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Rockwell Automation, Inc. (ROK)

Q1 2020 Earnings Call – Prepared Remarks

Corporate Participants

Jessica Kourakos, *Head of Investor Relations, Rockwell Automation, Inc.*

Patrick Goris, *Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.*

Blake Moret, *Chairman & Chief Executive Officer, Rockwell Automation, Inc.*

Operator

Thank you for holding and welcome to Rockwell Automation's Quarterly Conference Call. I need to remind everyone that today's conference call is being recorded. Later in the call, we will open up the lines for questions. If you have a question at that time, please press *1.

At this time, I would like to turn the call over to Jessica Kourakos, Head of Investor Relations. Ms. Kourakos, please go ahead.

Jessica Kourakos

Head of Investor Relations, Rockwell Automation, Inc.

Good morning and thank you for joining us for Rockwell Automation's first quarter fiscal 2020 Earnings Release Conference Call.

With me today is Blake Moret, our Chairman and CEO, and Patrick Goris, our CFO.

Our results were released earlier this morning, and the press release and charts have been posted to our website. Both the press release and charts include, and our call today will reference, non-GAAP measures. Both the press release and charts include reconciliations of these non-GAAP measures. A webcast of this call will be available at that website, for replay, for the next 30 days. For your convenience, a transcript of our prepared remarks will also be available on our website at the conclusion of today's call.

Before we get started, I need to remind you that our comments will include statements related to the expected future results of our Company and are, therefore, forward-looking statements. Our actual results may differ materially from our projections due to a wide range of risks and uncertainties that are described in our earnings release and detailed in all our SEC filings.

So, with that I'll hand the call over to Blake.

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Jessica, and good morning everyone. Thank you for joining us on the call today. Please turn to page 3 of the slide deck.

I'll begin by saying that I'm pleased with our execution in the quarter and our start to the year. Despite a tough manufacturing environment, both revenue and earnings were slightly better than our expectations for Q1. Total sales grew 3%, including over 4 points of contribution from inorganic investments primarily related to our Sensia joint venture. Organic sales were down 1% compared to a strong quarter a year ago. Backlog, however, was up year-over-year as well as sequentially.

Organic sales performance continues to include market share gains in core platforms. For instance, Independent Cart Motion Control Technology grew strong double-digits for us in the quarter. It is becoming a game-changing solution across a broad range of industries and applications.

Information Solutions and Connected Services, or IS/CS for short, had another great quarter, also growing strong double-digits. We had notable wins in Life Sciences, Food & Beverage, our first MES win in Luxury Goods, a significant MES win in Mining, and our first-ever augmented reality project in Oil & Gas. Our broader and more differentiated portfolio gives us more ways to win in a wide variety of industries, including those where we are not the incumbent control platform. Recurring revenue in the quarter grew double digits, led by an increase in software subscriptions.

As I mentioned, our earnings performance was slightly better than expected. Segment margins and Adjusted EPS include one-time items related to Sensia as well as investments we are making to increase our long-term differentiation.

As we look ahead to the rest of the year, we are reaffirming our organic sales and adjusted EPS guidance for fiscal 2020. While there have been recent positive developments on global trade, and the macro-environment is showing signs of stabilization, it is still too early to see that impact on customer spending.

Let's now turn to slide 4 and go a little deeper into our vertical sales performance for the quarter. Discrete and Hybrid end market segments did a little better than we expected this quarter while Process was a little weaker than we expected.

Within our Discrete segment, Auto grew mid-single digits, largely related to higher program spend in North America and Asia Pacific, and stabilization in MRO, albeit at low levels. While this higher program spend was better than anticipated, the overall auto market is still relatively weak and we think it is premature to change our flat full year outlook for this vertical. Semiconductor sales were notably better in all regions, up high-single digits. Historically, our exposure to semis has been largely in facilities management, but we are also seeing new traction in material handling, IOT and cybersecurity applications.

Turning now to our Hybrid market segment. Food & Beverage declined low-single digits, reflecting some project delays. However, given what we are hearing from customers, and the activity we have seen at packaging OEMs, we still believe Food & Beverage will grow low-single-digits for the year.

In Life Sciences, we had another solid quarter, with sales growing both year over year as well as sequentially. As we've said before, this is an industry where our scalable architecture and our differentiation in IS/CS are well aligned and paying dividends.

Our Process market segment declined slightly, especially in Chemicals and Pulp & Paper. Organically, Oil & Gas grew mid-single digits this quarter, and we continue to expect low-single digits sales performance for the year. Sensia, which had a good start to the year, is expected to grow double digits based on its differentiation in the fast-growing, digital oilfield segment of this vertical.

Turning to slide 5 and our regional sales performance in the quarter. North America was down 3% organically, reflecting a weak manufacturing environment. The weakness in process industries was partially offset by Auto, up double-digits, and strength in Semiconductor. EMEA was up 2% in the quarter, led by Oil & Gas, Life Sciences, and Tire.

Asia Pacific grew by 6%, led by strong demand for Oil & Gas, Life Sciences, and Auto. Auto was up over 10% in the region and included strong gains at EV battery manufacturers where our readiness to serve is high. Our portfolio is demonstrating how well-positioned we are to benefit from the transition to EV. Latin America sales were down 1%, largely due to a tough comparison from last year and weaker performance in Automotive and Mining.

I'll now make a few additional comments on our other accomplishments in the quarter. Our annual Automation Fair was held last November in Chicago, and I'm proud to say that we reached a new all-time attendance record. Customers are focusing on outcomes, and sharply increased sales leads from the event indicate we are demonstrating our increased value for a wide variety of industries.

We also had record attendance at our Investor Day in November. There we highlighted our execution plans to accelerate profitable long-term growth, while at the same time build even greater resiliency in our business through higher recurring revenue streams and a leaner, more flexible cost structure. We also had exciting new partners at the event, including Schlumberger, Accenture, and Ansys, which is a game-changing technology partner for simulation and digital twin applications. We are seeing our partnerships contribute to many strategic wins.

And we had some great wins this quarter, including in Life Sciences across all major geographies.

In Europe, we signed a major agreement with Roche. Roche will be implementing our PharmaSuite MES platform across 16 plants in their Pharma and Diagnostics divisions.

In North America, we entered into a new multi-site, multi-year agreement with a major pharmaceutical producer. They selected FactoryTalk Innovation Suite to drive their Digital Transformation program for a connected plant and supply chain. It will provide a common platform to drive real-time visibility of analytics to the operator, plant and enterprise levels, predict future events to avoid unplanned downtime and improve energy efficiency, and accelerate knowledge transfer and improve ease of use. Once implemented, this solution will eliminate hundreds of overlapping edge solutions, resulting in significant operational savings.

In China, Ruiying Pharma Group, a large pharmaceutical company, chose Rockwell to transform their factories to become smarter and more predictive, while at the same time assisting them to oversee quality management and ensuring that they comply with regulatory requirements.

From regulatory compliance, to safety and energy efficiency, Rockwell is becoming an increasingly important partner of our customers' ESG initiatives. In addition to what we are doing in our own facilities, everything we do for customers is about increasing efficiency, reducing energy usage, improving worker safety, and ensuring regulatory compliance - all of which lowers business risk and is good for the environment.

Now, turning to slide 6, let's talk a little more about our inorganic investments which are becoming an increasingly important complement to our long-term organic growth strategy. Starting with Sensia, this was our first quarter including Sensia as a fully operational joint venture consolidated in our results, and

I'm very pleased with its performance in Q1. Operationally, Sensia's top line grew double digits with strong traction at marquis Oil & Gas customers around the world. Our sales teams have been fully integrated, and we are looking forward to the launch of new solutions and products that will contribute to the double-digit sales performance we expect this year.

We also announced the acquisition of MESTECH at the beginning of Q1. MESTECH is an industrial software consulting and delivery services company based in India, and they have already been instrumental in winning key business for us in the quarter.

Earlier this month, we announced the acquisition of Avnet Data Security, a cybersecurity provider based in Israel with over 20 years of experience. Cybersecurity is one of the fastest growing parts of our services business. The extensive knowledge and experience of the Avnet team will support our company's strategic objective to achieve double-digit growth in Information Solutions and Connected Services by expanding our IT/OT cyber and network expertise globally. Plus, this acquisition will establish a global cybersecurity Center of Excellence for us in EMEA. This includes a remote managed service center and expands our portfolio of capabilities including a full training curriculum and labs.

As you can see, we are actively deploying capital to advance our strategic priorities to accelerate share gains in our core business, continue growing double digits in IS/CS, grow domain expertise in process, and accelerate our market access in Europe and Asia. We are focused on driving value with more intensity than ever before.

Let me now turn it over to Patrick who will elaborate on our first quarter financial performance and fiscal 2020 outlook in his remarks. Patrick?

Patrick Goris

Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.

Thank you, Blake, and good morning everyone.

I'll start on slide 7, "First Quarter Key Financial Information". First quarter reported sales were up 2.6% year over year. As expected, organic sales were down 1%. Acquisitions, which mainly represent the impact of Sensia, contributed 4.5 points of growth, better than expected. Currency translation decreased sales by 0.9 points, a higher headwind than we expected.

Segment operating margin was 20.1%, down 270 basis points compared to last year. About half of the year-over-year decrease relates to the impact of acquisitions and related one-time costs, primarily Sensia. The other half of the year-over-year margin decrease is about evenly split between higher investment spending and unfavorable mix.

General Corporate – Net expense of $32.8 million was up $11 million compared to last year. The increase is due to the impact of mark-to-market adjustments related to our deferred and non-qualified compensation plans and Sensia-related transaction fees.

The Adjusted Effective Tax Rate for the quarter was 7.9% compared to 18.7% last year. About half of the reduction in the year-over-year tax rate is due to a Sensia $19 million one-time tax benefit. The remainder is other discrete items, primarily tax benefits from option exercises.

Adjusted EPS of $2.11 was a bit better than we expected, and down $0.10 compared to the first quarter of last year, a decrease of 5%. The year-over-year decrease in Adjusted EPS is primarily due to lower organic sales, particularly in some of our product businesses leading to unfavorable mix, and higher investment spending. Partially offsetting that is a lower tax rate excluding the Sensia impacts, and the net benefit of a lower share count and higher net interest expense. The net year-over-year Adjusted EPS contribution of Sensia in the quarter was one penny. The Sensia contribution of one penny includes a $0.07 larger-than-expected headwind related to one-time items. Free Cash Flow was $194 million in the quarter, or about 80% of Adjusted Income. During the quarter, we paid the annual bonus that our employees earned in fiscal 2019.

A few additional items not shown on the slide: for Adjusted EPS, average diluted shares outstanding in the quarter were 116.6 million, down 4.9 million or about 4% from last year. We repurchased about 0.5 million shares in the quarter at a cost of $100 million. This is in line with our full year target of about $400 million. At December 31st, we had $1 billion remaining under our share repurchase authorization.

Slide 8 provides the sales and margin performance overview of our operating segments. The Architecture & Software segment had modest organic growth in the quarter. Segment margin was very strong at 29.8% and a bit lower than the record margin last year, mainly due to increased investment spending.

Organic sales of the Control Products & Solutions segment decreased 2.5%. Inorganic investments increased sales by 8.2% compared to last year. Sensia accounts for almost all of the inorganic growth. Organic sales for our solutions and services businesses in this segment was down about half a point year-over-year. The higher margin product businesses in this segment were down about 5% on an organic basis.

First quarter organic book to bill performance for our solutions and services businesses was 1.12, typical for a first quarter. Operating margin for this segment of 12.4% was down 310 basis points compared to Q1 last year, primarily due to Sensia one-time items, lower organic sales, and unfavorable mix**.** Segment margin excluding the year over year impact of Sensia was about 14%.

In the appendix, you will find two slides with a more detailed overview of the year-over-year incremental impact of Sensia for Q1 and for full year fiscal 2020 outlook. It is the same format we provided to you at our investor day. As I mentioned earlier, from an operational viewpoint, Sensia sales and earnings were a bit better than we expected. Non-recurring items, including the tax benefit, were $0.07 worse than we expected in the first quarter, primarily due to larger purchase accounting adjustments and a lower tax benefit. For full year fiscal 2020, we now expect the net year-over-year impact of Sensia to be about neutral to Adjusted EPS.

The financial framework we shared with you at investor day last November remains valid with Sensia. We continue to target 30 to 35% earnings conversion for Rockwell assuming mid-single-digit organic sales growth.

This takes us to slide 9, guidance. Our outlook for fiscal 2020 remains unchanged compared to our November guidance. We are maintaining our sales growth and Adjusted EPS guidance ranges.

For Adjusted EPS, in essence, compared to prior guidance, small headwinds due to Sensia one-time items, currency, and a higher share count are offset by a somewhat lower Adjusted Effective Tax rate. The lower tax rate is the result of a higher excess income tax benefit related to share-based compensation.

General Corporate – Net is now expected to be closer to $105 million. Purchase accounting amortization expense for the full year is expected to be about $40 million, up $20 million compared to last year. Net interest expense for fiscal 2020 is still expected to be about $100 million. We expect Non-Controlling-Interest to be about $10 million, or a $0.10 charge to Adjusted EPS.

Average diluted share count is now expected to be 116.5 million for fiscal 2020, and our Adjusted Effective Tax Rate is expected to be closer to 15.5%, which includes about a 150 basis point one-time benefit related to Sensia. We continue to project free cash flow conversion of about 100% of Adjusted Income.

Finally, we continue to project a weaker first half of the year, with organic sales down low single digits, followed by a stronger second half of the year. And as is typical for us, we expect weaker 2nd quarter Adjusted EPS performance versus the 1st quarter.

With that, I'll hand it to Jessica to start Q&A.

Question and Answer Section

Jessica Kourakos

Head of Investor Relations, Rockwell Automation, Inc.

Thank you. I'll turn it back to Blake for a few final comments.

Blake D. Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Jessica. As we've been discussing, I'm happy to see our new offerings delivering significantly increased value for customers. We've never been better positioned with a more differentiated offering, as the convergence of IT and OT creates tremendous new opportunities.

Our employees and partners continue to set us apart, and we're excited about the journey ahead.