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CSTE - Q2 2018 Caesarstone Ltd Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the Caesarstone Second Quarter 2018 Earnings Call. (Operator Instructions)

As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Ms. Sarah Bicknell with ICR. Thank you, you may begin.

Sarah Louise Bicknell

Thank you, operator, and good morning to everyone. I'm joined by Yair Averbuch, Caesarstone's Interim Chief Executive Officer, and Ophir Yakovian, our Chief Financial Officer.

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 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. The reconciliation of these non-GAAP measures to the most directly comparable GAAP measures can be found in the company's second 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. Please go ahead.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Thank you, Sarah, and good morning to everyone. Before we get into our performance, I will comment on our recent announcement regarding Executive Leadership. As many of you are aware, in 2017, I announced my planned departure and transition from Caesarstone. In July this year, the board announced the appointment of Yuval Dagim as the company's new CEO, and he will assume the position on August 12.

Yuval brings decades of experience in global businesses and leadership across multiple industries. This includes management of branded products on several continents. Combined with Ophir, who joined us as CFO earlier this year, and the other members of the management team, I am confident that Yuval will be able to lead the company to renewed growth improved profitability by effectively leveraging our global operating platform, powerful brand and innovative projects.

With Yuval coming on board, I am now in final stages of completing my transition process. Over the past 8 years with Caesarstone and in recent months serving as the interim CEO, it has been an absolute pleasure helping the company to navigate through an evolving industry landscape while also getting a chance to meet many of you on the line today. I am very grateful for this experience.

During the second quarter, our results showed considerable improvement compared to our performance in the first quarter of 2018. This included a significant expansion in gross margin, which we will work hard to carry forward, as Ophir will explain further. At the same time, the competitive environment remained challenging in several key market, especially in the U.S. We continue to make necessary changes to better position ourselves in order to more effectively capitalize on the strong global market opportunity for products. While manufacturing, so called, challenges in Israel, associated mainly with the increased complexity of our product, raw material cost inflation and FX are likely to remain a headwind. We are making progress to improve our U.S. sales operation and global manufacturing to achieve better performance in 2019.

Now I will refer to the second quarter financial highlights. Our second quarter revenue of $149.2 million was stable compared to last year. On a constant-currency basis, our revenue declined by 1.5%. Sales improvement in Canada, Europe and rest of the world were offset by pressures in the United States and Israel. Our adjusted EBITDA in the quarter was $24.6 million, representing margin of 16.5%. This compares to $29.6 million or margin of 19.9% in the second quarter of last year. This decline was anticipated and primarily reflect the lower gross margin compared to the prior year. Our adjusted net income in the second quarter was $14.9 million and adjusted EPS was $0.43.

Now I would like to provide update on each of the region for the second quarter. In the U.S., sales were down 6.9% to $60.4 million compared to $64.8 million last year. Weakness in sales to IKEA due to changes in its promotional structure compared to last year was part of the reason for the decline. That said, we have also experienced softness in our core business since the beginning of 2018. In response, we are making changes to enhance our go-to-market strategy and strengthen the distribution capability. We are confident in our ability to resume growth in this market as we realign our execution and progress with our business plans.

In terms of filling the permanent role for the President of the U.S. Sales and Distribution Operation, this search is progressing and we will keep you updated as appropriate. In the interim, our Chief Commercial Officer is heading this role and working hard to reposition the U.S. business.

Australia sales was $34.7 million, up 1.4% compared to $34.3 million last year. On a constant-currency basis, Australia was up 0.6%. We are pleased with our performance in Australia considering the soft housing market condition, mainly remodeling.

In Canada, sales grew by 8.1% to $27.3 million. On a constant-currency basis, Canada was up 3.8%. The sequential growth improvement was related to IKEA sales, resuming growth as expected, following the decline in Q1. This is a market where we believe that there is a meaningful growth potential for us going forward. Sales in Israel were down 15.9% to $9.1 million. On a constant-currency basis, sales were down by 16.2%, reflecting intense competition and challenging housing market condition.

Europe was a bright spot, with sales up 31.1% to $9.1 million. On a constant-currency basis, growth was 22% year-over-year, reflecting better product availability and leveraging the growth in the United Kingdom from our direct distribution operation.

Revenue in the rest of the world during the quarter also benefited from better product availability and was up 27.2% to $8.5 million. On a constant-currency basis, revenue was up 19.8%.

I would like now to turn the call over to Ophir, who will provide more detailed view of our consolidated results and full year outlook.

Ophir Yakovian - *Caesarstone Ltd. - CFO*

Thank you, Yair, and good morning, everyone. Global revenue in the second quarter of 2018 was $149.2 million, an increase of 0.2% compared to $148.9 million in the second quarter of last year. On a constant-currency basis, revenue declined by 1.5% versus last year. Gross margin in the quarter was 32.4% compared to 34.9% last year.

A decrease in margin reflects the following. Inventory and logistical inefficiencies along with higher raw material costs impacted margin unfavorably by approximately 300 basis points. Lower production throughput at our Israeli facilities impacted margin by roughly 200 basis points. These factors were partially offset by significant improvements in throughput and in -- at our Richmond Hill facility in the U.S, which continues to ramp up and contributed about 250 basis points.

With the volatility in our gross margin during the first half, we are also providing additional color on our second quarter performance compared to the first quarter to enhance visibility in our margin moving forward.

On a sequential basis, gross margin improved by approximately 700 basis points compared to the first quarter of 2018. The main factors that drove the sequential improvement were as follows. Higher average selling prices and volume benefited our margin by 300 basis points. Approximately 100 basis points of the sequential gross margin improvement came from reduced inefficiencies related to inventory and logistics, mainly in our U.S. distribution operation. Finally, roughly 300 basis points of the sequential gross margin improvements primarily reflect better operating performance in our manufacturing in Israel and the U.S.

Compared to the first quarter of 2018, we view the combined 400 basis points from better operating performance and the improvement inefficiencies related to inventory and logistics as good proxy for sustainable gains through year-end. Operating expenses in the second quarter were $35.1 million or 23.5% of revenue versus $32.6 million last year, which was 21.9%.

Excluding legal settlement and loss contingencies, operating expenses increased to 21.7% of revenue compared to 20.9% in the prior year quarter, mainly due to higher marketing and sales expenses in addition to nonrecurring expenses of approximately $1.2 million, mainly related to the relocation of our U.S. headquarter. Our second quarter operating income was $13.3 million compared to $19.3 million in the second quarter of last year.

Adjusted EBITDA in the second quarter was $24.6 million, a margin of 16.5% compared to $29.6 million, a margin of 19.9% in the prior year quarter. The decline in adjusted EBITDA margin primarily reflects the lower gross margin.

Finance expenses in the second quarter were approximately $0.5 million compared to $1.4 million in the second -- last year. This swing was mainly related to FX fluctuations. Our tax rate on adjusted income was 13.4% compared to 17% in the prior year quarter due to lower and nondeductible expenses as well as a lower tax rate in the U.S. Adjusted diluted earnings per share in the quarter were $0.43 compared to $0.49 in the same period last year, reflecting lower adjusted net income and stable share count.

Turning to our June 30 balance sheet. We had cash, cash equivalent and short-term bank deposit of $104.6 million and net cash position of $95.6 million. Based on our corporate performance during the second quarter, in the first half of 2018, our Board of Directors declared a dividend of $0.15 per share with a record date of August 22 and payment date of September 12, 2018.

Moving to our outlook for 2018. Since we provided our sales outlook last quarter, currency rate have moved unfavorably. Most specifically, the U.S. dollar appreciated in comparison to our main other currencies. As a result, this has created an adverse currency exchange impact of roughly $10 million to our 2018 sales outlook.

Therefore, we expect revenue to be at the low-end to midpoint of the previously announced range of $590 million to $610 million. With respect to adjusted EBITDA, we continue to anticipate full year to be at the range of $74 million to $82 million.

Thank you, and we are now ready to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Rehaut with JP Morgan.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Yair, best of luck in the future.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Thank you.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

First question, I just wanted to get -- make sure, I understood the comments around gross margin in terms of what was sustainable and what was not. I believe you said that of the 700 basis points sequential improvement, that the 300 and the 100, I believe both related to better operating performance or reduced inefficiencies or what's viewed as sustainable. And am I to understand from that, that the 32-type percent gross margin that you did in 2Q that of the 700 basis point performance that only 400 is what's viewed as sustainable, and we should be looking more like at a 29% type of gross margin in the second half? I just want to make sure, I'm understanding that correctly.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes, you got it right. That's correct.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. The 29% in the back half. And I guess the second question kind of relating to that, so the 300 basis points that wasn't viewed as sustainable relating to -- was that relating to the higher ASP and volumes? And why is that view -- is that kind of a temporary -- why is it viewed as more of a temporary benefit, I guess?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Well, it's not. I think that the way we see the results of headwind going forward on sequential basis, FX is an headwind for us as we mentioned. In -- the polyester price impact is increasing actually and its impact relative to -- sequentially. So there are different pressure that made us to believe that gross margin revenue will be a little bit below the 32% level.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And in terms of the U.S. sales decline, you mentioned 2 main drivers of that. First being weakness to IKEA, and second being softness in your core business. I was hoping to get a sense of the 7% decline if you could kind of give us a sense of which of those 2 factors, how much did each contribute to that decline? And how should we be thinking about -- I assume that something like, is not going to be easily turned around in the next quarter, if we should be is expecting further have declines in the back half?

Ophir Yakovian - *Caesarstone Ltd. - CFO*

So I would say without getting into too much detail that the impact of IKEA was significant, but even without it, we would have been down. So it's -- I would say, it's similar impact, maybe IKEA slightly lower impact than the core decline. And I think that the market in the U.S. is now currently very, very competitive for us. We ourselves -- as we mentioned before, we have made many changes in our organization to get that sales execution and better distribution capabilities and improve our supply chain, so we believe that we will see some improvement on a year-over-year basis compared to the first half in the second half.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

And when you say improvement, Yair, you're talking about dollars sequentially or year-over-year growth?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Both.

Michael Jason Rehaut - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Do you expect year-over-year growth in the back half in U.S.?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes.

Ophir Yakovian - *Caesarstone Ltd. - CFO*

Yes, we are.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes.

Operator

(Operator Instructions) Our next question comes from the line of Susan Maklari with Crédit Suisse.

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

Yair, my first question is you mentioned enhancing some of your U.S. strategy in terms of how you distribute and maybe market or sell the product. Can you just give us a little bit more color on what you're planning there, and how we should think about that coming together?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes. So I think there were 2 -- 3 elements, I would say to the planned improvement in U.S. top line growth. One is, as we mentioned before, we needed to strengthen our sales execution capabilities. There was the leadership change announced in Q1, and this has followed up by additional changes that have been made or are continuing to be happening now in the U.S., all of which, I believe will down the road contribute to a better performance on our part. So a, there is organizational capabilities especially on the sales side and we brought some important talent in recently. I believe that again, it will take -- it will bring its result down the road. The second thing is we've a major focus on trying to penetrate into the big boxes, we've been discussing for quite a while. There is some positive things happening, and I hope that it will result in something that we can announce sometime soon. But it's definitely a major focus on our part in the U.S. And we believe that the big boxes, big channel across the overall demand, so it's important for us to be there. The third matter is the distribution, the operation and distribution performance, and this has to sides for it. One is the ability to have the right product at the right place at the right time, which means not losing revenue on logistical element. And the second one is just to reduce the cost structure because it's still costly as relative to the benchmark that we have experienced before and relative to what we believe should be the benchmark.

In -- on those we have few initiatives that are now started to be on the pipeline. I prefer not to provide -- it's too competitive to provide information so I am -- so I prefer not to get into details on that part.

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

Got you. Okay.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

But that there are clear things on the pipe.

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

There's what?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

There are clearly things on the pipe being happening and develop.

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

Got you. Okay. And then I guess can you also give us an update on the U.S. facility? It sounds like things are definitely improving there in terms of your volume and your throughput. Can you just give us a little more color on that?

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Yes. I think that Richmond Hill performance was the most -- the brightest side of this quarter except from us making what we have planned to do in Q2 and recovering from Q1 performance. Richmond Hill was, by far, the shining star, and the improvement sequentially was just unbelievable, and it's converging to the inward planned performance very rapidly. Soon enough, I believe we'll just stop talking about it. And -- but in throughput basically -- in throughput, there are in par now with Israel on per line capacity, on per line productivity. On the yield side, which is how many goods left out of the total that we produced, how many of them ended up being good versus not good, there is still some room for improvement despite the major leap forward there -- that they did.

And on the cost as per square meter, which is what matters at the end the most, they converged very rapidly though we believe there will be still some gaps because labor cost in -- primarily because labor cost in the U.S. is much more expensive than in Israel. But it's converging very nicely into what we know.

Operator

Mr. Averbuch, there are no further questions at this time. I'll turn the floor back to you for final comments.

Yair Averbuch - *Caesarstone Ltd. - Interim CEO*

Thank you. Overall, we made good progress during the second quarter, but there are still many challenging -- challenges to resolve. Fortunately, we have a strong global platform, a powerful brand, leading product and the financial strength to generate strong returns over time. It has been a pleasure serving Caesarstone, and I am proud to be leaving the place -- to be leaving in place a strong team, which is highly aligned with implementing the targeted growth to resume growth and achieve higher margin. Additionally, we look forward to you, while working diligently with the team to further refine our strategy and strengthen our brand premium position at the top of our category. Thank you for your attention this morning.