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PRESENTATION

Operator

Greetings, and welcome to Caesarstone First Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. It's now my pleasure to introduce your host, Sarah Bicknell of IRC. Thank you. You may begin.

Sarah Louise Bicknell

Thank you, operator, and good morning to everyone. Certain statements in today's conference call and responses to various questions may constitute forward-looking statements. We caution you that such statements reflect only the company's current expectations and that the actual events or results may differ materially. For more information, please refer to the risk factors contained in the company's most recent annual report on Form 20-F and subsequent filings with the Securities and Exchange Commission.

In addition, on this call, the company will make reference to certain non-GAAP financial measures, including adjusted net income, adjusted net income per share and adjusted EBITDA. Reconciliation of these non-GAAP measures to the most directly comparable GAAP measures can be found in the company's first quarter 2018 earnings release, which is posted on the company's Investor Relations website. Thank you. And I would now like to turn the call over to Yair Averbuch, Caesarstone's Interim Chief Executive Officer. Yair, please go ahead.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Thank you, Sarah, and good morning to everyone. As you should have seen in the earnings press release today, we experienced a disappointing first quarter. Before I turn to discuss the quarter highlights, I would like to make 3 comments about how we see the remainder of the year. As for gross margin, we are very focused on import capacity utilization, increased production efficiency and better execution with respect to inventory management. The first quarter included charges related to inventory and logistical inefficiencies, the majority of which we do not expect will continue in the remainder of the year.

While margin pressure from higher raw material prices and from lower manufacturing throughput associated with increased mix of differentiated product will continue, our goal is to end 2018 with higher and more stable margin and a clear line of sight to additional improvement opportunities in 2019.

My second comment is with respect to the company management. Caesarstone has a strong team, but we further need to make changes that are better aligned with implementing our goals for growth resumption and higher margin. In addition to Ophir, our new CFO, we've now involved Yaron Mund as our new VP of Operations. Yaron brings with him deep experience background and proven track record. We are confident Yaron will lead our global operation teams to improve results. More recently, we parted ways with Dan Clifford, our President of U.S. Sales and Distribution Operations. Our Chief Commercial Officer, Israel Sandler, is taking this role in the interim, while we look to fill the position permanently. In my interim role as CEO, my partnership with Ariel Halperin, our Chairman, is very helpful, and we are working diligently to reposition the business and our strategy as the board completes the search for a permanent CEO.

Sales. While we consider the first quarter results and the reduced guidance we are reporting today to be clearly unacceptable, we are doing what is necessary to leverage our strong brand innovation capabilities and position in the market to grow the business and navigate to success in the competitive environment we are in.

While we endeavor to improve our near-term financial performance, we also consider other benefits. This will be realized over a longer time period to be just as important. Now I will refer to the first quarter financial highlights.

Our first quarter revenue of $136 million was similar to last year, and on a constant currency basis, our revenue declined by 3.7%. We saw a decline in revenue mainly in the United States and in Australia. The decline in the U.S. was mainly the result of a more competitive environment, including price pressure and execution challenges.

Our adjusted EBITDA in the quarter was $11.2 million, a margin of 8.2% compared to $24.3 million, a margin of 17.8% in the first quarter of last year. This was well below our expectation and has led the lower gross margin and the loss of scale related benefit because of softer-than-anticipated revenue performance in the quarter. Our adjusted net income in the first quarter was $3.4 million and adjusted EPS was $0.10.

Now I would like to provide an update on each of our regions for the first quarter.

In the United States, sales were down 2.2% to $56.8 million compared to $58 million last year. Although these results were below our expectation, we are confident in our ability to capture growth in this market as we realign our execution and progress with our business plans.

Australia sales were $28.9 million, down 2.1% compared to $29.5 million last year. On a constant currency basis, Australia was down 5.2%. The overall housing market in Australia remained soft, including remodeling activities and to some extent, we also suffered from inventory availability.

In Canada, sales grew by 4.7% to $23.4 million. On a constant currency basis, our business in Canada was flat to last year. Our core business performance was reasonably well but was offset by a decline in our IKEA business due to change in promotional event timing, which we expect to gain back later in the year.

Sales in Israel were up 0.8% to $11.8 million for the quarter. On a constant currency basis, however, sales were down by 6%, a reflection of challenging marketing -- market condition.

Europe sales were up 16.6% to $7.4 million from $6.4 million last year. On a constant currency basis, growth was 1.7% year-over-year. We had very strong growth in the U.K., offset by decline in some of our indirect markets.

Revenue in the rest of the world during the quarter was down 7.8% to $7.8 million. On a constant currency basis, revenue was down 19%. In this region, we experienced supply issues, and we were unable to fulfill demand for our product.

Before I turn the call to Ophir, I want to say again that we are dedicated to improving our results and our effectiveness in every aspect of the business. At the top of our list is to quickly improve our ability to grow revenue and to create sustainable gains in our production efficiencies.

These challenges are operational as well as strategic. We are working diligently to refine our strategy and our view of the future. I believe that over time, improved execution combined with good strategic decisions will yield strong business results.

I would like now to introduce and welcome Ophir Yakovian, our new CFO, who will provide more detailed review of our consolidated results and of our guidance.

Ophir Yakovian - *Caesarstone Ltd. - CFO*

Thank you, Yair, and good morning, everyone.

Global revenue in the first quarter of 2018 was $136.1 million, a decrease of 0.3% compared to $136.4 million in the first quarter of last year. On a constant currency basis, revenue declined by 3.7% versus last year. Gross margin in the quarter was 25.2% compared to 36.1% last year.

As Yair mentioned, there are number of factors that contributed to the 10.9 percentage point decline.

During the first quarter, the company recorded charges related to inventory and logistical inefficiencies, primarily related to the U.S. distribution activity, the majority of which we do not expect will continue to -- in the remainder of the year, accounting for approximately 300 basis points of the decline.

The other major factors that led to the decrease in margin year-over-year were: Lower production throughput in Israel impacting margins by 500 basis points, higher raw material prices impacting margin by approximately 150 basis points, and lower volume and average selling prices in certain regions, partially offset by regional mix, impacting margin by approximately 100 basis points.

Operating expense in the first quarter were $32.8 million or 24.1% of revenue versus $34.1 million last year, which was 25% of revenue. The year-over-year reduction in expenses were mainly due to timing of marketing and selling expenses offset by increased expenses for legal settlement and loss contingencies.

Excluding legal settlement and loss contingency expenses, operating expenses in the first quarter were $30.3 million or 22.3% of revenue compared to $33.4 million or 24.5% of revenue in the first quarter last year. This primarily reflects more moderate marketing and sales expenses in the U.S. Our first quarter GAAP operating income was $1.4 million compared to operating income of $15.1 million in the first quarter of last year.

Adjusted EBITDA in the first quarter, which eliminates share-based compensation and legal settlement and loss contingencies was $11.2 million, a margin of 8.2%, compared to $24.3 million, a margin of 17.8% last year. The decline in adjusted EBITDA margin primarily reflects the factors that pressured our gross margin in the quarter. We had finance income in the first quarter of $0.5 million compared to finance expenses of $1.5 million last year. This swing is due to the favorable impact of currencies, including its impact on our hedging instruments.

Taxes in the first quarter were $0.5 million compared to $2.3 million last year. Adjusted net income attributable to controlling interest in the first quarter was $3.4 million compared to $12.5 million last year. Adjusted diluted earnings per share in the quarter were $0.10 compared to $0.36 in the same period last year. Both figures are on 34.4 million shares.

Turning to March 31 balance sheet. We had cash, cash equivalent and short-term bank deposits of $112.1 million. I would note that during the quarter we had used $14.2 million of cash to settle previously announced Microgil arbitration and $10.5 million for payment of the dividend we announced at the end of the year. I will note that considering the quarter's result we will not distribute dividend this quarter.

With respect to our revised outlook and guidance for 2018, our current assumption for full year revenue is between $590 million to $610 million compared to our prior guidance for a range between $612 million to $632 million.

With respect to adjusted EBITDA given the variety of factors we experienced in the first quarter, most significantly the lower-than-anticipated gross margin, we now believe that the adjusted EBITDA is expected to be in the range of $74 million to $82 million compared to our prior guidance range of $110 -- $102 million to $110 million.

Thank you. And I will now turn the call back to Yair for closing remarks.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Thank you, Ophir. Thank you for your attention this morning. We have tough challenges in front of us for sure. Fortunately, we continue to have powerful advantages and strength. Our brand occupies a premium position at the top of our category. Our products and our reputation are excellent, and we are known for quality and innovation. We have a very capable global platform that we will be able to leverage for better results.

Finally, we have a strong balance sheet. We have an approximately $100 million of net cash balance, which provides us a wide variety of range of options as we determine our next steps towards driving value to our shareholders. Thank you.

And we are now ready to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Susan Maklari with Crédit Suisse.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

My first question is around the inventory and logistical inefficiencies, Yair, that you talked about. Can you just give us a little bit more color on that? And I guess, with it, can you discuss the U.S. plant? How the new management team there is doing? How the progress is coming along? And how we should be thinking about it coming up to speed over 2018?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

So with regards to the change of leadership in the U.S., the change is very, very recent. Susan, are you talking about the plants or the distribution operation?

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Well, both. I mean, in your commentary, Yair, you said that it was an inventory -- that there were inventory and some inefficiencies on the logistic side there. Are those related to plant?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Okay. So let me clarify this. So first of all, nothing that we have discussed in the call related to the U.S. plant. Let me put this one first out of the radar screening. The U.S. plant, we experienced a significant improvement both year-over-year and also sequentially. And the plant is really on track based on our plan. It didn't play any factor in this quarter results because on one hand, there was an internal major improvement in the factory. On the other hand, because the factory now is a bigger component of the total production and it's still more expensive than in Israel. So those 2 drivers kind of offset each other and Richmond Hill was not part of the gross margin drivers for the year. So most of the inventory and logistics inefficiencies and also the miss on the revenue side was related to our U.S. sales and marketing operation. As I said -- as I started to say, our leadership changeover is extremely recent. I believe that we aligned what we need to do now, how we should go about the market, and I believe that we are off to a better performance.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. All right. That's helpful. And then, Yair, one of your U.S. competitors has filed an antidumping suit in the U.S. given all the imports that are coming in here. Can you just give us any thoughts on that and maybe any way that you can be involved in that case as a significant player in this market?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes, Susan, we actually prefer not to refer to any specific allegations. But I would just say that in general, of course, we support fair trade practices in our markets. More specifically, this petition was not initiated or submitted by us. However, of course, if regulatory agencies will approach us, we will provide any relevant information.

Operator

(Operator Instructions) There are no more questions at this time. I would like to turn -- actually Susan Maklari has a follow-up question.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Yair, if I'm the only one that's in the queue, I'm going to ask you another question. I guess, with Dan Clifford gone, can you talk about the kind of person that you're looking to fill that role? What will be different about their profile relative to Dan's? And how are you going about the process?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Okay. So without referring to Dan at all, I would say that we're looking for somebody who has some specific industry experience ideally, who has a very strong marketing and sales capabilities and background, somebody who is a strategic thinker. And I would add to those 3 that we want somebody who can roll up his sleeves and move in quite a big organization with a lot of complexities, drive it to do strong execution. So in a nutshell, that's what I would -- that would be my ideal candidate.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. All right. That's helpful. And then just lastly, on the dividend reinstatement. So Yair, you're not going to pay the dividend in the second quarter, but then how should we think about it going forward?

Ophir Yakovian - *Caesarstone Ltd. - CFO*

So we set a -- I mean, the Board decided on dividend policy at the end of last year. And we believe that once we see a better performance in terms of the results, we will resume the distribution of dividends hopefully in the next quarter.

Operator

Our next question is from Michael Rehaut with JPMorgan.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

This is Neal BasuMullick in for Mike. I guess, I just wanted to continue on the gross margin performance. Your comments on the inefficiency were helpful, but on the raw materials part, what you're doing with pricing or otherwise as an offset? And I guess, as an add-on, sort of what you see as your pricing power?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Well, I think that in the industry of polyester prices and titanium oxide and those of the world -- those are commodities that I'm not sure that Caesarstone, in all due respect to ourselves, much power. This is a market that tends to fluctuate quite a bit. We of course try to be between different suppliers and do the maximum and optimize ourselves, but our capabilities there are not exactly -- it's like oil industry. I'm not sure that somebody has a buying power in oil industry.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

Okay. That makes sense. I mean, more pricing on your end as part of raising prices on products but...

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes, so what I would say about our prices is that the dynamic in our -- as far as we see it, is the following. There is generally an increased competition in the quartz market, especially in the U.S. from low-end manufacturers, mainly from China. So Caesarstone as a brand, as a differentiator in the market, we will continue to put a lot of weight and a lot of effort to try and introduce new product into the market and keep the gap between us and the competition. On the other end, to still optimize the top line growth, we are a bit more aggressive on the classical collection in general. And then -- and some of this all equation ends up in a more challenging environment in our plants because the newer product are more sophisticated, are more complex to introduce and take more cycle time in our plants.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

Okay, that makes sense. I want to ask a little bit on channels. Maybe if you could break down the results you're seeing in big box versus retail. Where is maybe trending better or worse than your expectations?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes, I would, without getting into a lot of specific, in the big box, as you know, we are in IKEA. IKEA, as we said, in Canada was a bit down due to the timing of the promotional event. In the U.S., if I remember right, IKEA was a growth. And in what we see for the remainder of the year in IKEA in the U.S., our outlook for IKEA is actually a bit negative. We see a decline because of change of the structure of the promotional events in IKEA. Basically, it's less favorable of a promotional method for the consumer in IKEA and because a lot of the demand comes in those promotional events, we are also impacted by that.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

Okay. That makes sense.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

So that's on the IKEA channel. I would say that in the more -- in the builders segment, we are doing quite well. I think our -- the challenges are mostly on the retail channel.

Operator

Our next question is from Dillard Watt with Stifel.

Dillard Watt - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Maybe if you want to talk a little bit about Australia, it's your second biggest market. You said you had some inventory availability issues there. Is that something that gets better through the rest of the year? Or you're going to continue to face the headwinds, along as, I guess, maybe the Israeli plant throughput is not where you want it to be?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

I expect Australia to be better in terms of inventory availability because we shifted some production there to juggle between all our capacity challenges. And I would say that in Q1, this was the case because in the second half of 2017, we put a lot of emphasis on buildup inventory for North America. And so Australia was impacted in Q1 somewhat. We are now fixing the situation. And I believe -- I hope that the revenue opportunities that are going to be low due to inventory availabilities will diminish dramatically.

Dillard Watt - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay. And just back on the inventory and logistics issues in the U.S., I mean, maybe if you could just again give us a little more detail on what happened and what gives you confidence that, that was a onetime charge? I assume, I guess, sort of through the first 5 weeks of the quarter maybe things are better or maybe that was just a first half of the first quarter issue that this was just a really big drag and then has since corrected itself, but what happened?

Ophir Yakovian - *Caesarstone Ltd. - CFO*

Yes, so we're in the -- as Yair mentioned, we built inventory in North America, both in the U.S. and in Canada. The way that we built it was in a way that there was some peaks in the delivery of our products, of the shipments to the location and that created some extra charges related to freight and storage and related expenses. And as a result, we saw -- we had some excess expenses that we don't expect now to return later in the year. In addition to that, we had some inventory write-downs related to some finished goods that we also don't expect to return in the remainder of the year. So these were the 2 main factors. And that's why we don't think it's -- the majority of which will not recur during the year.

Dillard Watt - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay. And raw material outlook for the rest of the year. I assume it gets better as we get through the year. What should we expect for the raw material impact on gross margins this year?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Well, we are always as good as the last quote and the last buy. And I wish we had a crystal ball on guessing where this is going. And prices of both polyester and titanium oxide has picked up on us sequentially. So I'm not sure that the future is brighter and that we'll have to wait and see.

Dillard Watt - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Okay. If you just assume maybe they were flat from here, is it a similar year-over-year pressure or is it get -- does it get a little easier just on a year-over-year comparison?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

I think it's maybe a milder impact on the year-over-year because the prices of polyester have trended up sequentially for quite a long time. So I guess that the impact is somewhat...

Ophir Yakovian - *Caesarstone Ltd. - CFO*

More moderated.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

More moderated as we go along if the prices will stay flat now.

Operator

Ladies and gentlemen, we have reached the end of our question-and-answer session. I would like to turn the conference back over to Yair for closing remarks.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

So thank you, everybody, for attending the call. And we look forward to provide better results in the next quarter. Thank you.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time, and thank you for your participation.
