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Rockwell Automation, Inc. (ROK)

Q2 2024 Earnings Call – Prepared Remarks

Corporate Participants

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

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

Aijana Zellner, *Head of Investor Relations & Market Strategy, 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 Aijana Zellner, Head of Investor Relations and Market Strategy. Ms. Zellner, please go ahead.

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thank you, Julianne. Good morning and thank you for joining us for Rockwell Automation's second quarter fiscal 2024 earnings release conference call.

With me today is Blake Moret, our Chairman and CEO, and Nick Gangestad, 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 on our 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 it over to Blake.

Blake Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Aijana, and good morning, everyone. Thank you for joining us today.

Before we turn to our second quarter results on slide 3, I'll make some initial comments. At a high level, our performance in Q2 was good, but I am not happy with the reduced guidance for the full year. The impact of high inventory levels at machine builders is larger than we expected. Orders are still expected to return to year-over-year growth in Q3 and continue to increase during the year, but the slower ramp is impacting shipments for the second half.

Consequently, here's what we are doing. We are accelerating actions to bring costs in line with the revised outlook on current year orders, aligned with the more comprehensive program to expand margins introduced during our Investor Day in November. We will save $100 million in the second half of this year from accelerated actions being taken now, creating a beneficial starting point for fiscal year 25. We will see incremental savings of $120 million next year from these actions alone, plus a larger amount of additional savings from the more comprehensive program targeting sourcing, manufacturing, and SG&A. And we will provide a more detailed view of this program on our next earnings call. We are improving our forecasting with new perspectives on the team, processes that include a deeper analysis of channel information, and better decision support technology.

I'm optimistic about our position when we exit fiscal year 24, regardless of next year's growth for several reasons. Rockwell has built an unmatched portfolio to meet the world's growing need for smart manufacturing. Our home market, North America, is expected to grow faster than the worldwide PAM. We are winning major new business, today, with both our traditional offerings and new sources of value, across Discrete, Hybrid, and Process industries. As we couple this with our focus on margin expansion through cost discipline, operational excellence, and organic growth, we will achieve the longer-range targets introduced in November and create significant shareowner value.

Turning to the quarter, as we indicate on slide 3, we returned to good operational performance in the second quarter, with both organic sales and Adjusted EPS above our expectations. Sales of product, configure-to-order offerings, software, and lifecycle services were all at or above our forecast. In products, we converted incoming orders at a much higher level than in Q1, and we now have sufficient mix of safety stock in place to convert orders at the current level or higher through the balance of the fiscal year. We are essentially back to booking and billing product orders in the quarter they are received at pre-pandemic conversion rates.

Our orders were up low double digits sequentially, with continued recovery across all business segments and regions. North America had the highest sequential increase in the quarter. Year-over-year, total sales were down 6.5% in the quarter, based on an organic sales decline of 8% and a point and a half of acquisition growth.

In our Intelligent Devices segment, organic sales declined about 7.5% year-over-year. I am pleased with our execution to meet our shipping commitments and build safety stock in the quarter for these products.

We also continue to see strong performance from our recent Clearpath acquisition, with sales of autonomous mobile robots contributing almost 2.5 points to ITD growth in the quarter. One notable Clearpath win this quarter was with the Hershey Company. The Hershey Company continues to advance digital capabilities to enhance agility and efficiency across its operations including supply chain and manufacturing processes. As part their efforts, Hershey has selected Otto Motors' technology to improve productivity in both fulfillment and manufacturing operations. Q2 margin performance for Clearpath was also better than expected.

Software & Control organic sales were down 23% versus prior year, largely as we expected. As you know, this segment is significantly impacted by difficult year-over-year comparables in our Logix business. In Q2 of last year we had 42% growth in Software and Control. There are particularly high levels of these products in inventory at our machine builders. Despite this temporary correction, we are gaining Logix share and winning new business across our software and hardware offerings. I'm proud of the vitality of our product development here, demonstrated by recent organic product launches, and partnerships with Microsoft and Nvidia that are focused on specific customer use cases, especially those that will benefit from simulation and simplification using artificial intelligence. These partners recognize that machines and manufacturing processes represent an enormous, largely untapped source of data, and Petabytes of this data flow through our controllers. They also know we have the manufacturing domain expertise to select the best use cases for their technology.

Lifecycle Services organic sales grew over 12% year-over-year and continue to outperform our expectations, driven by strong process end markets. Book-to-bill in this segment was 1.07, led by good order growth in our solutions and Sensia businesses. Our Sensia JV saw another quarter of over 25% year-over-year sales growth in Q2.

The Lifecycle Services segment also continues to contribute strong growth from our high-value services, including Cybersecurity, which saw orders growth of almost 50% in the quarter. We are making substantial progress to expand Lifecycle Services margin. We saw 16% margin this quarter, and we're not done working on the performance of this business segment.

Total ARR was up 20% again this quarter. We continue to see strong, profitable recurring growth from both high value services and software. Rockwell segment margin was 19%. This would have been about 17% without the reversal of the bonus accrual we recorded in the quarter. Adjusted EPS of $2.50 was above our expectations, even after adjusting for the reversal of the bonus accrual. Nick will cover this in more detail later on the call.

Let's now turn to slide 4 to review key highlights of our Q2 industry segment performance.

Sales in our Discrete industries were down high teens versus prior year. The impact of high product inventory levels in the channel are most pronounced in our Discrete and Hybrid industry segments. Automotive, eCommerce, and other Warehouse Automation sales were all impacted.

Within Discrete, Automotive sales were down 20%. Much of this year-over-year weakness is driven by excess product inventory in our channel. However, we are also starting to see some impact on our fiscal 2024 sales as customers take time to re-evaluate the timing of their EV investments. While we are not seeing any EV or battery project cancellations, we are seeing pushouts of certain production start dates. As we've mentioned, given our strong installed base and expanded portfolio, Rockwell is well-positioned with automotive customers, whether they are investing in electric vehicles or adding more hybrid options in the near term. They are all interested in increasing efficiency.

In addition to our traditional sources of value, Clearpath autonomous mobile robots helped us secure over half a dozen wins with major brand owners and Tier 1 suppliers this quarter. Semiconductor sales declined 25% year-over-year, with continued geopolitical pressures and a temporary oversupply of legacy chips weighing on semi customers' capex investments.

Our sales in eCommerce and Warehouse Automation were down high teens this quarter. We did see an improvement in sequential growth and increased our full-year sales outlook. We're re-building a strong warehouse pipeline with traditional retailers and global shipping and logistics customers.

Turning to our Hybrid sales, this industry segment was down mid-teens year-over-year. The weakness in this industry segment was led by Food & Beverage and Home & Personal Care. Food and Beverage sales declined 20% in the quarter, driven by slower activity at our packaging OEMs, who are still working through their excess inventory. There are also some signs of slower end user capex spend. Food and Beverage end users are continuing to fund capacity expansion in emerging markets like India and Southeast Asia, and modernization and resilience projects across their existing facilities. We had wins in the quarter including the AMR project I mentioned earlier and cybersecurity projects at new customers.

Life Sciences sales were down high-single digits. Results in the quarter were mainly driven by project delays, especially in China. Outside of that region, we continue to expand our installed base with newer software and hardware offerings. One example of new value in this vertical was an important Q2 order with an innovative contract manufacturer, National Resilience, who selected Clearpath to provide a comprehensive AMR solution as they bring cell and gene therapies to market.

Moving to Process, our sales here grew high single digits year over year, supported by continued strength in Oil & Gas and Mining. Oil & Gas sales were up over 20% this quarter, with continued momentum in energy transition projects. In Q2 we secured multiple decarbonization projects, including applications for carbon capture, storage, and hydrogen.

Let’s turn to slide 5 and our Q2 organic regional sales. The Americas continue to be our strongest region this year, with Latin America growing 8% versus prior year and North America organic sales down about 4% in the quarter. EMEA sales decreased 19%, due to high machine builder inventory in Germany and Italy, particularly in Consumer Packaged Goods. Asia Pacific sales declined 17% in the quarter, with sales in China down almost 30% versus prior year. We expect a combination of weaker market conditions and slower distributor destocking to continue to impact our China performance through the balance of this fiscal year.

Moving to slide 6 for our fiscal 2024 outlook. As I mentioned at an investor conference in March, while orders continue to increase sequentially from the trough in Q4 of last fiscal year, we have not yet seen the acceleration we expect once distributors and machine builders work through their excess inventory. The result is that some of the demand they are seeing does not translate to an equal amount of orders placed on Rockwell. I also said that if the pace of orders continued on its current trajectory, we would expect our full year 2024 financial results to track closer to the low end of both our organic growth and EPS range.

Since then, we've seen lower than expected order activity. While distributors and machine builders are continuing to work through their excess inventory, we have underestimated the amount of overstock at our machine builders. Based on information received directly from our largest machine builders, our downward revision is based largely on the size of their inventory and the expected pace of the reduction, resulting in a slower ramp of orders in the fiscal year. Again, we do expect to return to year-over-year growth in orders for the third quarter, and our updated forecast still implies sequential order growth in Q3 and Q4.

We believe we are taking share in our major product lines, globally and in the US. North America is our strongest market, and we are starting to see an increased order impact from customer mega-projects as the year progresses. We now expect our full-year orders to be down low-single digits versus prior year.

Based on our performance to date and the lower-than-expected order ramp, we are revising our fiscal 2024 sales guidance range with organic sales projected to decline 7% at the midpoint. And we continue to expect acquisitions to contribute a point and a half of growth. ARR is still expected to grow about 15%.

Segment margin of 20% is now expected to decline versus prior year, which still implies an increase in the second half, and specifically in fiscal Q4, driven by higher volume and the accelerated cost-out actions I mentioned earlier. Nick will share additional detail in his section.

Adjusted EPS is slated to decrease 13% year over year at the midpoint. We are increasing planned share repurchases to roughly double our original plan for the year, and we expect Free Cash Flow conversion of 80%. This is a reduction from our prior guide, and Nick will cover this in more detail later.

The reduced guide for the fiscal year only strengthens our commitment to building a strong foundation for future growth and profitability. The company-wide program to comprehensively take cost out of our products and operations will positively impact our results next year. Savings will be used to expand margins and re-invest to drive future growth. We will provide additional detail no later than the Q3 earnings call. Our intention is to manage our business segments for consistent, forecastable performance.

You have also seen the announcement of Nick's upcoming retirement. A search has been underway, and we expect to announce a new CFO in the coming months. Nick will be fully engaged in the transition to his successor. And he'll now provide more detail on our Q2 performance and financial outlook for fiscal '24. Nick?

Nicholas Gangestad

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

Thank you, Blake. And good morning, everyone. Although my family and I are excited about what comes next in retirement, my continued focus is on delivering our plans for this year and ensuring a smooth, seamless transition to a new CFO.

I'll start on slide 7, Second Quarter Key Financial Information.

Second quarter reported sales were down 6.6% compared to last year. Q2 organic sales were down 8.1% and acquisitions contributed 140 basis points to total growth. Currency translation increased sales by 10 basis points. About 150 basis points of our organic growth came from price, in line with our projections. Segment operating margin was 19.0% compared to 21.3% a year ago. This 230-basis point decrease reflects lower sales volume, partially offset by lower incentive compensation.

Adjusted EPS of $2.50 was higher than expectations. Given our lowered outlook for fiscal 2024, we did not accrue any bonus expense in Q2 and we reversed the prior quarter bonus accrual. This resulted in a total Adjusted EPS benefit of approximately $0.30 in the quarter. Even without the bonus impact, our Q2 Adjusted EPS was ahead of our expectation due to better than expected conversion of incoming orders into sales. I'll cover a year-over-year Adjusted EPS bridge on a later slide.

The Adjusted Effective Tax Rate for the second quarter was 14.8%, below the prior year rate. Free Cash Flow was $69 million compared to $156 million in the prior year. Our lower year-over-year Free Cash Flow generation in the quarter was driven by lower pre-tax income and higher tax payments, partially offset by decreases in working capital. The increased tax payments relate to our gain on our sale of PTC shares in FY 2023 and our payments on the 2018 TCJA transition tax.

One additional item not shown on the slide. We repurchased approximately 700,000 shares in the quarter at a cost of $195 million dollars. On March 30, $600 million remained available under our repurchase authorization.

Slide 8 provides the sales and margin performance overview of our three operating segments.

Intelligent Devices margin decreased to 16.5% compared to 20.2% a year ago. The decrease from the prior year was driven by lower sales volume and unfavorable mix, partially offset by lower incentive compensation. Higher sequential margin was driven by better volume and lower incentive compensation, partially offset by mix.

Software & Control margin of 25.7% decreased from 33.6% last year. The lower margin was driven by lower sales volume partially offset by lower incentive compensation, positive price/cost, and favorable mix, driven by higher software sales. Higher sequential margin was driven by lower incentive compensation, partially offset by lower volume.

Lifecycle Services margin of 16.6% tripled from the year-ago margin of 5.5%. The margin performance was driven by lower incentive compensation, higher sales, and higher margins in Sensia. Higher sequential margin was driven by volume, lower incentive compensation, and ongoing improvements in productivity. Lifecycle Services book-to-bill was 1.07 indicating continued strength in underlying demand.

The next slide, 9, provides the Adjusted EPS walk from Q2 fiscal 2023 to Q2 fiscal 2024.

Core performance was down $1.15, on an 8% organic sales decline. The EPS decline was driven by lower volume and unfavorable mix and was partially offset by positive price/cost. Incentive compensation was a $0.55 tailwind. This year-over-year improvement reflects no projected bonus payout this year vs. an above-target payout last year. The dilution impact from acquisitions was neutral due to better than expected profitability in Clearpath and Verve. The year-over-year impact from tax was a $0.10 tailwind.

Let’s now move on to the next slide, 10, guidance for fiscal 2024.

We are lowering our guidance for fiscal year '24. We now expect reported sales to decline in the range of -6.0% to -4.0% and organic sales to decline in the range of -8% to -6%. As Blake mentioned earlier, we continue to expect acquisitions to add 150 basis points to growth.

We now expect currency to contribute about 50 basis points to growth as we are seeing continued strengthening of the US dollar. We continue to expect price to be a positive contributor to growth for the year. We expect the full year Adjusted Effective Tax Rate to be around 17%. We are lowering our Adjusted EPS guidance to a range of $10.00 to $11.00.

We now expect full-year fiscal 2024 Free Cash Flow conversion of about 80% of Adjusted Income. The lowered expectations for Free Cash Flow conversion percent is driven by the fact that the positive earnings impact from zero incentive compensation recorded this fiscal year does not result in better cash generation this year. This is because payout of any annual incentive compensation occurs in the first quarter of the following fiscal year. Therefore, we will see the benefit of this on our cash flow conversion in fiscal year 25. From an inventory standpoint, we continue to expect that inventory days on hand will drop to 125 days by the end of fiscal year 24 compared to the 140 days of inventory we had at the end of fiscal year 23.

From a calendarization perspective, we expect mid-single digit sequential order growth in Q3 and high-teens sequential order growth in Q4. We expect Q3 sales dollars and segment margin to be lower than Q2 levels. Now that we have largely cleared our product backlog, we are generating most of our product sales from new orders in the quarter, which are ramping up slower than we expected. We expect Q4 to be the highest revenue dollar and margin quarter of the year.

From a sequential margin perspective, we expect margins in Q3 to be about 250 basis-points lower than in Q2 due to the non-repeat of the bonus accrual reversal that benefitted Q2, also lower volume, and mix. By segment, we expect our Q3 margins to be up slightly in Intelligent Devices, down significantly in Software & Control due to lower Logix controller sales, and flat in Lifecycle Services.

As Blake mentioned, we are adjusting our spending level with the lower outlook for this fiscal year. Last quarter, we expected our full-year FY24 investment spending to increase by $60 million year-over-year, or to be up about 2%. We now expect our full-year spend to be down approximately $50 million versus prior year.

This ~$100 million spend reduction in the second half of fiscal ‘24 is driven by a combination of structural and temporary cost-out actions, which will help protect our margins in the current fiscal year and will set the right foundation for fiscal year 25 and beyond. Some examples of temporary cost reduction items include not filling open positions, reducing contractor spend, and further reducing our travel and marketing spend for the year. In terms of structural actions, we are expecting about $60M of restructuring charges related to headcount reductions in the second half of the fiscal year. The expected restructuring charges are excluded from our Adjusted EPS. These savings and our continued cost structure optimization are aligned with our longer-term productivity focus and profitability targets.

A few additional comments on fiscal 2024 guidance. Corporate and Other expense is now expected to be around $130 million. We’re assuming average diluted shares outstanding of 114.3 million shares. We expect to deploy between $600 and $800 million to share repurchases during the year. This is an increase from our prior range of $300 to $500 million and reflects a higher near-term prioritization of returning cash to shareholders versus acquisitions. Net interest expense for fiscal 2024 is now expected to be about $135 million.

With that, I’ll turn it back over to Blake for some closing remarks before we start Q&A.

Blake Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Nick.

We are focused on getting synergies and efficiencies throughout the entire organization. The portfolio of capabilities that we have built and bought is second to none, and now is the time to knit all these pieces together. This will help us drive more customer value, efficiency, and cost savings, which in turn will yield higher margins and funds for re-investment.

Aijana will now begin the Q&A session.

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thanks, Blake. We would like to get to as many of you as possible, so please limit yourself to one question and a quick follow up. Julianne, let's take our first question.

Q&A Session

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thank you, everyone, for joining us today. That concludes today's conference call.