanks for taking my questions, and as everyone, I'd say, good quarter. I wanted to ask about the 65 bps of gross margin headwind from less favorable product and segment mix. Perhaps what some of the drivers were, and how we should think about those trends going forward?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Sure. A lot of that has to do with just the relative weight amongst the three segments, of the volume, you noticed we had outpaced growth in the Coaters and Components segment relative to the Buildings segment. Buildings segment has the highest gross margin, so its relative weighting came down. Also, within our products, we have high-end products and we have lower end, more commodity-based products. And at any point in time, we can see some underlying shifts there. We saw some of that in the Components group during the period that lowered the mix-related margins.

Scott Schrier
Citigroup Global Markets, Inc. (Broker)

Q

Got it. Okay. And I wanted to follow up on some of the margin questions and, specifically, on the natural hedge. It looks like, given your guidance and your margins, that, like you said, you should have some pretty good incremental margins going into 3Q. That taking into account the Buildings segment possibly having some headwinds. But when I look at Components, it looks like that could suggest that, because of CENTRIA, you might have a structural change in margin to a level where you might not have seen in about five years or six years in your business. So, I just wanted to see, if that's fair to say – fair comment to make.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Yeah. So, I think that the notion that the insulated metal panels are at higher margin generally does help our legacy blend, right? I mean, that's for sure. So, we would expect to see that play a role in the improvement of the margins in the Components group. But I also want to say, which is frankly a very pleasant surprise for us, and this is a surprise to some extent, the execution of the legacy business in a marketplace when steel prices were going down as they happened for the last 18 months, is a market that that part of our business has struggled with historically. Let me tell you. They've been doing very well in the last 18 months both growing volume, top line and profitability largely by their incredible focus on sales and service. And the team led by Bill Coleman and Joel Viechnicki has just done a first-class job there.

So, we have some advantages we wouldn't necessarily expect to have in the market that we're in. But we're also pleased with the investments that we've made in insulated metal panels and the role that plays.

Scott Schrier
Citigroup Global Markets, Inc. (Broker)

Q

Got it. Thank you.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Great.

Operator: Thank you. Our next question is from the line of Matt McCall with BBT Capital Markets (sic) [BB&T Capital Markets] (41:32). Please proceed with your question.

Reuben Garner
BB&T Securities LLC

Q

Good morning, everybody. This is Reuben in for Matt.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Good morning, Reuben.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP

A

Good morning.

Reuben Garner
BB&T Securities LLC

Q

Good morning. So, I just wanted to see if you could give us a little color on your top line guide for Q3. Can you tell us what your volume and mix and steel price assumptions are after – Q2, you had 16% volume growth, but you had a little bit of segment mix impact the price per ton, I guess. Can you talk about what you're assuming in your Q3 guide?

Norman C. Chambers
Chairman and Chief Executive Officer
A

So, I think, broadly, we're expecting a similar blend of work as we had in Q2. We don't see a big change there. And we see, as Mark has said, we'll still have a bit of a headwind on steel cost, but it'll be less than we've experienced in the first half. And that, as you can imagine, is a kind of linear approach, meaning that by the fourth quarter, that'll be gone completely. So, over the course of the third quarter, we will see that headwind decreasing.

Aside from that, the reality is that we go through this, and have for a decade or more the notion and working with our customers to pass all that on. So, that's baked into our view of the future and making sure we don't get ahead of ourselves in terms of how quickly we can get all that through. And so, that's all kind of wound together in what that guidance is.

Reuben Garner
BB&T Securities LLC
Q

Okay. Great. And then the gross margin guidance, the mid-point, it looks like it's about flat year-over-year – you guys just expanded close to 300 basis points, and it looked like you had, what I assume is, a near-term drag from those plant start-up and wind-down costs. Can you just talk about the puts and takes from the low end to the higher end of your guidance and how you came up with it?

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

Sure. I think the best thing to understand about the gross margins is we are now in our third quarter, going to lap some significant improvements over the last several years. Most notably, though, the third quarter of last year was a substantial uptick in our margin and we've maintained those higher margins since then. So, we're basically getting to higher comparables. You combine that with any level of uncertainty there would be around the steel prices that Norm was just talking through, creates a little bit wider range than we've used in the last couple of quarters, that provides for that variability.

Reuben Garner
BB&T Securities LLC
Q

Okay. That was very helpful. And if I could sneak one more. And you've talked in the past a little bit about any SG&A opportunity and maybe some accelerated savings last quarter. Did you realize any this quarter? Do you have any expectations for the next year or so that you could quantify on that line?

Norman C. Chambers
Chairman and Chief Executive Officer
A

Well, I would tell you that each of our businesses is very focused on all of the different reorganization efforts. And while we have seen reductions in certain areas, certain other areas we've seen some expansion in. Overall, our expectation is that our ESG&A as a percentage of revenue will be coming down each year. And we will see that this year. We will see that again next year in a meaningful way. But beyond that, I couldn't quantify anything for you.

Reuben Garner
BB&T Securities LLC
Q

Okay. Great. Thanks, guys.

Norman C. Chambers
Chairman and Chief Executive Officer
A

Thank you.

Operator: Thank you. [Operator Instructions] We ask that please ask one question and one follow-up question. You may re-queue for additional questions. The next question today comes from the line of Trey Grooms with Stephens. Please proceed with your question.

Drew Lipke
Stephens, Inc.
Q

Yeah. Good morning, Norm and Mark. This is Drew Lipke on for Trey.

Norman C. Chambers
Chairman and Chief Executive Officer
A

Good morning, sir.

Drew Lipke
Stephens, Inc.
Q

Congrats on a good quarter.

Mark E. Johnson
Chief Financial Officer, Treasurer & Executive VP
A

Thank you.

Norman C. Chambers
Chairman and Chief Executive Officer
A

Thank you. I appreciate that.

Drew Lipke
Stephens, Inc.
Q

I was curious – you mentioned earlier that you guys have faced rapidly rising steel prices many times in the past. And I'm curious, when you see a short-term spike or jump in steel prices like we have, have you seen a level of, call it, maybe pre-buy activity from your customers in Coatings or Components ahead of that price increase? Is there any kind of front-load there, historically?

Norman C. Chambers
Chairman and Chief Executive Officer
A

Yeah. And I think I said in my script that we saw some nice bookings in the Buildings group in both April and May, and single-digit growth in April and double-digit revenue growth in May. And I wouldn't be surprised a little with that, it was getting ahead of steel price increases. That's a normal occurrence. And what's also normal is that, in the past and when we've had serious steel price increases, there have been a number of increases. The steel mills have, in a serial way, increased their prices over a period of time. And we certainly have seen some of that this time.

So, what happens is that that event of pulling ahead some work kind of continues on every time there's a steel price increase. Now, I will tell you that I like that structure because it gives a chance for the market to react to it, and to adjust to it, and to move on. So, what I'm seeing in the market is consistent with the better, if you will, a better steel price improvements in the past years.

Drew Lipke
Stephens, Inc.

Q

Okay. Thanks. That's helpful. And then on the Buildings group, I'm looking at the volume there in the quarter, I'm guessing the reason that underperformed the other segments was partially maybe due to weather which you referenced in your prepared remarks, I'm curious could you quantify the weather impact that you guys saw in the quarter and what you've seen here recently.

Norman C. Chambers
Chairman and Chief Executive Officer

A

No. I'll tell you – I mean, at the end of day, we're trying to get of the weather business, and I will tell you what helped us though is having Easter in March. Having five weeks in April was a great thing because we had some really horrendous weather in the Houston area, but we had a week to recover from that. So, we're kind of trying to get beyond the notion of impacts on weather and trying to really encapsulate that in how we work. But I will say that we have seen all over our businesses across the entire things we do really be very focused. Very focused on the job they're doing, communicating and making sure things don't fall between the cracks and that's making an hell of a difference.

Drew Lipke
Stephens, Inc.

Q

All right. Thanks, guys. I appreciate it.

Norman C. Chambers
Chairman and Chief Executive Officer

A

Thanks, Trey (sic) [Drew] (48:43).

Operator: Thank you. I would like to turn the floor back over to Darcey Matthews for closing comments.

K. Darcey Matthews
Vice President, Investor Relations

Thank you, Rob, and we thank everyone for joining us today. The company will be participating in two non-deal road shows this month. The second week of June, we'll be heading to Boston in the mid-Atlantic region with Citibank. In the following week, we will be with CJS Securities in Chicago. So, we hope to meet you on one of these trips or some of our upcoming conferences later in the summer. Again, thank you for joining us, and 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.