Transcript of
Materion Corporation
Materion Third Quarter 2022 Earnings Conference Call
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Participants

John Zaranec - Chief Accounting Officer, Materion Corporation
Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation
Shelly Chadwick - Vice President, Finance and Chief Financial Officer, Materion Corporation

Analysts

Stefanos Crist - CJS Securities
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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Materion Third Quarter 2022 Earnings Conference Call. At this time, all participants have been placed on a listen-only mode, and the floor will be open for questions and comments after the presentation.

It is now my pleasure to turn the floor over to your host, John Zaranec, Chief Accounting Officer at Materion Corporation. Sir, the floor is yours.

John Zaranec - Chief Accounting Officer, Materion Corporation

Good morning and thank you for joining us on our third quarter 2022 earnings conference call. This is John Zaranec, Chief Accounting Officer.

Before we begin our remarks this morning, I would like to point out that we have posted materials on the company's website that we will reference as part of today's review of the quarterly results. You can also access the materials throughout the download feature on the earnings call webcast link.

With me today is Jugal Vijayvargiya, President and Chief Executive Officer, and Shelly Chadwick, Vice President and Chief Financial Officer. Our format for today's conference call is as follows. Jugal will provide opening comments on the quarter and an update on key strategic initiatives. Following Jugal, Shelly will review the detailed financial results for the quarter in addition to discussing our expectations for the remainder of 2022. We will then open the call for questions.

Let me remind investors that any forward-looking statements made in this presentation, including those in the outlook section and during the question-and-answer portion, are based on

current expectations. The company's actual 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 regarding earnings before interest, taxes, depreciation, depletion and amortization, net income and earnings per share reflect the adjusted GAAP numbers shown in attachments four through seven in this morning's press release. The adjustments are made in the prior year period for comparative purposes and remove special items, non-cash charges and certain discrete income tax adjustments.

And now, I'll turn over the call to Jugal for his comments.

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Thanks, John, and welcome, everyone. I'm pleased to be with you this morning to share details on another record quarter for Materion. And to cover some significant advancements we have made on our strategic initiatives. We remain on-track to deliver another record year, as we have continued to reset the bar each quarter for the last two years. In Q3, we achieved our highest ever top-line results, with value-added sales up 35% compared to the prior year.

Our organic outgrowth initiatives, combined with continued strength across most of our end-markets led by semiconductor, industrial, aerospace and energy, delivered a robust 15% organic growth in the quarter. The new precision clad strip facility contributed largely as expected with the plant now fully qualified by our customer. And HCS-Electronic Materials continues to perform well with strong sequential growth, meeting continued robust customer demand. We also achieved record EBITDA and EPS for the quarter, primarily due to higher sales and improved pricing.

EBITDA margins were approximately 17% performing close to our mid-term target of 20%. During the quarter, we did face some short-term headwinds that caused our profitability to fall short of our expectations. While our semiconductor related sales were up organically, our mix within semiconductor was weaker-than-expected due to lower precious metal target sales into a software consumer device market. The balance of our expanding portfolio is focused on the growing segments of semiconductors, such as Logic, Communications and other advanced chip applications, leading to increased demand for our non-precious metal products.

We also felt the impact of higher tantalum raw material costs in the quarter. As noted earlier, the demand of our HCS-Electronic Materials products remains very strong. However, with inherited customer contracts that are still being renegotiated, we were not able to pass along the unusual raw material price increases experienced recently. The market for tantalum has typically been quite stable, but it did see a run up over the past few months due to labor shortages at the mines. That pricing has started to come back closer to normal levels.

And lastly, one of our large Performance Materials facilities had some challenges with staffing and reduced yields. That team is working diligently to improve the yields in the near-term by delivering for our customers. We expect that each of these short-term headwinds will be

mitigated moving into next year, as we continue to drive our organic initiatives and deliver on operational excellence. Despite challenges incurred in the quarter, our teams performed well and continued to execute on our strategic initiatives, while building a pipeline of outgrowth opportunities for the future.

Organic outgrowth initiatives have become a cornerstone of Materion strategy. They have accelerated our top and bottom-line, leading to consistent outperformance versus our end markets. When we think about the economic uncertainty that is prevalent across most industries today, we feel confident about our ability to continue to outperform because of the robust pipeline of projects and customer partnerships we have established.

Let me give a short update on some of the major projects we currently have underway. We are pleased to share that our precision clad strip facility is fully qualified by our customer. We are continuing to ramp into Q4 and plan to be operating at expected levels by year end. In addition, the second phase of the precision clad strip project continues with asset procurement and project management on pace with the expected timeline. We anticipate start up in second half of 2024.

Our HCS-Electronic Materials business continues to accelerate growth as we have meaningfully increased headcount and output from the Newton facility. The recently announced $20 million capital investment to expand capacity and capabilities is on-track and will support our growth objectives for that business. Construction has begun and equipment is on order for the next generation electric vehicle battery material opportunity at our new facility in Milwaukee. And as it relates to our molten salt purification project, production of Flibe has started and we expect to ship material to the customer later this year. These announced initiatives, and several others that are in the development stage, will drive continued outgrowth as we move into '23 and beyond.

Moving ahead to expectations for the fourth quarter. I expect that our performance will be stronger to finish out a fantastic record year. We like what we have seen for October sales rates. Taking into account mainly the impact of the short-term headwinds, we are adjusting our guide to $5.20 at the midpoint. This represents a roughly 30% increase in EPS versus last year. While we are not ready to guide for '23, I'm confident that our organic growth portfolio and operational excellence initiatives will deliver another year of strong outgrowth.

In closing, as I reflect on our strong customer partnerships, strategic acquisitions, and the many exciting organic opportunities in our pipeline, I'm really proud of the progress we have made and the dedication and commitment of our 3,600 team members around the world. It is their commitment that is driving long-term value creation for our customers, our shareholders and for our people.

Now, let me turn the call over to Shelly to cover the financials.

Shelly Chadwick - Vice President, Finance and Chief Financial Officer, Materion Corporation

Thanks, Jugal, and good morning, everyone. During my comments, I will reference the slides posted on our website this morning. Starting on Slide 10. As Jugal outlined in his opening

remarks, we achieved another record quarter of value-added sales, adjusted EBITDA and earnings per share in the third quarter. Value added sales, which exclude the impact of pass-through precious metal costs, were 290.4 million for the quarter, up 35% from the prior year.

Organic VA sales, excluding the impact of both acquisitions and foreign currency, increased approximately 15% compared to the prior year. This significant market outgrowth was driven by strong demand across several of our end markets, particularly semiconductor, industrial, aerospace and energy. Our HCS-Electronic Materials acquisition continues to surpass top-line expectations, and it performed well despite the short-term unmitigated tantalum raw material cost increases experienced in the quarter.

Despite the market and operational headwinds Jugal outlined, we delivered adjusted earnings of $1.31 per share, up 14% as compared to the prior year, even with a $0.20 increase in interest expense.

Taking a look at Slide 11, adjusted EBITDA in the quarter was 48.8 million, up 18% from last year and up 29% with comparable mine amortization add back. This item is an immaterial change to the quaternization of the mine amortization add back in performance materials to better align with its cost of goods sold impact.

Prior to Q4 last year, we reflected EBITDA figures using a mine amortization add back tied to raw material production and not to our actual cost timing. Within any 12-month period, the add back was roughly the same, but the impact between quarters could be lumpy based on the timing of our mining activities.

Starting in Q4 of '21, we began reflecting our EBITDA amounts using an add back methodology aligned with the cost time. Given Q3 of '21 was the last quarter under the previous method, we provided the EBITDA growth with comparable mine amortization add back to better illustrate the year-over-year business performance, which drove a 29% increase in adjusted EBITDA year-over-year.

This increase was largely driven by strong volume, meaningful price mix and positive contribution from our HCS-Electronic Materials acquisition. As Jugal shared earlier in the call, these growth drivers were partially offset by unfavorable semiconductor mix and yield challenges at a large performance materials facility, as well as the delayed recovery timing in our precision optics segment. Commercial and R&D investments increased year-over-year, as expected, as we continue to support our organic growth initiatives in the near and mid-term.

Now, let me review third quarter performance by business segments. Starting with our Performance Materials business on Slide 12. Value added sales were a record 148.8 million, an increase of 29% compared to the prior year. The increase is driven by strong performance in the industrial, energy and aerospace end markets. In addition to the impact of the precision clad strip opportunity, contributing approximately 20 million of sales in the quarter.

EBITDA excluding special items was 33 million or 22.2% of value-added sales, compared to 28.8 million in the third quarter of '21, or 25.5 million with comparable mine amortization

impact. The increase in EBITDA was primarily due to the increased volume and positive price cost partially offset by the yield challenges previously mentioned.

Moving to the fourth quarter outlook, our order book remains strong and we expect another quarter of above market growth. With our precision clad strip facility ramping and our teams working together to improve yields, we expect sequential EBITDA improvement as well.

Next, turning to Electronic Materials on Slide 13. Third quarter value added sales were 113.9 million, up 63% versus the prior year and up 10% organically. Aside from strong VA contribution from the HCS-Electronic Materials acquisition, the organic increase was primarily driven by stronger demand in the semiconductor and industrial end markets.

EBITDA excluding special items was 17.2 million or 15.1% of value added sales in the quarter, an increase of 52% from the prior year. The increase was driven largely by higher organic volume and positive price costs offset by the unfavorable precious metal mix within semiconductor. HCS contributed meaningfully despite short-term tantalum raw material headwinds.

As we look to the fourth quarter, we expect the Electronic Materials business to deliver another strong quarter of year-on-year growth attributed to our diversified semiconductor portfolio, as well as organic initiatives on pace to deliver continued above market growth.

Finally, turning to the Precision Optics segment on Slide 14. Value added sales were 28 million, down 10% compared to the prior year. We experienced foreign currency headwinds of 2 million on the top line for this business. So when excluding the currency impact, sales were down 4% compared to the prior year. The decline is due to the discontinued consumer electronics application and certain timing of defense projects, which were slightly offset by stronger performance in the medical market.

EBITDA excluding special items was 4 million of 14.5% of value added sales, down from the prior year due to lower volume. Sequentially EBITDA increased 11% with a 230 basis point margin improvement. Pertaining to the fourth quarter outlook, we expect sequential improvement supported by growth in defense and space.

Moving now to cash, debt and liquidity on Slide 15. We ended the quarter with a net debt position of approximately 473 million and 127 million available capacity on the company's credit facility. Our leverage at 2.6 times remains within our target range. With strong free cash flow expected in the fourth quarter, we expect this leverage ratio to be approaching lower 2s by year end.

Lastly, transitioning to Slide 16, let me address our outlook. While we remain confident in our strong order book and organic initiatives pipeline, when considering the impact of the recent short-term market and operational headwinds, we are updating our full year outlook to the range of $5.15 to $5.25 per share, representing a roughly 30% increase year-over-year. Among other items, the timing of certain defense orders in Performance Materials, would push results to the high-end of that range.

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As in previous quarters, we have also updated two modeling assumptions for you. In closing, we are proud to have delivered another quarter of record results. We are headed into the fourth quarter with good momentum expecting sequential improvement to finish the year on a high note.

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

Operator

[Operator Instructions]. Your first question for today is coming from Dan Moore. Please announce your affiliation and then post your question.

Q: This is Stefanos Crist calling in for Dan. Thanks for taking our questions. Can you just update on what your semi customers are telling you about their expansion plans, as it relates to the Inflation Reduction Act? Any change either in the scope or timing of potential capacity additions?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Well, I think in general, I mean, as some of the customers have made their announcements, couple of them have indicated that they will maybe back-off on some CapEx investments into the New Year, perhaps in the '23, '24 timeframe. But I would say that there has not been a wholesale announcement from everybody on decreases, based on the economic conditions. So there is some minor announcements, but I don't think there is anything major. From what we are seeing with our customers, we are continuing to see good growth. Our semi business is quite diversified.

Not only do we serve the memory market, which is an area that I know has been challenged here in the near-term, but we serve very well the data storage, communication, power devices, logic devices, et cetera. So we are a very diversified semi base for us the business that we have. And so, I think from our side, we are not seeing the type of things that maybe some of some of the folks have announced. But overall, I would say longer-term in terms of investments, nothing substantial, minor, minor announcements from some of the semi players.

Q: And just a follow-up on the tantalum cost. Was it simply just a matter of just a lag of timing in passing those through? And when do you expect those to return to a normalized level?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Yes. Tantalum is something that has been a fairly stable material, one that we and, in fact our previous owners of the business, had never really thought much about, I think. And then there was a run up that happened in a fairly short period of time. It was a result of labor shortages. Labor had been diverted to tin mines, which happened to be located nearby the tantalum mines. And as a result, there was a run up on the price. That price has started to come down. As we just look at our inventory turns and just kind of how we process things, I would say that probably in

the first quarter of the new year, we would start to see the positive effects of the price, that's coming down for tantalum.

I think the second thing that's important to note is the contracts. I mean, I think as you know, we've talked about it on many calls. We absolutely do not want to be the sponge, when it comes to inflation related pricing from our supply base. We have worked very hard to make sure that our contracts are aligned with our customers in a way that we can recover pricing. These contracts, which are legacy contracts that we inherited from the buyer, were not structured in that way. And so we are working very hard to restructure those contracts, we've made good progress on that. And I would expect that in the new year, those contracts will be, you know, in a way that will allow us to be that will allow us to pass the costs as we incur them in, which would be more in line with the type of contracts that we have with many of our customers.

And so that is exactly where we're headed and so we would really see a turnaround here in the new year. So we really see this as a short-term, a very short-term item, one that we expect, as I said, to be recovered from in the new year.

Operator

Your next question is coming from Phil Gibbs. Please announce your affiliation then pose your question.

Q: It's Phil Gibbs, KeyBanc. Just sticking once, how much do you think, relative to where your new contracts could be and where these costs went that misalignment? How much did that impact the quarter? Was it 5 million? Was it 1 million? It seemed to be pretty sizable to me in some [indiscernible]?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Phil, it is a sizable impact and just to give you an idea. The tantalum pricing was approximately, in this one up, went up about 50%. So fairly sizable increase, when you look at our cost of goods sold for tantalum, it's roughly about a 75% cost of goods sold for tantalum related products is the actual cost of the tantalum. So when you look at that type of impact, I mean, it's in the neighborhood of about $4 million, is the impact that we faced. So a very sizable impact. Our expectation was that we would be able to recover that.

I mean, as I indicated, in my earlier comments, I think our team has done a really a fantastic job of being able to recover, inflation related, cost related items from our customers, and we, through various discussions, through surcharges, through price adjustments, we just based on the contractual arrangements that we have, we just were not able to execute on that. It wasn't for a lack of trying, I can assure you of that.

And, we will have this issue fixed and taken care of, so that we were not having to incur this type of situation. In case, if there's ever a run up in the future. But as I noted, the cost of tantalum is starting to come back down and we want to make sure that we have a win-win situation with our

customers. So obviously, if the cost comes down, then the customers will feel the benefit of that. But if the cost goes up, and the customers will have to participate in that.

Q: Well, incrementally in Q4, and is this misalignment expected to continue at that magnitude, or is the misalignment easing row to the Q3?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Look, I think the misalignment first of all is going to continue, and we can talk about the magnitude or the misalignment is going to continue just based on the fact that, we're buying and there's a lag time from the time that we're actually buying the raw material, processing the raw material, getting through our inventory turns and then getting that over to our customers.

So I think that takes time, and so it will continue into Q4. I think the magnitude I would say is probably in the similar neighborhood is what I would expect. Probably, improving that perhaps towards the end of the year and then certainly into the new year, but it will be a sizeable magnitude still in Q4.

Q: Is that going? Do you think that that goes away in Q1 or is it just sort of a glide?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

It's a glide, I really would see an improvement in Q1 and then really, I think by Q2. Our expectation is to really have this issue fully addressed, but we got to continue to work through it here over the next couple of quarters. But as I indicated, this is not something that we're going to have to deal with in the future. We know how to manage these types of things, we manage them on a daily basis on all of our other materials and that we're going to make sure that this is managed properly, going forward.

Shelly Chadwick - Vice President, Finance and Chief Financial Officer, Materion Corporation

So I think, right, there's two elements to the easing, and I think Jugal touched on both of them. It's the new pricing coming in, or the new contract being implemented, as well as working through the inventory of that higher priced channel. And so that's why you don't see just kind of a switch over one-one

Q: Appreciate all the detail on that. As it relates to just the overall order book, what's the texture of what you're seeing just across the business in its entirety. And what are your order books telling you at this point across your end markets?

Jugal Vijayvargiya - President and Chief Executive Officer, Materion Corporation

Yes. Look, our business continues to do really well. I mean, we delivered as you saw 35%, year-over-year growth and 15% organic for the quarter, which I think is very substantial. And we expect our organic growth to continue, our order books continue to be strong. And certainly there

are some areas that are perhaps a little bit more challenged. On the semiconductor side there are parts of semiconductor, that are probably a little more challenged as we go into Q4 and perhaps into the new year. But like I indicated, in my earlier comments, we were a very diversified portfolio for semiconductor. So we believe we're going to continue to outperform the market.

Automotive, there seems to be some issues regarding inventory correction, I think there was a lot of buy that happened in anticipation of semiconductor chips availability, that chip availability has been slow. And so I think there's been some usage of the inventory that's going on. So automotive is a bit of a little bit more challenge for us, than we probably would have expected at the beginning of the year.

But I think in general, we have a really good growth in our aerospace business and our energy business, we continue to do well in industrial, our semiconductor business says that the rest of the business of semiconductor continues to do well, Telecom has continued to do well. I mean, when you look at our order book, from, just from end of last year to kind of where we're at right now, our order book is up about 13% from end of last year to now and I think it's just a testament to the type of organic growth our teams are driving, the projects that our teams are driving.

So, we continue to see good progress on the organic side. So I would see Q4 is a good continued progress of our growth, and when you look at, in fact, our overall order book, I mean, it's been it's been pretty much stable even in the Q3 timeframe.

Operator

There are no further questions in queue. I would like to turn the floor over to John Zaranec for any closing remarks.

John Zaranec - Chief Accounting Officer, Materion Corporation

Thank you. This concludes our third quarter 2022 earnings call. Recorded playback of this call will be available on the company's website materion.com. Now, I'd like to thank you for participating on the call this morning and your interest in Materion. I will be available for any follow up questions, and my number is 216-383-4010. Thanks again.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference call. You may disconnect your phone lines at this time and have a wonderful day. Thank you for participation.

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