

***Transcript of
Materion Corporation
Second Quarter 2019 Earnings
July 25, 2019***

Participants

Steve Shamrock - Vice President, Corporate Controller and Investor Relations
Jugal Vijayvargiya - President and Chief Executive Officer
Joseph Kelley - Vice President of Finance and Chief Financial Officer

Analysts

Edward Marshall - Sidoti & Company
Phil Gibbs - KeyBanc Capital Markets

Presentation

Operator

Greetings. Welcome to the Materion Corporation Second Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator instructions]. Please note, this conference is being recorded.

I will now turn the conference over to your host, Steve Shamrock. Mr. Shamrock, you may begin.

Steve Shamrock - Vice President, Corporate Controller and 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 quarter and an update on key initiatives. Following Jugal, Joe Kelley will review detailed financial results for the quarter 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 GAAP numbers shown in Attachment No. 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 non-recurring special items for pension curtailment, legacy legal and environmental matters, and certain income tax adjustments.

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

Jugal Vijayvargiya - President and Chief Executive Officer

Thanks, Steve, and welcome, everyone. I am once again extremely pleased to report record financial results for the quarter. We delivered all-time records for value-added sales, operating profit, operating margin, and earnings per share in the second quarter. EPS for the quarter was \$0.88 a share, representing a 63% increase over prior year. I can't stress enough how impressed I am with our team and their ability to execute on our multi-pillar growth strategy. We have now delivered ten consecutive quarters of both top and bottom-line growth, an impressive milestone.

Our strong second quarter performance provides significant momentum heading into the second half. Despite uncertainty around macroeconomic environment and headwinds in select end markets and geographies, we are raising our full-year earnings guidance a second time this year. Joe will provide financial details for the quarter and the full year. Let me spend a few minutes reviewing strategic commercial actions under way to deliver continued profitable growth.

Last quarter, I reviewed some commercial excellence initiatives, and now I will expand on those by providing an update on our One Materion go-to-market strategy. You may be aware that we issued a press release last week announcing the recategorization of commercial end markets. This announcement was more than simply reclassifying how we externally report end market sales. It highlights changes in how we are identifying new business opportunities and better positioning Materion to deliver solutions our customers desire.

This end market focus is driving new business opportunities and leveraging the complete One Materion product portfolio. For example, our deep customer relationships and market knowledge in the defense and aerospace market in the PAC and PC segments is allowing us to identify new opportunities for the AM segment. Likewise, market knowledge and position in the semiconductor space for the AM segment is helping to identify new business opportunities for the PAC segment.

In our prior calls, I spoke about realignment of the business units based on global product lines. To complement this, we have appointed senior leaders for key end markets to strengthen identifying and developing go-to-market strategies in support of new business opportunities and supporting customers for the respective end markets. We have also invested in CRM software and are implementing common processes to categorize, capture, and report useful information to deliver business growth. This is an example of the investments we are making to drive commercial excellence strategies to better serve global customers and growth markets.

Another example of growth investment in our commercial arm is the meaningful progress we are making in developing commercial capabilities in Asia. This region continues to represent a significant growth opportunity for us. We have been actively assembling a local leadership team comprised of seasoned professionals experienced in local markets and technologies. They are identifying growth opportunities and developing local capabilities to deliver on the region's growth potential.

We are leading similar initiatives to build One Materion commercial capabilities in Europe. Following our most recent regional and business unit reviews in Asia, I am more optimistic than ever about the future of Materion. Our differentiated product portfolio, innovation capabilities, and strategic commercial investments are positioning us to consistently deliver profitable growth. I look forward to sharing more updates with you on future calls.

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

Joseph Kelley - Vice President of Finance and Chief Financial Officer

Thank you, Jugal, and welcome to everyone joining us on the call today. During my comments, I will cover second quarter 2019 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.

I am very pleased to report record financial results for the second quarter of 2019. This represents the tenth consecutive quarter with year-over-year growth in both value-added sales and adjusted operating profit. Second quarter 2019 value-added sales, which exclude the impact of pass-through precious metal cost, were \$194.9 million, an all-time record, and up 3% versus the prior year second quarter, and up 4% sequentially. New product sales were \$30.8 million or 16% of value-added sales. As Jugal mentioned earlier, we recategorized how we view our end markets and related go-to-market strategy. Accordingly, we plan to report value-added sales in this revised format going forward.

Strong commercial execution in energy and industrial end markets drove our second quarter growth. The improved performance in these end markets more than offset continued weakness in the automotive and semiconductor end markets. The semiconductor end market remains weak, primarily due to reduced demand for smartphone devices, while the automotive end market remains soft, particularly in Europe and Asia. Despite our second-largest end market being down 9%, we delivered the 12th consecutive quarter of year-over-year value-added sales growth.

Strong commercial execution and ability to leverage our differentiated product portfolio has continued to deliver profitable growth. Gross profit was \$69.6 million in the second quarter, an increase of 13% from \$61.8 million in the prior year. Expressed as a percentage of value-added sales, gross margins expanded 320 basis points to 35.7%, driven by favorable sales mix and manufacturing performance improvements.

We continue to have success in driving improved sales mix from a product, geographic, and end market perspective. Growth in high-purity beryllium products and complex optical filters and arrays continue to outpace the company average. Strip product sales in Asia were down almost 30% year-over-year, led by market softness in China and strategic pruning of some low-margin business. The net result of this purposeful sales mix change combined with manufacturing performance improvements is driving meaningful gross profit margin expansion. Looking at the first half of 2019, sales mix has been very favorable from an end market perspective. Sales into the aerospace and defense, energy, and telecom data center remains strong, representing 33% of year-to-date value-added sales, up from 30% in the prior year period.

Shifting to selling general and administrative expense, cost for the quarter totaled \$39.9 million, up \$1.4 million over the prior year second quarter of \$38.5 million. The increase includes commercial investments to drive our long-term strategy, partially offset by administrative cost reduction actions. As a percentage of value-added sales, SG&A expense was 20%, consistent with the second quarter of 2018. Operating profit totaled a record \$22.8 million in the second quarter of 2019, up 50% compared to the prior year second quarter operating profit of \$15.2 million. As a percentage of value-added sales, operating profit in the second quarter of 2019 was 11.7%, also a record for any quarter, and the fourth consecutive quarter with double-digit profit margins. Commercial and manufacturing performance improvement initiatives, along with general cost reductions, drove the year-over-year increase.

Moving now to other non-operating expense, we recorded a non-cash \$3.3 million pension curtailment charge in the second quarter of 2019 related to our decision to freeze defined pension benefits for active participants in the U.S. pension plan, effective at the end of this year. As you may recall, we annuitized approximately 43%, or \$110 million, of our U.S. pension liability in the fourth quarter of 2018. This latest action is another step in our long-term goal to reduce volatility and uncertainty related to U.S. pension benefit expense. The net impact of the change should reduce the volatility of cash contributions and reduce ongoing annual expense starting in 2020.

Shifting to income taxes, we recorded \$3.6 million of tax expense in the second quarter of 2019, which results in a 19% effective tax rate, within our full year 2019 guidance range. Net income for the second quarter of 2019 totaled \$15.5 million, or \$0.75 per diluted share. Excluding the \$3.3 million non-cash pension curtailment charge,

tax effected, we reported record adjusted earnings of \$18.1 million, or \$0.88 per share, an increase of 63% versus the prior year.

Now, let me review 2019 second quarter performance by segment. Starting with our Performance Alloys and Composites business, value-added sales were a record \$115.3 million, up 5% sequentially and versus the prior year. Commercial execution in this business continues to produce strong results, led by sales into the energy and consumer electronics end market and increased beryllium hydroxide sales, which more than offset weakness in the automotive end market. We continue to gain share in the energy end market with our ToughMet and copper beryllium products, and we also had increased success with engineered strip products utilized in consumer electronic connector applications. On the negative side, the automotive end market continues to be soft, especially related to demand in Europe and Asia.

Operating profit in the second quarter of 2019 totaled \$19.3 million, or 17% of value-added sales, a 57% increase over the prior year, and the fourth consecutive quarter with operating profit margins greater than 15%. We remain focused on our ongoing commercial and operational improvements to sustain this positive momentum.

Moving to Advanced Materials, value-added sales in the second quarter 2019 were \$58.3 million, up 2% compared to the second quarter 2018 value-added sales of \$57.3 million. Value-added sales increased primarily due to higher sales in the industrial and energy end markets. Advanced chemical sales for currency security applications drove the industrial end market increase in the quarter. The increase in energy end market sales was the result of new business wins in the large area glass product line, leveraging the rotatable target technology acquired in the Heraeus high-performance target materials acquisition.

Operating profit for the second quarter 2019 totaled \$6.1 million, or 10% of value-added sales, an increase of 9% versus \$5.6 million in the prior year quarter. The improvement in operating profit is due to sales growth, lower metal consignment fees, and savings from cost reduction actions, which more than offset unfavorable manufacturing yields. The poor manufacturing yields experienced in Q2 are not forecasted to continue in the second half of 2019. We remain committed to return this business to the historical operating profit margins by year end.

Turning finally now to the Precision Coatings segment, second quarter value-added sales were \$23.1 million, compared to \$23.4 million in the second quarter of 2018. Sales were down slightly due primarily to weakness in the consumer electronics end market, more specifically, weaker demand in Asia for projector display products. Operating profit for the Precision Coatings segment totaled \$3.9 million in the second quarter of 2019, up 77% compared to \$2.2 million in the second quarter of 2018. As a percentage of value-added sales, operating profit margin was a record for any quarter at 16.9%. The increase was due to favorable products mix, manufacturing efficiency improvements, primarily in the optical coating product line, and lower precious metal consignment cost.

If you recall our comments in previous quarters for this business, product mix within an end market can significantly impact margins in any given quarter. During the quarter, we successfully delivered very high end optical filters and arrays into the aerospace and defense end markets. Looking at the first half of 2019 for this segment, operating profit margins totaled 13.2% of value-added sales, which is up 100 basis points over the segment's 2018 full year performance.

Moving now to the balance sheet and cash flow, we generated operating cash flow of \$30 million in the second quarter of 2019, up versus \$29.3 million in the prior year due to higher earnings and lower pension contributions, partially offset by increased working capital requirements to fund sales growth. The company ended the second quarter of 2019 with a net cash position of \$72.2 million, compared to a net cash position of \$39.5 million at the end of the second quarter of 2018.

Our balance sheet remains very strong, and we have significant available liquidity to support capital allocation priorities mentioned on previous calls, including organic growth opportunities, inorganic growth opportunities, and to consistently return capital to shareholders. In the second quarter of 2019, we announced an increase to our quarterly dividend of approximately 5%, representing the seventh consecutive year of increasing the shareholder dividend.

For financial modeling purposes in 2019, capital spending should run approximately \$30 million. Mine development investment should be less than \$5 million. Annual depreciation and amortization should run approximately \$40 million, due to timing of ore extraction versus pit openings at the mine.

And finally, now the earnings outlook for 2019. We have now delivered ten consecutive quarters of year-over-year value-added sales growth and profit growth driven by commercial and operational performance improvements. We remain committed to consistently delivering profitable growth over the long term. Based on our strong first-half performance, timing of shipments, current order activity, strategic investments, and our current view on end market demand for the remainder of 2019, we are raising the full year 2019 earnings guidance range to \$3.10 to \$3.25 per share. The midpoint of this range represents a 33% improvement over 2018 adjusted earnings of \$2.38 per share. From a quarterly guidance perspective, we expect the third quarter of 2019 earnings to be approximately 10% to 20% higher than third quarter 2018 adjusted earnings.

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

Operator

At this time, we will be conducting a question and answer session. [Operator instructions]. One moment, please, while we poll for questions.

Our first question is from Edward Marshall, Sidoti & Company. Please proceed with your question.

Q: Hi, guys. How are you? Good morning.

Jugal Vijayvargiya - President and Chief Executive Officer

Good morning, Ed. How are you?

Joseph Kelley - Vice President of Finance and Chief Financial Officer

Good morning, Ed.

Q: Good. So, I'm looking at AMT [Advanced Materials] to start. I guess there's been plenty of news about a troubled customer there that many of your customers, many of your people that you supply have seen some revision to their outlooks. I'm not seeing it in your results. I'm just kind of curious how you've been able to kind of navigate those waters, and maybe what you're seeing, and maybe how you look at the balance of the year around that particular customer?

Jugal Vijayvargiya - President and Chief Executive Officer

Ed, as we've already reported, we had another quarter of year-over-year sales growth and 12th consecutive quarter, and then Joe mentioned that even though semiconductor, which is what that customer that you were referring to falls under, based on that market was down 9% for us for the quarter, we were able to still deliver year-over-year growth, and I think that's where the very, very strong diversification efforts that we have in the company are paying off, and we are very focused on making sure the diversification continues across the company.

Now, with that said, let me just comment a little bit I think on that customer as well as maybe perhaps China in general because, obviously, that fits into the overall China situation. For us, our sales into China are less than 10% of our total value-added sales. Now, even though it's a meaningful number, I mean, it's not a significant part of our sales. So, we don't have the necessary exposure that maybe perhaps others you may have heard about that have overall with the China situation as well as perhaps to that customer.

The second thing is that we are probably two, or three, or four links back from the main supply chains that occur into that market, so the effect that we feel is typically lagging. So, maybe it's lagging two to three months. We are starting to see some slowdown in that market from China and from that customer in both I'll say direct sales as well as indirect sales that we'll feel the effect of here in the third quarter and perhaps in the fourth quarter depending on how long it goes, but I think I just want to continue to emphasize though that we are really focused on diversification and making sure that we have a very diversified market, and especially focusing in on what we consider higher margin type of markets. And as a result, we're able to deliver the year-over-year growth, and we're committed to deliver year-over-year growth top line for the balance of the year. That's our focus.

Q: Got you. And you gave the details on semi. I also understand there's some telecom with the 5G rollout as well that may go to that customer, but you've talked about telecom being very, very strong in backlog. Have you seen any impact on the telecom side at all from—

Jugal Vijayvargiya - President and Chief Executive Officer

No. In general, we're not seeing a direct impact. We have a very diversified customer base when it comes to the telecom and data side, so that customer is not the only customer for us. In fact, we have little, I would say, direct sales to that customer. And so, we are, I would say, going into the second half, I would classify probably neutral in that overall market.

Q: Got it. And then, finally, as we look at the reorganization of the segment levels, and I understand kind of the One Materion focus, I'm curious as you look across the three different larger, bigger segments that you have, Advanced Materials, PC, and Performance Alloys and Composites, where do you think you'll have maybe the initial successes of that cross-branding of Materion? For instance, maybe automotive or aerospace in one of the, say, Advanced Materials. I mean, where do you think you potentially will see the most growth and the soonest?

Jugal Vijayvargiya - President and Chief Executive Officer

So, I can talk about two or three markets, in fact, that I think we're actively involved in. Defense market is a big area for us, as you know, and we're actually actively involved in leveraging our relationships that we have on the PAC side. Particularly, we have relationships on the PC side as well, but we're really leveraging the PAC relationships to pull in our microelectronics packaging business into the defense sector much more. We're looking at the semiconductor side. We have really good relationships on the AM side with a number of customers, particularly in Korea, and so we've got a concerted effort in being able to take advantage of those relationships and pull in PAC. So, those are just maybe very real-time, specific examples I can give you of the semiconductor space, particularly in Korea as well as the defense market here in the U.S. for our AM business where we're looking at how we can expand our business.

What we did, Ed, is we've actually taken senior leaders, very, very senior leaders from within our company, and we've appointed market vice presidents or market leaders, market executives, whatever title you want to give them, to really look at what is the business that we have in that market today, what are the potentials that we could have as we go forward, and how do we step-by-step bridge to achieving those potentials. And I can tell you that our teams are excited about it. Our technology rollout work that we're doing across the company is starting to come together in terms of putting those three businesses and the teams together so they can start to leverage each other from the technology perspective, and so hopefully we can start to see some real good opportunities.

We have in support of this, by the way, and in general, we are accelerating our efforts for investment to be able to take advantage of this. We have a sizable, really meaningful investments, growth investments, planned for the second half in both our R&D and in our commercial arm to support all of these initiatives. So, I think the opportunities are there for us to get, and we're putting the steps in place to be able to get those.

Q: Good to hear. It'll be fun to watch. Joe, just real quick, the depreciation jumped in the quarter about \$4 million. Is that depletion? And if so, should I think about maybe PAC's margin actually potentially being a little bit higher in the future? I'm just trying to think that through.

Joseph Kelley - Vice President of Finance and Chief Financial Officer

So, that's due to our revision of our activity in the second half out at the mines, so we will be extracting more ore than previously anticipated, and so what that does is that drives mine amortization, which, as you're aware, recategorizes it up into inventory, so it won't put any pressure on margins from a historical run rate in the PAC business. It will pressure our working capital percentage as it moves it up into inventory.

Q: Got it. That's fair. Thanks, guys. I appreciate it.

Joseph Kelley - Vice President of Finance and Chief Financial Officer

Thank you.

Jugal Vijayvargiya - President and Chief Executive Officer

Thanks, Ed.

Operator

As a reminder, we are now conducting a question and answer session. [Operator instructions]. One moment, please, while we poll for questions.

Our next question comes from Phil Gibbs, KeyBanc Capital Markets. Please proceed with your question.

Q: Hi, good morning.

Jugal Vijayvargiya - President and Chief Executive Officer

Good morning, Phil.

Joseph Kelley - Vice President of Finance and Chief Financial Officer

Good morning, Phil.

Q: I was interested in the commentary on auto specifically. I know it was down pretty heavily, but you also talked a lot about targeted mix improvements in PAC, and I know a lot of this is beryllium copper strips, so are these also some of the areas where the mix has been light historically in the past as you've really shifted it?

Joseph Kelley - Vice President of Finance and Chief Financial Officer

I think as it relates to mix in automotive, our comments were we saw it particularly down in Asia and in Europe. I would say a portion of the Asia down is not just the market but intentional pruning as we are driving improvements to our mix. And again, in my comments, I mentioned strip sales in Asia were down approximately 30%, and that's more than just the market decrease. That was also driven by our strategic decision to prune lower-margin business.

Jugal Vijayvargiya - President and Chief Executive Officer

I think the other thing, Phil, to note here, when we talk about mix, and good mix, and continued improvement in the PAC business, we have to recognize that we're really pushing a lot on the aerospace side, on the defense side, and on the energy side. I mean, those are very important markets for us. Of course, telecom is more of an emerging market with 5G coming in, but we have share gains that we're delivering in really all three areas: aerospace, defense, and energy. More ToughMet, for example, in all three drilling exploration side, more parts, more material into the aerospace with the content for plane, as well as just additional planes that we're getting content on. And all of that business is business that we want to be in. It's a long-term type of contract that we end up having with these types of markets.

So, with auto experiencing some of the downturn, like you mentioned, and the downturn that we're experiencing as well, particularly in the Asia market and China market, I think the positive developments in these other markets and our focus on those other markets is balancing the drop.

Q: Good. That's kind of what I hoped or thought you'd say on that. In terms of the expected margin targets in AM by the end of the year, I think mid-teens, you reiterated that perhaps a couple of times, but that's also where a lot of the macro-challenges are with semiconductor and perhaps consumer electronics in the short term, smartphones, etc. I'm trying to think about how you get there with the macro-challenges that you may not have seen a quarter or two ago.

Jugal Vijayvargiya - President and Chief Executive Officer

That's a great point that you bring up because we are very focused on delivering top-line growth in that business despite the macro-challenges, right. I mean, semiconductor in total, like you mentioned, the customer that Ed mentioned earlier in China, the overall China market, so that area has a lot of external factors that are sort of pressing on it. But I think a couple of things: one, we're very focused on delivering on new products in that business, so we have a number of new products, especially on the memory side, that we're really challenging our team to launch and launch quickly. We already are in, I'm going to say, launch phase on some of them and pushing to deliver even more, faster. So, even though we may have some downturn on some of the things that you highlighted and that I've highlighted, we're trying to push other things that we can do to balance on that business.

I think the second thing is that we continue to see improvements in our integration and acquisition that we did. We mentioned to you guys in the last few quarters about the new plant that we had opened, making sure that we were doing the proper integration of that plant, launching of that plant. I think that's starting to go well, and we continue to see improvements there. And then, of course, qualifying customers so that we are able to have a good continued growth from that plant.

We also have a good growth in the energy market in that business. We have a really nice new business on the target side for smart window applications. That business is progressing really nicely well. We've developed, you could almost say, a partnership with one of the key customers, and so that business growth is starting to now come in. And then, in the second quarter, as part of these new products, we did have yield issues because as you can imagine, anytime you're launching new products, there's some challenges on the manufacturing side, and so we did have some yield issues in the second half [quarter], which we are really focused on in making sure that we're putting those two to bed.

So, when you put all those things together, all those number of things together, we feel that we'll continue to make progress on this business and exit the year at mid-teens. But I will tell you, it is very, very challenging, and in fact, it's probably becoming a lot more challenging than what we thought at the beginning of the year because of I think the continued headwinds from the overall end market side, but you know us, we're not giving up. We're making sure that we've got all the levers that we can pull to exit at mid-teens by the end of the year.

Q: That's really helpful. So, sounds like an approach kind of on all sides in terms of both new products and then also some of the integration and cost efforts too, so that's good to hear. On the pension comments, I think, Joe, you had made some in terms of the annuitization. You guys have done some really good work with the balance sheet and I guess on a lag here because pension expense I think it's been pretty stable the last couple years. You expect to see some improvement in 2020. Could you just remind us what that net expense is right now and then just give us a little flavor of what it could be?

Joseph Kelley - Vice President of Finance and Chief Financial Officer

So, when you look at the net expense now for our U.S. pension plan, it's running around, let's say, \$7 million on an annualized run rate. And so, going forward, that service cost component of it will go away. It'll be replaced with the DC contribution, so from an OP standpoint, there won't be a benefit. Where the benefit will come is down in other non-operating expense. There, you'll see a benefit of approximately \$2 million year-over-year, but as you know, that depends on asset return assumptions and discount rates. But based on where we sit today, we would anticipate approximately a \$2 million savings year-over-year.

Q: Thanks, guys, very much.

Jugal Vijayvargiya - President and Chief Executive Officer

Thank you.

Joseph Kelley - Vice President of Finance and Chief Financial Officer

Thank you, Phil.

Operator

We have reached the end of the question and answer session, and I will now turn the call back over to Steve Shamrock for closing remarks.

Steve Shamrock - Vice President, Corporate Controller and Investor Relations

Thank you. This is Steve Shamrock, and this concludes our second quarter 2019 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.