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Transcript of
Materion Corporation
Year End 2018 Earnings
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Participants

Stephen Shamrock – Vice President, Corporate Controller, Investor Relations
Jugal Vijayvargiya – President and CEO
Joe Kelley – Vice President and CFO

Analysts

Martin Englert – Jefferies
Edward Marshall – Sidoti & Company
Phil Gibbs – KeyBanc
Marco Rodriguez – Stonegate Capital

Presentation

Operator
Greetings, and welcome to Materion Corporation Year End 2018 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 call is being recorded.

It is now my pleasure to introduce your host, Steve Shamrock, Vice President, Corporate Controller, Investor Relations. Thank you, sir. You may begin.

Stephen Shamrock – Vice President, Corporate Controller, Investor Relations
Good morning. This is Steve Shamrock, Vice President, Corporate Controller, and Investor Relations. With me today is Jugal Vijayvargiya, President and Chief Executive Officer, and Joe Kelley, Vice President and Chief Financial Officer.

Our format for today's conference call is as follows: Jugal Vijayvargiya will provide opening comments on the company's 2018 performance, and a strategic direction and outlook as we move forward into 2019. Following Jugal, Joe Kelley will review detailed financial results for the quarter and full year highlights, and then we will open up the call for questions.

Before we begin, let me remind investors that any forward-looking statements made in this announcement, including those in the outlook section and during the question and answer portion, are based on current expectations. The company's actual future performance may materially differ from that contemplated by the forward-looking statements as a result of a variety of factors. Those factors are listed in the earnings press release we issued this morning.

Additionally, comments with regard to operating profit, net income, and earnings per share reflect the adjusted gap number shown in attachment Number 5 in this morning's press release. The adjustments are made in both the current year and prior year periods for comparative purposes, and remove special non-recurring items, non-cash pension settlement charges, and certain income tax adjustments.

And now I'll turn it over to Jugal for his comments.

Jugal Vijayvargiya – President and CEO
Thanks, Steve, and welcome, everyone. On today's call, I'm very pleased to report record results for the fourth quarter and for the full year. Earnings for the quarter improved by 27%, to a fourth quarter record of $0.65 per share, while valued-added sales grew to $186 million, also a fourth quarter record. These represent the eighth consecutive quarter of both top and bottom line growth. Our PAC business delivered all-time quarterly records for valued-added sales, operating profit, and operating profit margin.

For the full year, we delivered record earnings of $2.38 per share, a 38% improvement from the prior year, and the second consecutive year of greater than 30% earnings growth. All three businesses reported double-digit operating profit margins for the first time ever, including record operating profit margins for our PAC and PC businesses. Valued-added sales reached an all-time high of $739 million, representing 9% growth from prior year. Joe will cover additional detail on the financials.

Let me shift gears and provide a progress update on our multi-pillar strategy reviewed with you on previous calls. As a reminder, we established pillars around commercial excellence, operational excellence, innovation, inorganic growth, and digital transformation, all supported by laser-like focus on performance-based culture. Our global teams have made substantial progress establishing these pillars, as evidenced by the results I just reviewed.

In commercial excellence, our focus on value-based pricing, improved sales mix, addressing underperforming businesses, and creating a global salesforce has led to record value-added sales and operating profit. We're in the midst of creating a world-class salesforce essential to achieving our aspirations of consistently delivering profitable growth.

In operational excellence, safety has been our overriding priority, leading to the best safety rates in history, with 19 sites achieving 0 incidents. With our focus on improving working capital, we reduced inventory levels by 2.5%, while supporting 9% sales growth. This enabled us to achieve the most efficient level of working capital in five plus years and contributed significantly to our strong cash flow. Yield and efficiency improvements across the majority of our sites contributed to the improved profit margins, and we made a significant step in lowering our cost structure by reducing a third of the workforce at our German facility.

As part of the innovation pillar, we established global technology and innovation groups within each of our business units. This is allowing us to eliminate redundancies and accelerate efforts in developing and commercializing new products. We increased R&D spending by 9% and will continue to make strategic investments to fund a new product pipeline and drive organic growth.

Within the inorganic growth pillar we have been active in evaluating acquisition opportunities, but as we've stated before, we will not do M&A just for the sake of doing M&A. While we did not find an acquisition that fit our strategic and financial intent, we will continue to focus on M&A in 2019. Our strong cash flow generation and available liquidity give us the flexibility to act, as we continue evaluating potential targets.

As part of the digital pillar, we're leveraging digital systems and tools to improve business processes and associated competitiveness. We started to implement shop floor tools to better understand equipment downtime and improve operational efficiency. We continue to convert sites to our common ERP platform and standardize master data to fully embrace and leverage digital tools. This will continue to be a major pillar going forward, as we see opportunities to further improve our cost structure and customer support. With these pillars, we've been driving a performance-based culture throughout the company. Our consistent quarterly results for the last two years serve as proof of the call for transformation taking place.

In addition to the pillar framework, we launched One Materion. The idea that creating unified, focused core competencies to serve the entire company is much more effective than uneven inconsistent efforts across individual business units. This is intended to drive further improvements in both top and bottom line performance. One Materion applies to functions, regions, and businesses. Each senior leader has been busy developing One Materion, and in many cases implementation has commenced. We've created regional organizations to leverage the power of One Materion. I fully anticipate that, as we move forward, One Materion will pay substantial dividends. As we enter 2019, our objective remains the same: Create a high-performing advanced materials company delivering superior returns. We're doubling down on each pillar, and fully leveraging the power of One Materion.

We all read about the uncertainty surrounding us. However, we are committed to moving the company forward in all aspects and delivering significant earnings growth for the third consecutive year. We expect earnings to be in the $2.62 to $2.74 range, a 10% to 15% improvement from the prior year. I look forward to providing updates on our progress in future calls.

Now I'll turn the call over to Joe to cover financial details.

Joe Kelley – Vice President and CFO
Thank you, Jugal, and welcome to everyone joining us on the call today. During my comments I will cover fourth quarter and full year 2018 financial highlights, review profitability by segment, provide brief comments on the balance sheet, cash flow, and modeling assumptions, and finally, cover the earnings outlook for 2019. Following my remarks, we will open the line for questions.

Fourth quarter 2018 was a very strong quarter for Materion and marks the eighth consecutive quarter with year-over-year growth in valued-added sales and adjusted operating profit. Our consistent delivery of profitable growth is driven by the multi-pillar strategy Jugal referenced, and it is the continued execution of this strategy which provides momentum as we head into 2019.

Fourth quarter 2018 valued-added sales, which exclude the impact of pass-through precious metal costs, were $185.8 million, up 3% versus the prior year fourth quarter. We set a fourth quarter valued-added sales record, despite the drop off in demand in our largest end market of consumer electronics. The record fourth quarter value-added sales exemplifies our market diversification, differentiated product portfolio, and success in commercial execution. New product sales in the fourth quarter of 2018 were $27.3 million, or 15% of value-added sales.

We delivered year-over-year valued-added sales growth in six of our top seven end markets, with particularly strong performance in energy, medical, and telecommunications infrastructure. The growth in these markets was due to a combination of new business wins and stronger overall demand. Consistent with previous quarters, the decrease in consumer electronics was due to lower sales in the display and wireless portion of this market, as customers continue to rebalance inventory levels in response to weaker consumer demand.

Despite softness in consumer electronics, commercial execution initiatives related to product mix and market share gains, combined with favorable end-market demand in other end markets, have now delivered ten consecutive quarters of year-over-year value-added sales growth. Gross profit was $66.1 million in the fourth quarter, excluding a copper LIFO inventory benefit of $1.9 million, adjusted gross profit was $64.2 million, an increase of 9% from the prior year. Gross profit margins expanded over 200 basis points, to 35%, driven by commercial and operational performance improvements, and leveraging the sales volume growth.

Selling, general, and administrative expense totaled $37.7 million, flat compared to the prior year fourth quarter. As a percentage of valued-added sales, SG&A was approximately 20% in both periods. The company incurred

$5.6 million of restructuring expense related to severance paid to approximately 40 employees in our German operation. I remind investors that we relocated our German advanced materials manufacturing operation in July of 2018, from the legacy Heraeus facility, to a standalone Materion location.

The headcount reduction completed in the fourth quarter represents a 30% reduction in the workforce and will enable efficiencies and cost savings in excess of $3 million annually. These actions reflect efficiency levels now possible in the new facility.

Operating profit totaled $14.4 million in the fourth quarter of 2018. Excluding restructuring severance and the copper LIFO inventory benefit, adjusted operating profit was $18.1 million, or 10% of value-added sales; an increase of 29% compared to adjusted operating profit of $14 million in the fourth quarter of 2017. Commercial and operational initiatives, combined with sales volume growth, delivered double-digit operating margins for the second consecutive quarter.

Moving now to other non-operating expense. As previously announced, in October of 2018 we annuitized approximately 43% of our US domestic pension liability to reduce volatility in pension costs and funding requirements on a go-forward basis, and to secure pension benefits for participants in payment status. As a result, we recognized a non-cash, non-operating pension settlement charge of approximately $41 million in the fourth quarter.

The combination of the annuitization of the retiree pension liability, and pension funding actions taken in 2018 to maximize tax savings, has significantly strengthened the overall financial position of the Company. The Materion US defined benefit pension obligation has been reduced from approximately $280 million, to $140 million, and the funded status on the remaining liability has increased to 95% as of year-end 2018.

Looking at income taxes, we recorded a tax benefit of $6.3 million in the fourth quarter of 2018. Excluding the impact from the new US tax reform legislation, and discreet items related to tax planning strategies, our effective tax rate in the quarter was 22%, slightly higher than our historical run rate, based on the mix of earnings. For the full year, income tax was a benefit of $4.5 million, which included an $11.1 million benefit from finalizing the impact of the new US tax reform. Excluding the impacts of the tax law change and special items, the full-year 2018 effective tax rate was 20%, in line with our previous guidance.

Adjusted earnings totaled a fourth quarter record of $0.65 per share diluted, up 27% from the adjusted $0.51 per share recorded in the fourth quarter of 2017. Our differentiated product portfolio, and focus on commercial and operational execution, continues to produce record financial results.

Let me now briefly comment on full-year 2018 consolidated financial performance. Value-added sales totaled $739 million for the full-year 2018, up 9% compared to 2017, and a record for the second year in a row. Excluding the Heraeus acquisition, the base business grew 8% year-over-year, due to commercial performance improvements and stronger demand, particularly in the energy, defense, and industrial end markets. Full-year 2018 adjusted operating profit totaled $66 million, which represents a 39% increase compared to adjusting operating profit of $47.4 million in 2017.

Expressed as a percentage of value-added sales, operating profit margins expanded 200 basis points over the prior year to 9%. Full-year 2018 adjusted earnings totaled $2.38 per share, up 38% versus 2017 adjusted earnings of $1.72 per share.

Now let me review 2018 fourth quarter full-year performance by business segment, starting first with Performance Alloys and Composites. Value-added sales were $110.1 million, up 9% versus the fourth quarter of 2017, and a record for any quarter. The increase in value-added sales is due to commercial performance improvements and

improved end-market demand. Higher sales into the energy end market was a major growth contributor year-over-year due to new business wins in drilling applications for both ToughMet and copper beryllium products. Operating profit in the fourth quarter of 2018 totaled $19.9 million, compared to $9.5 million in the prior year. Excluding a copper LIFO benefit, adjusted operating profit was $18 million, nearly double the prior year amount, and 16% of value-added sales. This represents a second consecutive quarter of operating profit margins greater than 15% and reflects the commercial and operational improvements being made across the business, as well as stronger end-market demand. We have exceeded our commitment to return this business to historical profitability levels, and we remain excited and committed to delivering profit margins reflective of the highly differentiated, value creating portfolio or products contained within this segment.

Looking at Advanced Materials, value-added sales in the fourth quarter 2018 were $52.8 million, compared to fourth quarter 2017 value-added sales of $58.3 million. Value-added sales declined 9%, due primarily to softer demand in the display and wireless portion of the consumer electronics end market, and timing related to the ongoing customer requalification process associated with the relocation of our German manufacturing facility.

Operating profit, excluding the restructuring severance, totaled $4.9 million, compared to $7.9 million in the prior year. The decrease in adjusted operating profit is due to lower sales volumes, unfavorable product mix, and manufacturing inefficiencies associated with the ramp up of the new German facility.

The headwinds of the German relocation are largely behind us. The workforce has been right-sized, and the facility is producing high-quality products and passing all customer audits. For the full-year 2018, Advanced Materials value-added sales decreased 2%, and delivered a 10% operating profit margin. Challenging macroeconomic conditions in the consumer electronics end market, which represents over 50% of total value-added sales for this segment, was the main driver behind the segment's 2018 performance. We are committed to returning this business to historical operating profit margin levels in the 15% range.

Turning finally now to the Precision Coatings segment. Fourth quarter value-added sales were $24.2 million, up 6% compared to $22.9 million in the fourth quarter of 2017, due primarily to stronger optical filter sales in the defense end market. Operating profit for the Precisions Coatings segment totaled $2.4 million in the fourth quarter of 2018, or 10% of value-added sales, compared to $2.3 million in the fourth quarter of 2017. The year-over-year improvement was driven by higher sales volume and manufacturing efficiencies, which more than offset increased precious metal consignment costs. For the full year of 2018, the Precision Coatings segment reported $94.2 million in value-added sales, a 4% increase compared to 2017. This segment recorded an operating profit margin of 12%, an all-time record, due to strong performance of our optical filter products and manufacturing performance improvements. We remain committed to consistently delivering double-digit margins in this business.

Moving now to the balance sheet and cash flow. Cash flow from operations improved $9 million in 2018 compared to the prior year, due to stronger earnings and improved working capital efficiencies. We improved our operating cash flow year-over-year, despite an incremental $26 million of pension contributions to fund our domestic pension plan. As a result, we further strengthened our already solid balance sheet, and have significant available liquidity to support allocation priorities mentioned on previous calls, including organic growth opportunities, further inorganic growth opportunities, and consistently return capital to shareholders.

For financial modeling purposes in 2019, capital spending should run approximately $30 million; mine development investments should be $5 million to $10 million; annual depreciation and amortization should run approximately $35 million; cash flow from operations greater than $90 million; the effective tax rate should be 18% to 20%.

And finally now, the earnings outlook for 2019. Based on the momentum we have exiting 2018, we expect profitable growth to continue in 2019. However, macroeconomic conditions remain uncertain and could impact the end markets we serve. At a more company-specific level, we remain focused on executing our multi-pillar strategy, and leveraging our commercial and operational performance improvements to drive profitable growth. Based on these factors, we are guiding full-year 2019 earnings to range from $2.62 to $2.74 per share, a 10% to 15% improvement over 2018 results. From a quarterly guidance perspective, we expect the first quarter of 2019 earnings to be approximately 15% higher than first quarter 2018 earnings.

This concludes our prepared remarks. We will now open the line for questions.

Operator
Our first question comes from the line of Martin Englert with Jefferies.

Q: I wanted to see if you can provide a little bit more detail on color around the headwinds in consumer electronics—I know you called out some of this as due to displays and smartphones—maybe how you see that trending quarter-on-quarter, and into 1Q.

And then, how the supply chain is adjusting to that, I'd be curious when the destock started, and whether you think that's getting close to the bottom, or we're going to see continued headwinds over first half '19.

Jugal Vijayvargiya – President and CEO
Martin, let me give you some numbers, and then try to give you some color around that. Our consumer electronics business, in total, at the company level, we were basically flat year-over-year; however, in the fourth quarter we were down about 9%. As you know, the destocking was really starting probably about Q1. We started to see the headwinds around that time. And then, throughout the year, there was expectation that the destocking, and just general sales, would start to improve maybe in the back half of the year. Unfortunately, I think the market just didn't recover to the level that maybe everybody was expecting.

As we look at our order entry and where we see things going, I think consumer electronics will continue to face some headwinds. First of all, Q1 is a very low consumer electronics quarter anyway, just based on seasonality. So you have the headwinds, just general headwinds and market headwinds, plus the seasonality, and then, I think we expect that the headwinds will continue into Q2. There is some expectation that maybe in the back half of this year it will start to recover, but I just want to caution us that there was the same type of commentary last year, as well, and it didn't materialize.

I think we just have to be very, very cautious. We're looking at, from our standpoint, we're making sure that we have the right cost measures in place, the right pricing and measures in place, to be able to make sure that, from a profitability standpoint, we can weather the storm, so to speak, as it happens this year as well. But I think the great thing about our market positioning is that we're very diversified. As you know, we have really good positions in industrial, and defense, and energy, and medical, and automotive, and telecom infrastructure, etc., and I think that allows us to maybe deal with some of the headwinds in consumer electronics. Even though consumer electronics was down 9% in Q4, for example, we still were able to hit a 3% year-over-year increase on overall value-added sales.

I mean, it is an issue for us, but it's one that we're basically dealing head-on, and trying to get more value-added sales through other markets, as well as making sure that the cost side of the equation is dealt with.

Q: Kind of delving into the year-on-year, so it was flattish for the group, can you talk about what is factored in for consumer electronics in your guide for 2019 on value-added sales?

Jugal Vijayvargiya – President and CEO
Yes. I think we're going to see a challenging environment, I think, for the value-added sales. As I indicated, I think in the first half of the year, we expect consumer electronics to be down, and then, perhaps, in the second half of the year, I could see maybe a flat, perhaps a slight uptick, but I would expect it to be very, very close to really just being flat.

In general, a slight negative for the full year is what I would expect consumer electronics to be right now, but let's see. I mean, let's see as the year progresses, and see if the market recovers and reacts, hopefully better than what I'm seeing.

Q: And if I could, one last one. Could you discuss what you're seeing regarding the base price across some of your product portfolio, and maybe what you've been able to achieve with price increases as we move through 2019 here?

Jugal Vijayvargiya – President and CEO
Value-based pricing has been a major initiative for us, as far as our commercial excellence pillar. I mean, we've really gone through and looked at contract by contract and using a pricing database and tool that we have to understand what type of value we're providing to our customers, and then, are we getting the right type of pricing for that value. I will tell you that that has been a major initiative for us, and we made significant improvements in '18. We believe that there are still some opportunities for '19, certainly not to the level that we experienced in '18, but this is a very important item for us. And then the second thing that we're focused on is making sure that we don't get into any new contracts with our customers where the pricing model that we have doesn't reflect the value that we're providing.

In general, it's a very important element for us in our commercial excellence pillar.

Operator
Our next question comes from the line of Edward Marshall with Sidoti.

Q: I want to start, I guess, on the AM. Given the guidance that you talked about from a revenue perspective, and the commitment that you talked about, the 15% range for operating margins, I'm curious, timing, if you can kind of put any timing to that margin discussion so that we can kind of get a sense as to maybe what's embedded in your 2019 guidance for that business; but then, also, kind of the outlook, and when you kind of get to the recovery there.

Jugal Vijayvargiya – President and CEO
First, let me just start off and say that we are absolutely committed to getting that business back to historical margins. We're doing everything we can to make sure that we're going to do that. And now let me provide a little bit of color, I think, of sort of what's happened with that business and where we see it going.

There are really two big things that hit that business in '18. One, consumer electronics, we just talked about it. It's a major, major part of that business, is roughly 50% of the sales are consumer electronics for that business, so any type of headwind is certainly going to have an impact.

The second thing is, we went through this transition from the Heraeus business over to our factory in Germany, and as we did that, a number of things. One, general inefficiencies of a move from one plant to another plant. The second thing is, we had to go through and validate our entire glass business and customers with the glass business, and then customers with the semiconductor business. So those combination of sales drop, as a result of that, the sales drop as a result of the consumer electronics headwinds, and then the cost impacts of the actual move were just major, major impact items for us on that business.

Now, as we get into '19, let me kind of give you a flavor of how we see things. Well, consumer electronics, I just commented, based on Martin's question, kind of how we see consumer electronics as a market. From a cost perspective, we've actually made significant improvements on the cost side, and in particular, the restructuring that we did, taking out about a third of the workforce in our German operation. And that is complete, by the way, we completed that in Q4, and so, we should realize the full benefit of that here in '19.

And then the third is, the actual sales recovery of that business, based on qualifying with our customers on the glass side, which we have now done a very good job of, and I would say, for the most part, we've really re-qualified with the glass customers, and we're starting to get that sales back; but the semiconductor customers, it just takes longer. So that's going to run during the year.

So as I see this business, I see every quarter, would be my estimate, that it will continue to improve. Our expectation is that we're reaching 15% at some point during the year. I would think it's going to be in the back half of the year, probably towards the fourth quarter, but every quarter, I expect that we're going to improve, and exit the year going into 2020 at the historical margins.

Q: And can you confirm for me that that 15% by the fourth quarter is embedded in the guidance look that you have for—is that what you just said? I'm just curious.

Jugal Vijayvargiya – President and CEO
Yes. I mean, all the things that I just mentioned to you, the sales recovery, the glass business, the semiconductor, all of that, I would say, is really what we have included in our estimation of what the business is going to do.

Q: And so, on the German facility, specifically to the fourth quarter, can you talk about maybe the revenue impact that the transition—and if you want to break it down glass and semi, that would be great, and maybe the earnings or profit margin impact that that business might've had on the transition from the one facility to the other.

Jugal Vijayvargiya – President and CEO
Yes. I can talk a little bit about the sales side. So, first of all, as you know, we don't break out specifically our sales and profit for a site or that part of the business, but I'll give you some general flavor around it.

Certainly, we had more of an impact from the semiconductor side than we did from the glass side, based on the re-qualification, but there was clearly a sales impact. We expect that sales impact to now go away as we get into '19, and as we continue to qualify more and more of our customers. So there was an impact.

In terms of the profit impact, I would say it was a fairly substantial impact. I mean, as I indicated, we just took out a third of our workforce, which would give us about a $3 million run rate improvement starting in '19. That, right away, you can look at as a potential. I mean, if you want to classify that as a hit in '18, and then, of course, the hit associated with the lower sales. It was a fairly substantial impact to our overall AM business, and that's why we feel that during the year, as we now get the customers back and as we have the full impact of this restructuring, we feel that we should be able to exit the year with historical margins.

Q: And if I can to what I think seems to be driving the business and the results right now is PAC, and some pretty good color there on what the business is doing. But I'm curious, could you specifically talk about which pillar, in particular, is working in that to really drive the margin? I know some of that's market demand and so forth, but you've done a good job of getting to margins.

And then the second part, follow-up to that, is you've talked about historical profit levels. As I kind of walk back in the model it looks kind of like high single digits, you're already producing above that. Do you assume that margin goes down? I just wanted to get some clarity on that. Thank you.

Jugal Vijayvargiya – President and CEO
Yes. Let me just first talk about what's really, I think, been some of the key contributing factors in our PAC business to drive the improvements. So first I have to say, from a pillar standpoint, commercial excellence has really been a core part of what we've done in that business, and that goes from evaluating businesses that we shouldn't of, perhaps, been in, or maybe the pricing wasn't the correct pricing, and so making sure that we go through and evaluate value-based pricing. Looking at our mix that we have in different parts of the world, as we price new products, that we're pricing them appropriately, and then knocking on customers' doors. I mean, let's face it, that business delivered 17%, I mean, 17, 1-7 percent year-over-year growth. That's a substantial growth, and that certainly wasn't just based on the market. Our salesforce knocking on doors and promoting of products was a contributing factor, so clearly, commercial excellence was a big player.

Operational excellence has been a very, very important element for us, both from the operating profit side, as well as from a cash flow and balance sheet side. We focus a lot on what the plants are doing, and looking at yields of certain operations, especially where we had bottlenecks, efficiency improvements. We've really done substantial amount of work getting some lean initiatives. We utilized, in fact, an outside firm that worked with us, and is continuing to work with us on lean initiatives. And so, operational excellence, and then associated cash flow impact, as I said, with the inventory improvements as well. That's been a major improvement. Certainly, the market mix, by the way, helped us as well. Defense and energy, which are really two good markets for us, were up quite a bit in '18.

As we look to '19, your point about historical margins, I mean, I certainly would not want this business to go to a 10% type of a margin, no way, but I will tell you that a lot of the tailwinds that we had in '18, we're going to be challenging those tailwinds. So, in particular, for example, the mix. Mix is going to be a big factor for us as we go year-over-year. I don't expect the same type of growth rate that we had. We had an 80% growth rate, for example, on energy, 33% growth rate on defense. I mean, those are really, really substantial growth rates on very good businesses for us. I think that is going to be challenged. This business is exposed to China, and so, as we all know, China has a substantial slowdown that's happening right now.

And then, just general, overall macro environment that we have to deal with. The expectation that, can this business continue at 16% margins, I think is a very, very optimistic expectation going forward, but I can assure you that we are focused on driving as much as possible in this business.

Operator
Our next question comes from the line of Phil Gibbs with KeyBanc.

Q: Question on the pension annuitization. Should we expect the expense levels to come down in 2019? If so, what's the potential reduction? And then, secondarily, what should we be thinking about in terms of your contributions in '19, relative to the $42 million that you had in '18?

Joe Kelley – Vice President and CFO
Phil, when you look at our operating profit and you think about the annuitization, what we annuitized was retirees. And so, we annuitized a portion of those that were receiving payments, and so, that will have no impact on our OP, as it relates to pension expense included in operating profit going forward.

What has impact there is the discount rates and the asset return assumptions, and so, when we look at '18 to '19, pension expense included in operating profit should be flat, relatively flat, year-over-year, is the answer.

Q: What about your expected contributions?

Joe Kelley – Vice President and CFO
And the expected contributions next year in the plan is $6 million of cash contributions. In 2019. I'm still mixing up my this year versus last year.

Q: So that's a big change, so that's good. And then, just generally speaking, I know a lot has been read and a lot has been discussed about the potential tariffs between the US and China, who knows how it's all going to play out, but curious if you felt like the potential for tariffs between the US and China had any impact on the business, one way or another, in 2018, from a supply chain reorientation, customers asking for material early, that sort of thing; particularly, I think, when we look at your fourth quarter results, certainly very strong in PAC, but bucked a lot of the normal seasonality that we tend to see in that business.

Jugal Vijayvargiya – President and CEO
Phil, what I would say is that, for the full-year '18, I would say that I don't think we experienced really a material impact based on the tariffs. But what I will tell you is that I think in the fourth quarter, we started to see direct and indirect impacts. In particular, for example, there's a substantial slowdown occurring, as you know, in China, and that slowdown is starting to show up in our order take.

Now, China, in total, is not a very large part of our business. I mean, it's less than 10% of our business. Again, a small, smaller amount of impact, but it's still an impact. And then, the general market uncertainty that's happened, I think, around tariffs, companies, and I think countries don't know exactly how things are going to settle out, I think it's caused just overall market weakness, and that's certainly played out, I think, in the fourth quarter, as we experienced even in our markets. When you look at the type of growth rates that we had during the first three quarters, and then the type of growth rates we had in the fourth quarter, you can see the difference.

I would say for the full year, really not a material impact for us. Probably some impact in the fourth quarter, and then as we now enter into 2019, especially the China concerns and the China market slowdown, which, I think, have something to do with some of the uncertainty around tariffs, can have some impact on us, but again, it's not a large material impact for us.

Operator
Our next question comes from the line of Marco Rodriguez with Stonegate Capital.

Q: I wanted to kind of follow up on some of the line of questioning on operating margins, not necessarily for near-term specific guidance here, but just kind of bigger picture thinking in terms of the long-term margins. If I'm remembering correctly, then, obviously, listening to some of the commentary here as far as where you're targeting your operating margins on the various segments, we're looking at kind of a mid-teens, if you will, operating margin on VA sales as kind of like a target, if you will. So first, I just want to make sure that I'm thinking about that correctly.

And then just kind of listening to the commentary on the call here, it kind of sounds like hitting that number, assuming there's no major macroeconomic headwinds in the next few years, that maybe this is a 2020 event where you try to kind of hit that normalized goal. Can you maybe talk a little bit about that?

Jugal Vijayvargiya – President and CEO
Yes. As you know, we have not and don't give out a long-term projection for margins, but I will tell you, and as I indicated in my prepared remarks, we are focused on developing Materion as a high-performing advanced

materials company delivering superior returns. I think those were the words I used. And we've also stated that, hey, that is approximately mid-teens type of margins.

Now, when we look at our historical performance and kind of where things have been, we were at 6% in 2016, we were roughly 7% in 2017, and we're at 9% in 2018. I mean, that's been the step-up that we've done over the last two-year period. And so, substantial increase, I think that has happened.

What we're focused on, I would say, is that all three of our businesses need to be at double-digit margins. Overall, I would say mid-teens for the company. I think it's certainly going to take a little bit of time. I mean, we closed out at 9% in 2018, so we certainly aren't going to get there in '19, and you mentioned '20. I'm not sure, '20 just seems to be around the corner when you think about it. But I can assure you we are committed to getting our business to mid-teens margins, with all three businesses delivering double-digit margins.

Q: And then, shifting here to some of the operational excellence that you've been putting into place over the last year or so. If you can maybe talk a little more about the yield and efficiency improvements, and the working capital improvements. How much more room do you have there to make a big difference, if you will?

Jugal Vijayvargiya – President and CEO
Yes. I think operational improvements and the lean journey, as we say, it's a never-ending item. No matter what improvements you make, you can always go in and make more improvements. Number one, I don't see it as something that's a one-time event. I think it's a continuous activity, and we're going to keep at it. I think our biggest impact in operational improvements, and sort of the lean journey, were in our PAC business. I see PAC business continuing to be on this journey.

And then we have to add in a lot more of the AM business and PC business as we move forward. We have to look at our footprint rationalization, which is part of our lean journey, and kind of where our customers are, where are we producing products, our facilities in general. I think that has to become a part of it, but that's not today or tomorrow. I think our bigger issue right now is just a basic blocking and tackling and getting yield and efficiency improvements across the board.

I see this as a journey. We've started on it, and we're going to continue on it.

Q: And lastly, Jugal, in your prepared remarks you talked about your salesforce, kind of in the midst of creating a very efficient salesforce. Maybe you could talk a little bit about what sort of activities, or what sort of promotions, or efforts you're making there to, what sounds like kind of beef up the salesforce or make them more efficient.

Jugal Vijayvargiya – President and CEO
Yes. So, we've done a number of things already, and we have a number of things planned for 2019 but let me just highlight a couple of the big items. Number one, we've done a substantial amount of salesforce training. We're working, actually, with an external company, where we're doing training globally. So we've actually conducted a training in Asia. We've conducted a training in Europe. We've done two sessions in North America, and I think we have two more coming up here, North America. And so we're going to continue at it , to really help our people understand how to go and market our products and technologies to our customers and help them understand the value that we provide. At the end of the day, if our people can't do that effectively, then we're not doing justice to our customers. That's number one.

Number two is really making sure that our salespeople are located in the right places. We can't have salespeople sitting at our plants, because our customers aren't located at our plants. Our customers are located all over the world, and we have to make sure our salespeople are located where our customers are. So either, ideally, if we can figure out a way to get our salespeople at the customer's location, but if not, in their backyard.

And then I think the other thing is, we have to make sure we incentivize properly, our salespeople, to deliver the right type of value-added sales growth. Growth for the sake of growth, as we know, it can be very dangerous, but making sure that the right type of value-added sales is being delivered so that we can consistently deliver profitable growth.

Those are some of the main things I can highlight that we've been working on, but clearly, commercial excellence is a very important part of our go-forward strategy.

Q: Is there an expectation that you need to grow the size of the salesforce, or you think you can maintain it with now just making it more efficient?

Jugal Vijayvargiya – President and CEO
I think it's being able to make it more efficient. I think it's very important. I think making sure the roles and responsibilities of the salesforce are clearly defined and understood, because you have inside sales, you have outside sales, you have product management, your marketing management. And so, making sure that all those things are properly defined so everybody understands their role, and they can properly block and tackle, and then, each one of those individuals has the right skillset and capability to our training process.

Operator
Mr. Shamrock, we have no further questions at this time. I would now like to turn the floor back over to you for closing comments.

Stephen Shamrock – Vice President, Corporate Controller, Investor Relations
Thank you. This concludes our fourth quarter 2018 earnings call. A recorded playback of this call will be available on the company's website, materion.com. We would like to thank all of you for participating on the call this morning, and your interest in Materion. I will be available to answer any follow-up questions. My direct number is 216-383-4010. Thank you very much.