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Neenah, Inc. (NP)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and thank you for standing by. Welcome to the Neenah Q2 2021 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' presentation there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Kyle Anderson, Vice President of Corporate Strategy and Investor Relations. Please go ahead.

Kyle Anderson

Vice President-Corporate Strategy & Investor Relations, Neenah, Inc.

Good morning and thank you for joining us on Neenah's second quarter 2021 earnings call. On the call with me today are Julie Schertell, Chief Executive Officer and Paul DeSantis, Chief Financial Officer. By way of introduction, my name is Kyle Anderson and Paul and I will be responsible for investor relations following the retirement of Bill McCarthy. I've been with Neenah in various roles since 2004 and I look forward to working with you in this new capacity. Julie and Paul will discuss recent activities and results as well as share some thoughts on our strategy as we look ahead in the year.

We issued a press release covering financial results yesterday afternoon and hopefully many of you have had a chance to review that information. As always, actual results could differ from these forward-looking statements due to risk noted on our website and in our SEC filings. Following our prepared remarks, we will open the call for questions.

In second quarter, we continued our growth momentum with adjusted earnings of \$0.65 per share excluding \$2.41 of unusual costs. In second quarter 2020, the adjusted loss per share of \$0.08, excluded \$2.90 of such costs. Details of these adjusting items along with a reconciliation to GAAP amounts can be found in our press release.

With that, I'd like to turn things over to Julie.

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Thanks, Kyle, and good morning, everyone. Second quarter was very active and we continue to demonstrate strong traction both in terms of operating performance and in executing our strategy. I want to start by highlighting our safety performance. The health and well-being of our employees is our number one value. And I'm proud to say we continue to make solid progress toward a zero injury culture. We reached a new safety milestone for recordable incidents during the quarter. And currently more than half of our facilities are over 100 days incident free.

Now, turning to operating performance, second quarter showed continued top line momentum with near record quarterly revenue driven by strong organic growth in all categories especially in technical products where we achieved an all-time record for the quarter. Demand was strong with improving conditions in end markets, share gains, and new product placement with key customers. We also successfully completed the ITASA acquisition and initiated both the restarting of an idled asset and the closure of our Appleton facility, driving meaningful value in all cases.

As with many companies, we are experiencing near-term challenges from supply chain disruptions and rapidly increasing input costs. We're continuing to work through these disruptions, but expect them to continue throughout the third quarter. During this time, we have effectively been able to gain share due to our ability to quickly commercialize alternative solutions for our customers. However, the higher costs are impacting our margins in the short-term. We've taken pricing actions across our entire portfolio and in some cases multiple times in order to address the extraordinary level of raw material inflation we are experiencing. The timing of our pricing actions varies by business, but all business lines have either implemented price increases or communicated to customers an increase that will be effective in early 2022.

I'm confident we will offset these raw material cost increases this year through our volume price and cost initiatives. And we'll enter 2022 on a good margin trajectory and with additional pricing actions becoming effective. In addition to our operating performance, we're clearly focused on advancing our ESG efforts. From an environmental standpoint, we were recently recognized with a Focus on Energy Award for Energy Efficiency Excellence at our largest North American facility.

We also welcome the new member to our board of directors, Shruti Singhal. Shruti has a global leadership experience with Dow Chemical and Henkel and is currently the CEO at Chroma Color. We're pleased to welcome Shruti and believe he will further strengthen our board. I'm encouraged with our execution during the quarter as well as the meaningful progress in activating our long-term strategy, which I'll cover later in this call.

Now, I'd like to turn it over to Paul to review financials.

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

Thanks, Julie and good morning everyone. The second quarter was extremely busy for Neenah as we took actions to drive our strategy including the successful completion of the ITASA acquisition at the beginning of the quarter, which resulted in \$33 million of sales and accretive EBITDA margins in the high teens. Synergy realization is on track.

From a cash earnings perspective, the business contributed about \$0.15 per share for the quarter. We announced the closure of the Appleton facility, which is expected to result in annual savings of \$7 million to \$8 million beginning in the fourth quarter of this year. We began to see unprecedented raw material cost increases as expected, and we continue to respond with pricing.

In some of our businesses, we've announced multiple price increases as we work to offset the rapidly evolving input cost environment. We announced the restart of a production line in Neenah Wisconsin as a result of the success of our Fine Paper and Packaging team's efforts to drive volume. We committed \$13 million of capital for a new coater to support our recently acquired release liner business as we continue to see the growth we have expected in a location that was a greenfield less than three years ago. And we've refinanced our debt at favorable terms to support our acquisition and reduce cash costs.

Sales reached \$269 million, up \$108 million from last year's pandemic-influenced second quarter, and up \$42 million from the first quarter of this year. This quarter's result includes \$33 million from the ITASA acquisition. Technical Products sales were a record \$180 million, up 79% from last year and up 24% sequentially from the first quarter. Fine Paper and Packaging sales were \$90 million for the quarter, up 48% from last year and up 10% sequentially from the first quarter. We were pleased with the results in a number of our key businesses including filtration, packaging, industrial solutions, and release liners, all of which performed well during the second quarter.

Adjusted earnings were \$19.3 million compared to \$500,000 in last year's second quarter. In the first quarter of 2021, we reported adjusted earnings of \$26.1 million. The second quarter results reflect the rapid increase of input costs which, as anticipated, are impacting the business in advance of our pricing initiatives. As our pricing actions, volume increases, and other efficiency initiatives begin to take hold, we expect to offset the impact of the cost increases by the end of the year.

Technical Products adjusted earnings were \$14.7 million, up from \$5.8 million in the last year's second quarter and down from \$19.5 million in this year's first quarter, reflecting the disproportionate impact of raw material cost increases in this segment. The second quarter results for technical products compares favorably to the almost \$13 million delivered during the second quarter of 2019, reflecting the strength in underlying markets such as filtration as well as the impact of the ITASA acquisition.

Fine Paper And Packaging adjusted earnings were \$10 million for the second quarter, up from last year's loss of \$600,000 and down from \$12.8 million in this year's first quarter. Again, reflecting the impact of raw material costs and the timing of price increases. We're pleased with the top line performance of Fine Paper And Packaging as we're seeing it recovered to 90% of the pre-COVID run rate as expected.

Turning to the balance sheet and cash flows, liquidity remains strong while cash flow from operations of \$23 million was down from the \$44 million recorded for the first six months of last year. The difference was due to working capital reflecting the rebound in business. Trailing 12-month adjusted EBITDA reached \$121 million as of June 30 this year compared to the \$101 million we recorded last calendar year as we see the benefits of our continued growth and the impact of the ITASA acquisition.

As a result of the strong EBITDA growth and free cash flow, we're on a path to see adjusted net leverage dropped to approximately 3 turns by the end of the year, absent any other actions. Year-to-date CapEx was \$11 million versus \$8 million last year. We're expecting CapEx to pick up in the second half of the year getting us into the low to mid \$30 million range as safety, growth and cost reduction initiatives are implemented including the beginning of the \$13 million of ITASA expansion CapEx.

Our effective income tax rate was a benefit of 21% in the second quarter of this year compared to a benefit of 19% in the second quarter of last year. Both periods were significantly impacted by the effects of impairment losses, which will not repeat. And this year's 21% rate includes the effects of the acquisition of ITASA and associated acquisition costs. ITASA carries a blended tax rate in the mid-20s, so our tax rate is expected to rise slightly from our historical rate as we will be around 23% for this year.

As we mentioned in the Q1 earnings call and you can see in our Q2 results, we continue to face rapid escalation in input costs including many fibers reaching all-time high pricing levels during the second quarter. Global demand resurgence has significantly contributed to widespread shortages in many chemical markets resulting in a limited number of raw material shortages and stubbornly elevated costs for many materials.

The input cost increase has significantly impacted our results in Q2. Trends in the past month are beginning to indicate that our costs will peak in Q3 and generally stabilize in Q4. As we mentioned, our teams are continuing to work to offset these input costs with pricing action. We expect the impact of the input costs in the third quarter to be \$7 million to \$8 million incremental to that of the second quarter of which we expect to offset about half of the additional costs directly with our pricing initiatives as they begin to gain steam.

Also, as a reminder, we have most of our annual maintenance downs in the third quarter, which adds \$1 million to \$2 million to quarterly costs. As I said earlier, we expect to fully offset the increases by the end of the year through a combination of pricing actions, volume increases and efficiency improvements. And we expect to see the gap between raw material costs and pricing begin to narrow in the fourth quarter.

And on that note, I'll turn it back to Julie.

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Thanks, Paul. As we wrap up the call, I wanted to provide some additional comments on how we are executing our strategy and positioning Neenah for long-term value creation. We're focused on building our business into one that rewards shareholders by consistently growing the top line at around 5% annually, achieving mid-teen operating margins, earning returns above our cost of capital and generating significant cash flow.

Our success starts with growth and we have four targeted platforms to fuel our growth; filtration media, specialty coating, engineered materials, and imaging and packaging. These platforms provide a framework that creates focus and guides resource allocation, investment decisions, innovation and M&A efforts.

Further, this approach offers ways to extend the business while remaining aligned with Neenah's core strengths, including our asset and technical capabilities, and material science know-how. Using these four growth platforms as a backdrop, let me provide a few examples of recent progress and successes, which are good indicators of how we're building for future growth through our strong innovation process, organic investments, and M&A activities.

First, our filtration business was up almost 11% from 2019 levels, following a record performance in Q1 of this year. We continue to focus on innovative high efficiency solutions and extending beyond transportation filtration. As such, we recently launched our NeenahPure Air Filtration portfolio, utilizing proprietary technology, we created a premium solution for HVAC and air purifier elements for both commercial and residential use.

Our electrostatically charged media can reach efficiencies of up to 99.9%, the highest level available in the marketplace. With strong macro trends focused on air quality, this is an important new part of our portfolio. Second, we continue to build our specialty coatings platform with our most recent efforts centered on the ITASA acquisition and growth in release liner.

ITASA is performing well, including record revenue and record earnings in the month of June. This is a business that serves multiple end markets, giving it low volatility and multiple avenues for growth. Integration is well underway and on track with expectations. We are also progressing as expected on our synergies including new trials with crossover customers and new business with two very large customers in North America. Further, as Paul mentioned, we recently announced a \$13 million investment in new coating capacity to support growth in this category and meet ongoing demand for our products.

Within engineered materials, we expanded our innovative water-dispersible product portfolio, which we branded, DISPERSA. This is a labeled product line that allows for the products along with printed and written graphics to disperse in the presence of water. Neenah is the only North American manufacturer of this market leading solution, which provides an environmentally friendly alternative for residential and commercial applications.

Lastly, within imaging and packaging, our back-to-school items and newly designed planners, journals and teacher tools have all been very well-received at major retailers and continue to outpace the category and grow share. Our premium packaging business has rebounded nicely and is accelerating with significant new business in gift cards, box wrap and folding board applications. M&A is also key to how we build out these growth platforms. And as an important part of our strategy, we continue to be active and engaged with a robust pipeline of targets that help extend our capabilities or broaden participation in markets with strong growth dynamics. At the same time, we remain committed to maintaining a strong balance sheet and generating strong cash flow, which we'll use in a prudent manner as we grow and transform our company.

Additionally, we continue to make progress on the Neenah operating system, which is our approach to applying lean manufacturing methods to systemically drive continuous improvement in our facilities. To date, our Neenah operating system implementation is delivering results ahead of plan and is expanding beyond the two facilities originally targeted this year. We're seeing benefits in capacity improvements, efficiency gains, and waste reductions.

Our focus on efficiently managing our asset footprint is also key to delivering growth and margins as evidenced by our recent announcement to restart an idled asset by investing in additional coating capacity and closing our Appleton facility. Regarding the closure of Appleton, in 2020, we lost a multifaceted project to accelerate and improve the returns on this asset with clear milestones.

As the year progressed, we had not achieved targeted milestones and did not see a long-term financially viable option to achieve our expected margins. And we made the decision to close the facility. This closure will result in a benefit of \$7 million to \$8 million annually. And we will ramp down and close the facility in the fourth quarter of this year. This, by no means, lessens our focus on filtration. We remain committed to the broad filtration market as a key growth platform and continue to drive record results in this business.

So in summary, we're taking actions to drive continued performance [ph] from Neenah (00:19:48) in alignment with our strategy. We have multiple avenues for growth both top and bottom line and our trajectory looks promising.

I'd now like to open the call for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Jon from CJS Securities. Your line is open.

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Hi. Good morning, everyone. Thank you for taking my question.

Q

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

Good morning, Jon.

A

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Good morning.

A

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Wanted to start with the Paper segment. It seems to have recovered pretty nicely and I think a little bit ahead of schedule. Any thoughts on the trends from here? I think you had previously called on 90% as kind of the full recovery for that business. Is there more upside now that we're a little bit ahead of schedule?

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Jon, that is a business that when business comes, it comes not necessarily linearly, but in chunks. And so, we saw some nice new business in our packaging part of that portfolio as well as in consumer products. And commercial print has recovered pretty much as we expected. I would say, in regards to the prior communications around 90% of pre-COVID levels, we're still expecting to recover at that level. But we'll see a little bit of fluctuation. The startup of the asset that we announced really is to support that demand path as well as to provide flexibility and [ph] surge (00:21:25) capacity for us.

A

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Okay, great. Thank you for that color. Also, just in terms of things potentially happening earlier than expected. It sounds like you're going to catch up to the COGS inflation by Q4. I had previously remembered you saying it would take until next year. Is that in fact the case now and maybe you were able to pull in all that pricing action compared to what you might have thought a quarter earlier?

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Yeah. Let me start with that one, Jon; and then, Paul, feel free to add anything that I may miss. Pricing has – we've taken pricing with all of our customers or we've communicated with customers about pricing actions that will be effective early 2022. So, I think from a timing standpoint, what we've talked about and what Paul mentioned

A

was we expect about \$7 million to \$8 million of incremental inflationary costs in Q3 versus Q2, and we expect to recover about half of that amount in Q3.

For the entire year, we're still expecting north of \$30 million of inflationary cost increases in our raw materials including freight and we expect to recover more than half of that, but not all of it in 2021. As you know, we get quicker recovery in Fine Paper and Packaging and then we have annual agreements in our filtration business. So, those agreements, we've had those conversations, those plans in place, but they don't become effective until early 2022.

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Okay. Great.

Q

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

And, Jon, just to add a little bit to that, so we think that in the third quarter like we talked about, \$7 million to \$8 million of which we'll be able to offset half, so incremental to the second quarter. And I think what we said in the fourth quarter is we expect to start making traction again and narrowing the gap between the pricing and the raw material inputs. But like Julie said, we expect to offset about half directly with pricing and then the rest with our other actions for the full year.

A

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Got it. That's helpful. Okay. I'm just wondering how much the Appleton facility contributes until it winds down and [ph] get to that total (00:23:42), I guess, to \$20 million to \$25 million revenue reduction? I know it's still cost, but just in terms of on the revenue side?

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

It'll be about a quarter of that each quarter. So, while – we are ramping down with customer orders throughout Q3 and running out with customers, some of the Appleton business, we are transitioning to other assets. So it's about – in the fourth quarter I would expect about a quarter of that \$25 million that we won't see for Appleton and about a quarter of the benefit as well.

A

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Okay. Great. And then finally, Julie, you mentioned the Neenah operating system improvements. Just is there any quantification on how much more you're saving this year or is it just an acceleration spreading out to different plants and then getting out sooner?

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

It's a little of both. I mean, we're accelerating and spreading out to additional plants, but we're also seeing savings come in even higher than we originally estimated. It is a ramp-up and we do have third parties in place this year helping us implement. So that is offsetting some of the benefits falling directly to the bottom line. As we continue

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to implement this across our facilities and we have consultants and other folks that are supporting us to exit, we'll see even greater improvements in the out years from an operating system standpoint.

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Okay. Great. Thank you.

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Thank you, Jon.

A

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

Thanks, Jon.

A

Operator: [Operator Instructions] Your next question comes from the line of Chris McGinnis from Sidoti and Company. Your line is open.

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

Good morning. Thanks for taking my questions and congrats on the results.

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Good morning. Thanks, Chris.

A

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

If we can maybe just start with the inflationary environment. Do you see that at all impacting demand for you at all or is that not an issue or something so publicly out there I guess?

Q

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

Our demand is very strong across pretty much all of our categories. So, it is impacting our costs. And that's where we're really seeing it. And that's a timing issue just like it has been historically. If you think about our margins, they're going to be compressed in the short-term as we catch up on pricing. They'll be more immediately recovering in fine paper and then it takes us a little bit longer in filtration and some of our technical products categories. But we have historically recovered that pricing over time, and we expect to do that again. From a demand standpoint, we're seeing really strong demand in signals of future demand.

A

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

Okay. Great. And I think you mentioned market share gains in [ph] TP (00:26:25), if I'm correct. And is that – can you maybe just talk about what's driving that? I've been hearing more of supply chain issues leading to maybe

Q

more North America-based companies taking that. I know that [ph] TP (00:26:42) is a little bit more broken up regionally, but can you just talk about those market share gains that you mentioned?

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

A

Sure. I think we're seeing a couple of things. When we're experiencing supply chain disruption, it's really impacting us from a cost standpoint. We're juggling around machine schedules. We're managing shorter runs on our assets, things like that. From a demand standpoint, it's still very strong. And what we've been able to do is provide substitute or alternatives from our innovation team who's really helping us to grow share by providing new formulations for our customers.

So, if we have a supply constraint with a particular chemical being able to quickly alternate to a different solution for our customers. And quite honestly, this is giving our customers some additional incentive to make some of those changes with us. So that's really what's driven the share gain.

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

Q

Right. And just two questions on ITASA. I guess just, one, with the investment you're doing with the \$13 million for a new coater, how do you think about that in terms of – is that a you hit your growth for this year and how often would you have to add a coater to expand your capacity? How much time does this give you before you have to expand given kind of the growth rate there?

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

A

Yeah. This is a investment that we knew going in to the ITASA acquisition that we would be making. And so it's really exciting for us to be able to continue to invest in organic growth in the future. And it goes into an existing facility, which I think, as Paul mentioned, was a greenfield facility just a few years ago. That facility is ramping up really strongly, and ITASA has had over 8% growth over their history and record performance top line and bottom line in June of this year and really strong demand signals.

So all that to say, this is to meet the expected growth that we have in release liner, and we'll continue to evaluate that market for continued growth. I view ITASA as a foundational acquisition that really gives us a strong footprint to build from, whether that's organic investment or inorganic investment. So, you'll see us continue to grow in this area within our specialty coating platform.

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

Q

And then you mentioned two large customers in North America. Can you just talk a little bit – are those new customers to ITASA and that's you're using your relationship? Can you just expand a little bit on that? It sounds like early success there.

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

A

Sure. It's a little bit of two things. One of the large customers was an existing Neenah customer, and so our ability to work and cross-pollinate with the ITASA business has been very successful there. Another one is one that the ITASA team has been working on for some time and landed in North America because of the additional capacity and capabilities that are ramping up in the facility in Mexico.

Chris P. McGinnis

Analyst, Sidoti & Co. LLC

Q

Thanks for taking my questions. Good luck in Q3 and I'll jump back in queue for now.

Julie A. Schertell

Chief Executive Officer, President & Director, Neenah, Inc.

A

Thanks, Chris.

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

A

Thanks, Chris.

Operator: Next is from Jon again from CJS Securities. Your line is open.

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Q

Hi. Just one more for me, guys. I was wondering if you could just give us a little color on how trends have gone in July, number one?

And number two, what are your expectations are of August? I know usually it's a seasonally down quarter, people go on vacation. But I'm wondering if there's a different expectation this year? Just given the state of inventories across a number of industries and then things that are still in high demand?

Paul F. DeSantis

Executive Vice President, Chief Financial Officer & Treasurer, Neenah, Inc.

A

Yeah, Jon. This is Paul. I think what Julie said earlier on the call was really, really important and that we've seen very strong demand. And so, we – like the demand that we've seen and it's a question of the raw material side of it and the timing on pricing for us, but the top line has been pretty robust.

Jonathan E. Tanwanteng

Analyst, CJS Securities, Inc.

Q

Okay. Thank you.

Operator: There are no further question at this time. Kyle Anderson, please proceed with your closing remarks.

Kyle Anderson

Vice President-Corporate Strategy & Investor Relations, Neenah, Inc.

Great. And thank you for your time today. To recap, we are aggressively pursuing pricing and other actions to offset near-term raw material impacts over time. We continue to focus on our four growth platforms with disproportionate capital investment, innovation and M&A activities. We're seeing traction on our strategy to achieve 5% top line and double-digit bottom line growth consistently over time. So, we're looking forward to updating you on our continued progress next quarter.

Thanks. Have a nice day.

Operator: This concludes today's conference call. Thank you all for your participation. You may now disconnect.

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