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Q3 2018 NCI Building Systems Inc Earnings Call

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PRESENTATION

Operator
Greetings, and welcome to the NCI Building Systems Third Quarter Earnings Conference Call.

(Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ms. Darcey Matthews, Vice President of Investor Relations. 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 Brad Little, our CFO.

Please be reminded that the following 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 presentations. The company's actual results may differ materially from the anticipated performance or results expressed or implied by these forward-looking statements.

The following comments also contain certain non-GAAP measures. These non-GAAP measures are performance measures that provide supplemental information that NCI believes are useful to analysts and investors to evaluate ongoing results of operations when considered alongside other GAAP measures such as net income, operating income and gross profit. Such measures are not prepared in accordance with U.S. GAAP and should not be construed as an alternative to reported results determined in accordance with U.S. GAAP. You will find a reconciliation of these non-GAAP financial measures and other related information in the earnings release and supplemental presentation located on our website.

In conjunction with the proposed transaction, NCI has filed a proxy statement to obtain the approval of its shareholders for the proposed merger of NCI and Ply Gem. Shareholders of NCI are urged to carefully read the important information contained in the proxy statement, including all amendments and supplements; and other documents related to the merger. NCI and its respective directors and executive officers may be deemed to be participants in the solicitation of proxies from NCI stockholders in connection with the proposed merger. Information about the persons who may be deemed as participants in the solicitation of the company stockholders in connection with the merger, including a description of their direct and indirect interests by security holdings or otherwise, will be set forth in NCI's definitive proxy statement and other filings with the SEC.

Our third quarter 2018 earnings results 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, the merger and some of our key initiatives; and then turn the call over to Brad for more specific financial commentary before we open up the call to 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 third quarter results.

We delivered another positive quarter that turned out to be in line with our internal expectations and demonstrated the NCI team's ability to achieve strong results in a period of macroeconomic headwinds.

For Q3, NCI's year-over-year revenues and adjusted EBITDA were up 17% and 26%, respectively. And adjusted earnings per share were up 89%. Our consolidated backlog grew 12%, and bookings and coating activity remained positive. Our performance to date has positioned us well for the remainder of 2018 and into 2019.

Led by commercial discipline, we were able to offset the ongoing inflation in material, freight and labor costs. Anecdotally, average freight costs have risen approximately 10% to 15% year-over-year, with spot rates as high as 25% to 30% year-over-year. While our gross profit margin was essentially flat versus last year, we were able to expand gross margin in our Buildings business against the prior year and sequentially for NCI as a whole. As noted on our past 2 earnings calls this year, we have a lot of experience in dealing with these periods of rising inflationary pressures and continue to remain confident in our ability to manage through them. We continue to expect low-rise nonresidential construction starts to grow mid-single digits, with the addressable markets for our legacy businesses growing 2% to 4%. Insulated Metal Panels, based upon increasing market penetration, should continue to grow at low double-digit rates. Our current backlog and incoming order rates across our businesses continue to support these baseline assumptions.

As discussed previously, we have 3 key areas of focus around cost efficiency and growth, which will drive $40 million to $50 million of incremental profitability through 2020. 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 was the implementation of an automated frame line for the Buildings business. The frame line is now fully operational and is in full production mode, creating new opportunities for the Buildings segment in the areas of trim and door automation. In addition, we'll be able to add to the company's flexibility in terms of scaling up for peak seasons. We have also identified several follow-on areas in building-strained manufacturing where similar technology can be applied, which is very exciting.

Second, we are making favorable strides with our continuous improvement initiative where we're taking advantage of the great work that has been done in our manufacturing facilities to deliver cost reductions with Lean and Six Sigma initiatives across our entire business. We are ahead of our implementation plan for 2018, having trained over 400 employees in Lean and Six Sigma principles; and are pushing forward on tripling the number of continuous improvement projects when compared to 2017. Third, NCI solutions, our growth strategy around Insulated Metal Panels and our ability to drive adjacent products across our legacy distribution channels, is meeting our expectations. Sales of IMP and commercial roll-up doors through internal distribution channels in our Buildings and Components segments increased by greater than 25% year-over-year as we continue to execute on our adjacency initiative. Doors revenues increased 29%, and IMP revenues grew almost 12% year-over-year. For Q3, IMP represented [26] of NCI's consolidated EBITDA.

As mentioned earlier, we expect the impact from these 3 key initiatives will deliver between $40 million and $50 million in cost savings by 2020, [building] margin and EBITDA expansion; and a reduction in our overall ESG&A. We continue to remain confident in these ranges and have a direct line of sight for hitting these targets.

Before I conclude, I'd like to spend a couple of moments on our proposed merger with Ply Gem that we announced in July. We strongly believe that this transformational transaction represents a significant step in the planned evolution of NCI for our vision of strategy creating the largest exterior buildings product platform in North America. Our management team and board strongly believes that the combined companies will provide an industry-leading growth profile with strong cash flow allowing for the rapid delevering and better positioning of the combined company through any cycle. Further insight on the transaction can be gained by reading the presentation announcing the transaction, follow-on investor presentations and proxies filed with the SEC. We encourage you to review these documents and others, which are available on our website.

The proposed transaction, which is subject to NCI shareholder and customary regulatory approvals, remains on track for an anticipated close in the fourth calendar quarter.

And Ply Gem also announced yesterday that it intends to acquire the Silver Line vinyl window and patio door division from Andersen Corporation for $190 million. This acquisition includes the Silver Line and American Craftsman vinyl window brands. The acquisition, with $440 million in revenues, represents a strategic industry consolidation for Ply Gem in the vinyl window space given the company's leading U.S. market share position. Additionally, this establishes a more comprehensive and balanced portfolio across the repair and remodeling and new construction segments for Ply Gem. After giving effect to the anticipated cost savings and synergies, the transaction is expected to be leverage neutral to Ply Gem, per their announcement, and the combined NCI and Ply Gem entities.

To wrap up. It is very clear from where we stand today that NCI is well positioned. As we enter the final quarter of 2018, we are focused on commercial discipline and operational excellence while staying true to our long-term growth strategies around IMP, product adjacencies and an advantaged customer platform. Our financial results in 2018 will be meaningfully better than 2017, as adjusted EBITDA for the first 9 months is 20% ahead of prior year, with our backlog of $651 million up 12% year-over-year.

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

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
Thank you, Don.

As is customary, we have issued a press release discussing our results and additional analysis and a supplemental information which is now posted on our website. My comments this morning are designed to add additional color on our financial results for the quarter and update our expectations for the fourth quarter and full year.

Our consolidated external revenues were up 17% year-over-year to $549 million, which was above the upper end of our guidance range and reflects double-digit increases in each of our 4 business segments. While we did achieve year-over-year volume growth, especially in products manufactured by the company, the majority of the increase is related to commercial discipline. Several price increases announced earlier in the year have allowed us to stay ahead of a prolonged inflationary environment and most of -- and which most of our input costs continued to rise. These include not only raw materials such as steel, chemicals and paint but also transportation and labor costs.

In terms of volume growth, external gains primarily came in the Buildings and Components segments reflective of the bookings and backlog levels we saw earlier in the year. As we communicated in our previous call, the rising cost environment is motivating customers to accelerate delivery to avoid further price increases where possible. This pulled some orders from the third quarter into the second quarter, and as expected, it pulled some from the fourth quarter into the third quarter.

Consolidated gross margin of 24.3% was just below the midpoint of our guidance range and, while slightly down year-over-year, was up 150 basis points sequentially. The product mix within our IMP segment was the primary contributor to the slight margin decline year-over-year, as the sales of cold storage and commercial and industrial panels continued to outpace the higher-margin architectural panels. Headwinds from cost inflation and rising steel prices were successfully offset by commercial discipline and the effective patch-through of these costs, primarily within the Buildings and Components segments.

Looking at our operating margins. We saw roughly a 170 basis point improvement over last year's third quarter. The increase in our operating margins is mostly driven by controlling and leveraging our ESG&A costs, which have been a focus in our cost-reduction efforts over the past several years.

Before turning to our outlook, I'll comment on a few cash flow and balance sheet items.

During the third quarter, we generated nearly $17 million in cash flow from operations. On a year-to-date basis, our operating cash flow grew from virtually breakeven in the prior year to approximately $57 million this year. The improvement in operating cash flow was achieved due to increased profitability, better year-over-year working capital management, lower taxes and lower interest rates. This improved cash flow has enhanced our ability to fund operations and continue to invest in our capital plan. On a year-to-date basis, we have invested approximately $35 million in CapEx, an increase of $19.2 million or 123%, as we continue to execute on our advanced manufacturing, continuous improvement and adjacency initiatives.

Now turning to our outlook. Consolidated backlog is up 12.1% year-over-year to approximately $651 million as of the end of July. Based on this as well; as our key leading indicators, which give us a good indication of market trends to come over a 9- to 12-month period, our view of continuing growth remains consistent with our previous calls. We continue to expect our Buildings and Components segment to track in the range of 2% to 4% growth, consistent with our expectation for low-rise construction starts, which we believe represents our addressable portion of the market. And for our IMP product line, we expect the revenue to continue to grow at low double-digit rates driven by greater wall market penetration and our ability to accelerate sales of these products through our Buildings and Components channels.

For the fourth quarter, we believe that the rising cost environment previously discussed has motivated customers to accelerate delivery of products into our third quarter in order to avoid further price increases. This is predominantly in our Components segment. As a result, while we expect there to be a step-up in activity levels from the third quarter to our fourth fiscal quarter, it is likely to be less pronounced and than normal and consistent with what we've discussed in our previous earnings call.

With these considerations in mind, we currently estimate consolidated revenue for the fourth quarter will range between $550 million and $570 million, with adjusted EBITDA ranging between $60 million and $70 million. We also expect fourth quarter gross margin to range between 23% and 25.5%, relatively in line with our third quarter. As a reminder, we have provided additional guidance for the fourth quarter in the supplemental presentation which is posted on our website.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Lee Jagoda with CJS Securities.

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

So just starting with the acquisition that Ply Gem announced last night. Can you talk about the pre-synergy levels of EBITDA there and how to think about timing of the expected synergies to get back to that 4.5x -- or 4.4x purchase price?

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

Sure. So what we've stated publicly is that the -- they paid $190 million on a revenue of $440 million and that the multiple pay was approximately 10x. And giving the effect for synergies, it comes in at about 4.4x, and as we said, that makes us leverage neutral relative to the merger that we've announced. And the synergies come about half from procurement; and then the balance come from manufacturing, logistics and SG&A. And so we anticipate that you'll be able to get some of that in the first year, but it'll be over the similar horizon that we have outlined for the synergies associated with the Ply Gem merger.

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

Got it. So day 1, it'll have, call it, $19 million of EBITDA, ramping towards that 4.4x over 2, 3 years.

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

Approximately.

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

Okay, and I assume that was not in the preliminary proxy bank estimates.

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

No, it was not. I think that EBITDA calculation is slightly off, that you did. We'll get that number for you, but I think it's -- I think you're a little bit lower.

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

Well, you were saying you paid 10x on -- you paid $190 million, which is 10x.

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

When I say we, it wasn't we. So just to be clear: I...

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

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

Lee M. Jagoda ***CJS Securities, Inc. - Senior MD & Analyst***
And then in terms of your core business, how does the forecast you provided for fiscal Q4 compare to the EBITDA forecast for 2018 that you provided when the Ply Gem merger was announced?

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***
Sure. So a couple things. One, the number that we just gave is our guidance. And then the numbers that you've seen in the proxy and that we've used from an investor perspective was a financial perspective to evaluate the overall investment [in terms of] forecast. And so right now we're showing in our guidance, if you take the midpoint, that we're going to come in at approximately $200 million. And I think the calendar year '18 number that you saw in the investor materials was also $200 million, and it's probably reasonably conservative when you roll in the remaining 2 months of the year on a trailing 12-month view.

Operator
Our next question comes from the line of Steven Fisher with UBS.

Steven Fisher ***UBS Investment Bank, Research Division - Executive Director and Senior Analyst***
It looks like you guys had some big inventory and receivable cash flow headwinds in the quarter. Can you just talk about what was going on there and what you're seeing for Q4 and how overall cash flow might shape up for the year?

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
Great question, Steve. This is Brad. So escalating commodity costs are utilizing more working capital dollars this year than last year, obviously, with the increase in steel prices. Overall, our working capital metrics are continuing to improve, but as we pass-through these higher costs, it is inflating some of our inventory and receivable balances. That's just natural. As we moved into the remainder of the year, we expect this to normalize and show year-over-year improvements year-over-year, but we're continuing to see the investment in working capital.

Steven Fisher ***UBS Investment Bank, Research Division - Executive Director and Senior Analyst***
Okay, and that's helpful. And what do you think might be the swing between the low end and the high end of your gross margin target for Q4? [Would that be fixed]? And what does your current backlog tell you about mix for Q4 at the moment?

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
So as you mentioned, our visibility comes from what we see in our backlog and recent booking trends.

And we generally expect to see similar product mix between Q3 and Q4, and we believe we're priced accordingly for the rising input costs. That's where we're deriving our margin.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***
And so I would expect to see a consistent mix in Q4 that we've seen in Q3.

Operator
(Operator Instructions) Our next question comes from the line of Scott Schrier with Citi.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***
First question I've got, just on the backlog. Can you give us any sense for the parsing it out between tonnage and price in both Buildings and the overall backlog?

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
Yes, Scott. So the growth is predominantly price, but volume has also contributed. The volume growth that we've seen is consistent with what we've communicated in the past, low single-digit growth for our legacy business and low double-digit growth for our IMP business.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***
Got it, okay. And then in Buildings obviously it's been a few years since we've seen a double-digit-margin quarter. And I think, last time, it was more in a declining cost environment, so I'm curious if you can parse out that 280 bps increase maybe into different buckets and talk about how it was relatively a very good-margin quarter there and if that's something that's sustainable or if there's anything that's one-off in there that we should consider.

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
Just to clarify your question, Steve, is -- you're talking, Scott, sequentially from Q2 to Q3, or year-over-year.

Scott Evan Schrier ***Citigroup Inc, Research Division - Senior Associate***
No, just year-over-year. And I mean you had a pretty strong operating margin in Buildings for the quarter, and I just wanted to see what's kind of the different buckets in that.

Bradley Scott Little ***NCI Building Systems, Inc. - VP of Finance, CAO, Interim CFO & Treasurer***
Sure. So the increased volume that we had this year, obviously it improved our utilization and manufacturing and fixed-cost structure. So we did have some leverage there year-over-year. The other thing is just being proactively ahead of the rising costs, both inflation and steel and wage, has allowed us to really get ahead of that. And so that, along with the commercial discipline and some of the other pricing initiatives that we've had, has helped us stay ahead.

Donald R. Riley ***NCI Building Systems, Inc. - President, CEO & Director***
You have to think it'd be pretty balanced across those. The team has done a good job. And then the

initiatives have definitely been taking effect and starting to show through in the bottom line, so you also saw improvements in ESG&A. So I would say it's been balanced between manufacturing leverage and ESG&A and commercial discipline. And I'm really pleased with the job that, that team has done.

Operator

Thank you. There are no further questions at this time. I would like to turn the call back over to Ms. Matthews for any closing remarks.

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

Thank you, Michelle. And thank you, everyone, for your time today. And we look forward to speaking with you soon. Have a good 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.
