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CSTE - Q4 2018 Caesarstone Ltd Earnings Call

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**Yuval Dagim** *Caesarstone Ltd. - CEO*

## CONFERENCE CALL PARTICIPANTS

**Amanda Nessa Luper** *Crédit Suisse AG, Research Division - Research Analyst*

**John Allen Baugh** *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

**Brad Cray**

## PRESENTATION

### Operator

Greetings, and welcome to the Caesarstone Fourth Quarter and Full Year 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Brad Cray of ICR. Thank you. You may begin.

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### Brad Cray

Thank you, operator, and good morning to everyone. I am joined by Yuval Dagim, Caesarstone's Chief Executive Officer; and Ophir Yakovian, Caesarstone's 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, adjusted gross profit and adjusted EBITDA. The reconciliation of these non-GAAP measures to the most directly comparable GAAP measures can be found in the company's fourth 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 Yuval. Please go ahead.

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### Yuval Dagim - Caesarstone Ltd. - CEO

Thank you, Brad, and good morning to everyone. With 6 months of my tenure as Caesarstone's CEO, I've been able to spend a significant amount of time with our teams and customers around the world. The many great attributes and assets I've witnessed with the Caesarstone organization have instilled greater confidence in me as we move forward.

We spent the last few months preparing our annual operating plan for 2019, where we met the opportunities and the challenges we are facing both internally and externally, and we built the plan to address them. While we are realizing that most of the improvements will take time and investment to mature, we see a few near-term solutions.

Just last month, we took a major step forward in North America by combining our U.S. and Canadian operations to take advantage of the many similarities between the 2 regions. We understand that the combined North American region provides us numerous opportunities. Scale benefits



include the ability to unify certain functions under one team that can create and enhance go-to-market strategy, refine operations and improve efficiencies.

The main goal of this step is to better position us to capture additional market share in the U.S. and increase our stability in coming years. This is especially important now given the recently implemented tariff on U.S. imports of quartz countertops from China. Once our North American realignment is integrated and working well, we expect to better execute our objectives in the region.

Backfilling our capabilities in North America is directly aligned with our actions to enhance our global platform and to more effectively leverage the Caesarstone brand. We are making investments in talent and technology throughout the organization in order to better manage our go-to-market supply chain and production processes. This will allow us more efficiently having the right product at the right place and at the right time.

In terms of people, we have already begun to enhance our ranks at all levels. As part of our North American region realignment, we recently promoted Ken Williams to lead this effort. Ken has shown remarkable ability in this management of our Canadian businesses by assembling a strong operating team and overseeing impressive results during his time with us.

We have also brought to our company a number of individuals with deep experience at the global and publicly traded companies. Some of these recent appointments include our new VP of Supply Chain, VP of Production, Richmond-Hill Plant Manager, General Counsel and VP of HR, along with a range of other talent enhancements throughout the company.

Another area of focus for 2019 is our brand, which we believe carries a lot of commercial value with our retailers, fabricators and consumers. We are committed to strengthening our global brand awareness by inspiring design lovers with our innovative products and solutions. Along these lines, we are increasingly dedicating our production resources to high-end products in order to better maximize our core opportunity as a premium quartz countertop leader.

Finally, the initiatives that I've discussed today, along with other ongoing efforts, are concurrent with the development of an organizational culture that values accountability. We are simplifying our hierarchy to allow faster decision-making processes while empowering our people to be fully accountable for their business.

We are determined to generate better results as we pivot our company to focus on growing sustained EBITDA margins. We have to evolve Caesarstone into a best-in-class leader in the lifestyle design and building product sector. I look forward to updating you further on our progress in coming months.

With that, let me turn the call over to Ophir, who will provide details on our results and outlook.

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**Ophir Yakovian** - *Caesarstone Ltd. - CFO*

Thank you, Yuval, and good morning, everyone. I will start with our revenue for the fourth quarter. For the fourth quarter 2018, global revenue was \$142.9 million compared to \$148.1 million in the fourth quarter of last year. This was mostly attributable to an adverse FX impact of \$4 million. On a constant currency basis, revenue declined by 0.7% versus last year.

We saw sales improvement in Europe, stable performance in Canada and softer performance in other regions. In the United States, fourth quarter sales were off by 0.7% compared to the fourth quarter of 2017. This was primarily attributable to continued weakness at the retailer IKEA.

As discussed in prior calls, changes in IKEA's promotional structure continued to impact our results. While IKEA represent an attractive source of revenue and returns to Caesarstone, the timing and structure of their promotional activity does affect our results.

In our core U.S. business, revenue grew at a low mid-single-digit base, which represent the second consecutive quarter of growth. Ongoing changes to enhance our go-to-market strategy and strength in distribution capabilities allowed us to grow despite the previously discussed second half 2018 surge in pre-buy activity ahead of recently implemented tariffs on U.S. imports of quartz countertops from China.

As a reminder, since August, there have been several announcements from U.S. government agencies in the interest of promoting fair trade in response to Chinese imports. As it pertains to quartz countertops, there are 3 cumulative tariffs. The first of which is a 10% tariffs on broad basket of Chinese imports in August.

The other 2 preliminary tariffs announced are specific to quartz countertops, including countervailing duty of effectively 34% since September and antidumping duty ranging from 242% to 341% since November. Adding all of this up, the U.S. has to take placed collective tariffs in the range of 285% to 385% on Chinese import to the U.S. The final determination on tariffs is expected in the first half of 2019.

In Australia, constant currency sales were down 2.2%. The decline was mainly due to continued softness in the housing and remodeling markets, coupled with continued competition, which were affected by more rigid lending standards and increased mortgage rates.

In Canada, constant currency sales were flat. We experienced further performance in IKEA sales, partially offset by slightly lighter results in our core business.

Sales in Israel on a constant currency basis were down 1.3%, primarily benefiting from stronger pricing, which partially offset lower volume, mainly due to challenging housing market condition and increased competition.

In Europe, constant currency sales grew 40.7%, reflecting strong execution in the U.K. as well as in our indirect distribution operation in Europe.

Revenue in the Rest of the World on a constant currency basis was down 23.1%.

Looking at our fourth quarter P&L performance. Adjusted gross margin was 27.4% compared to 31.3% in the prior year quarter. The decrease in adjusted gross margin reflects the following: increased product manufacturing costs in our Israeli facilities, foreign exchange headwinds, along with inventory and logistics inefficiencies, and higher raw material cost. These factors were partly offset by more favorable geographic and product mix.

Operating expenses for the fourth quarter benefited primarily from lower legal settlements and loss contingencies compared to the prior year quarter. Tighter expense control drove an additional 270 basis points of improvement year-over-year.

Adjusted EBITDA in the fourth quarter was \$17.8 million, a margin of 12.5%, compared to \$21 million, a margin of 14.2% in the prior year quarter. Adjusted diluted earnings per share in the quarter were \$0.20 compared to \$0.22 in the same period last year on stable share count. While adjusted EBITDA and adjusted EPS performance were in line with our expectation, the decline in both metrics primarily reflects the lower gross margin, partly offset by lower operating expenses.

Now I would like to note some of our full year financial performance highlights. Sales for the full year were down 2.1%. On a constant currency basis, sales were off 1.9%. Adjusted gross margin was 28.7% compared to 33.5% last year. The decrease was primarily driven by similar factors experienced in the fourth quarter.

For the year, we saw improved performance in our U.S. manufacturing facility, which contributed positively to margins compared to the prior year. Operating expenses improved to 22.7% of revenue compared to 26.6% in the prior year, driven by lower legal settlement and loss contingencies, along with 120 basis points of improvement from lower marketing and sales expenses.

Our adjusted EBITDA was \$75.2 million, a 13.1% margin, down from \$100.4 million last year, a 17.1% margin. Adjusted diluted earnings per share were \$1.05 compared to \$1.45 in the prior year. Similar to Q4, the full year decrease in adjusted EBITDA and adjusted net income mainly reflects the lower gross margin, partly offset by lower operating expenses.

Turning to our balance sheet and cash flow. During 2018, CapEx totaled \$21 million for the year, representing less than 4% of revenue, consistent with the prior year.



When we entered Canada in 2010, we did so through a strategic joint venture with Canadian Quartz Holdings. The relationship has been beneficial to both parties for the past 8 years, and we experienced great success in Canada. In December 2018, as part of creating a North America region, we acquired the remaining 45% ownership interest in our Canadian joint venture for a purchase price of approximately \$20 million.

The purchase provided significant flexibility to more efficiently integrate our wholly owned Canadian operation with our existing U.S. operations. In addition, the purchase provided an attractive value to the company, simplifies our financial reporting and eliminates future minority distributions.

We ended 2018 with a strong balance sheet, including cash, cash equivalent and short-term bank deposits of \$93.6 million.

Moving to our outlook. For the full year 2019, we anticipate revenue to be in the range of \$580 million to \$600 million and adjusted EBITDA to be in the range of \$72 million to \$80 million. This outlook assume a similar gross margin for the full year 2019 compared to the full year 2018. Our outlook also factors in expectation for a soft global market condition and competitive environment to persist in many of our regions into 2019. We expect this dynamic to be most evident in the first half of 2019, particularly in the first quarter.

To formulate our outlook, we have used current foreign exchange rates and preliminary determinations on U.S. tariffs on Chinese imports. As I mentioned earlier, the final determination on tariffs is expected in the first half of 2019. Changes into tariffs or FX may impact our outlook as we move through 2019.

While we expect the first quarter will be challenged from a year-over-year comparison, as we move through the year, we expect to show improvement in key metrics. In the U.S., we expect stronger revenue growth in the second half of 2019 as we expect inventory levels to return to normal following the previously discussed 2018 tariffs related to pre-buy activities. Furthermore, we anticipate that the previously discussed enhancement in North America will start yielding results in the second half of 2019.

Outside of the U.S., we are carefully monitoring the collateral impact of tariffs on the global supply chain as Chinese producer potentially seeks to ship their products to other developed markets.

Overall, we are confident in the steps that we are taking to improve our business and look forward to accomplishing our objectives in 2019. We are focused on getting Caesarstone in a better position to capture share and improve profitability. We are improving our processes, prioritizing health and safety and enhancing talent where needed. We are confident that those steps will bring stronger performance in our organization in time as we better realize the power of our brand and leading global market position.

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

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## QUESTIONS AND ANSWERS

### Operator

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

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### Amanda Nessa Luper - *Crédit Suisse AG, Research Division - Research Analyst*

This is Amanda on for Susan. So just given the significant amount of pre-buy ahead of the tariffs, can you talk to that near-term impact? And what the risk that the higher inventory continues to impact post 1Q? And also any additional color on the tariff impact to your global operations?

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

Amanda, it's Yuval. I think it is right at the moment the markets are kind of flattened with the prebuying slabs from China. And I think we are experiencing that through same demand as before, not an increase or spike in any market demand as we see from the first quarter. We expect that to be fully absorbed in the market in quarter 1 and quarter 2. And therefore, we expect to see some kind of increase in volumes and demand on the second half of the year.

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**Ophir Yakovian** - *Caesarstone Ltd. - CFO*

And looking at the global, so we are monitoring the effect globally. We can say that we see a much -- or a very different environment than we've experienced in the past quarter. But we are monitoring, and we will react accordingly. But currently, this is what we see.

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**Amanda Nessa Luper** - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. Great. And then can you just provide an update on maybe output at your Israeli facility? Are you continuing to see improvement in throughput and streamlining production there despite additional product complexities?

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

Yes. Sure. I think it's quite -- I'm quite happy with the improvements we see in our operations from quarter-to-quarter. That includes the Israeli facilities and our facility in Richmond Hill, where we just appointed the new plant manager who started at the beginning of the year. So we look quite positively on our production efficiency as we move throughout the year. And in line with that, we see actually no shortage of capacity for the next foreseeable time. I guess for the next 2, 3 years, we see us serving -- servicing the markets quite well with our 3 facilities.

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**Operator**

Our next question comes from the line of John Baugh with Stifel.

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**John Allen Baugh** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

I have 2 questions. I guess, the first was around the gross margins and maybe we could focus on calendar '18 as opposed to fourth quarter. In the past, we've got some color on the various numbers, basis-point impacts from, I believe, the 4 factors that you cited. Is there any color that you could provide, again, for the year on those? And I'm particularly interested in Israel and what those plants have done through the year, whether they're truly improving because it sounds like Richmond Hill is getting better. I just don't have a frame of reference as to whether Israel gross margins are getting better.

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

Yes. So you asked about the Q4 main drivers for the gross margin?

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**John Allen Baugh** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

I'm really focused on the year, year 2018.



**Ophir Yakovian** - *Caesarstone Ltd. - CFO*

Yes. So I think as we said, I mean, the main factors for the year and actually for the fourth quarter, we experienced the same. It's the same trend of the product, the manufacturing costs in Israel, which is higher, and this is -- we see it as a negative impact on the gross margin. Another one is the foreign exchange headwinds that we experienced, the inventory and logistic inefficiencies. We talked about that in previous calls, and it still affects us, and the higher raw material costs. On the other side, the positive side, we see a better geographic and product mix. And for the full year, the improvement that we see in Richmond, the significant improvement in the output in Richmond and in the yield there is also driving a favorable outcome in the gross margin for the full year.

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

And if I may add, John, I think if you look forward, there is still room for improvement in our operations and supply chain divisions. And for that, I think we recruited quite many new talents, 2 of which are the new VP for Operations and new VP for Supply Chain. Both -- one just joined the business, the other one will be joining the business next week. So I'm looking forward there to see more improvement throughout the year.

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**John Allen Baugh** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

So Yuval, is the Israeli -- are the Israeli plants in terms of gross margin, I mean, are they improving sequentially? It's been quite some time where that's been a factor, a drag on gross margins. And you've talked about product complexity there in terms of producing too many complex products. Has that been resolved? Where does that specific issue sit? And are we seeing any sequential improvement?

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

Thanks for the question, John, because I think it's maybe our opportunity to clear some of the things. Most of the pressure that we see on gross margin actually comes from the market and are commoditizing some of our designs and products. Actually, when we go to -- when we look more deeply on the different models that we have, we actually benefited -- beneficial quite a lot from the new products even though they are more complicated to produce. But if you look all in all in terms of gross margin, they are very profitable. And when you analyze it properly, you actually see that the pressure comes from commoditizing some of the simple products that we have that can be produced in other facilities of our competitors, mostly low manufacturing -- low-cost manufacturing facilities in China.

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**John Allen Baugh** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Got it. And then just quickly on IKEA, in the U.S. piece of IKEA. And I appreciate that you don't like to talk about customers specifically. But this has been a source of pretty wide fluctuations for some time now in terms of performance. So I think investors in general don't have a sense for whether IKEA U.S. is growing, shrinking, still very profitable. Is there any help you can give us on that account going forward?

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

I think, John, it's fair to say that quarter-on-quarter, we still see a [load] quarter this year rather than last year. I think the promotional change that IKEA did probably second quarter last year hasn't been fully manifested itself on the third quarter last year, and it's now fully impacting our quarter this year. Yet, I think the relationship and the volumes are quite stable with IKEA. And I don't expect for 2019 any spikes that I can envisage in the moment. It looks quite stable for this year.



**Ophir Yakovian** - *Caesarstone Ltd. - CFO*

And just to add there, John, we do -- we will see a tough comp in IKEA for Q1. And the -- as Yuval mentioned, we have less control on this, on the activities that IKEA is taking on their promotional and how they structure their promos and the timing and the length of their promotional activities. But our expectation for what we know is to be more pretty stable activity.

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**Operator**

(Operator Instructions) There are no further questions at this time. I would like to turn the call back over to Mr. Dagim for any closing remarks.

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**Yuval Dagim** - *Caesarstone Ltd. - CEO*

Thank you for your attention this morning. We look forward to updating you on our progress in the quarters to come. Thank you very much.

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**Operator**

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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