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CSTE - Q3 2019 Caesarstone Ltd Earnings Call

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CONFERENCE CALL PARTICIPANTS

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

Brad Cray *ICR, LLC - VP & Senior Associate*

PRESENTATION

Operator

Greetings. Welcome to Caesarstone Third Quarter 2019 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.

Brad Cray - *ICR, LLC - VP & Senior Associate*

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 third quarter 2019 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.

Yuval Dagim - *Caesarstone Ltd. - CEO*

Thank you, Brad, and good morning, everyone. Our third quarter 2019 results reflect our focused efforts to execute the various aspects of our Global Growth Acceleration Plan that we introduced earlier this year. Execution against this plan, combined with tight cost control, were the primary drivers in helping us grow adjusted EBITDA and achieve higher adjusted EBITDA margin compared to the prior year quarter.

In addition, I'm encouraged with our execution in the U.S., where we drove 8% growth in our core business. This was largely due to the solid execution of our North American leadership team following the realignment of our operation in that region early this year. While many of our markets outside the U.S. continue to experience intense competition from low price manufacturers, I'm confident in the steps we are taking to improve our performance and enhance our position.

Our new leadership team is now fully in place, executing our strategies through a variety of projects to better leverage our strong brand, more effectively control costs, increase efficiencies and streamline processes. To date, we have started 90% out of an initial 30 identified projects under the growth acceleration plan. Now I'd like to provide several updates on our progress so far.

First, on the production side, we have already begun to develop improved sourcing strategies and initiated projects to enhance productivity and stability of our manufacturing process. Our initial reduction early this year to less than 50% of our full capacity in our Richmond Hill manufacturing facility has provided us the opportunity to further improve productivity and quality. Working off this new efficient base, we now believe we are in a position to increase effective capacity to 60% while maintaining improved level of performance.

Within our supply chain, we are implementing new processes and technologies to improve our forecasting, planning, distribution and inventory management that will provide efficiencies and better service to our customers.

On the technology front, we have initiated a new IT strategy that will transform our company into a data-driven organization as well as automate processes.

Overall, we are confident that these strategic initiatives, along with our strong balance sheet, will better position us to generate additional value for our shareholders over the long term.

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

Ophir Yakovian - *Caesarstone Ltd. - CFO*

Thank you, Yuval, and good morning, everyone. I will start by discussing our third quarter results. For the third quarter 2019, global revenue was $142.8 million compared to $147.7 million in the third quarter of last year. More than half of the decline was attributable to adverse FX impact of $2.7 million. On a constant currency basis, revenue declined by 1.5% compared to last year due to softer market condition in most of the region outside the U.S. combined with more competitive markets, mainly in Australia and Canada, along with lower performance in IKEA U.S. This was partially offset by improved performance in our core U.S. business and strong demand in the U.K.

In the United States, third quarter sales increased by 5% compared to the third quarter of 2018. Our core U.S. business grew 8% year-over-year. This marked the fifth consecutive quarter of revenue growth in our core U.S. business and is mainly attributable to the success of our North America region realignment earlier this year, including the installment of new regional leadership team.

As mentioned on our last earning call, intense competition from Chinese manufacturer at low price point continue to pressure our global footprint outside the U.S.

In Australia, constant currency sales were down 10.1% as a result of the factor I just discussed, coupled with soft housing and remodeling markets and a more challenging lending environment.

In Canada, constant currency sales were down 12.1%. Our performance was affected by softer housing and remodeling markets, combined with more intense competition from Chinese imports.

In Europe, constant currency sales grew 16.3%, primarily reflecting continued strong performance in the U.K.

Sales in Israel, on a constant currency basis, were up 7.5% as we experienced benefits from a higher number of selling days compared to the prior year quarter due to the timing of the Jewish holidays.

Revenue in the rest of the world continued to experience unfavorable impact related to the Chinese competition discussed earlier, and on a constant currency basis was down 10.7%.

Looking at our third quarter P&L performance. Adjusted gross margin was 29.9% compared to 29.7% in the prior year quarter and 27.3% in the second quarter of 2019. The modest year-over-year improvement in adjusted gross margin mainly reflects lower raw material costs and more favorable regional mix, partially offset by increased manufacturing unit costs due to lower fixed cost absorption resulting from lower capacity utilization in addition to lower average selling prices and foreign exchange headwinds.

Excluding legal settlement and loss contingencies, operating expenses for the third quarter benefited primarily from the execution of our Global Growth Acceleration Plan combined with tight cost control, driving lower marketing and sales expenses as well as lower general and administrative expenses.

Adjusted EBITDA in the third quarter was $22.5 million, a margin of 15.8% compared to $21.6 million, a margin of 14.6% in the prior year quarter. This solid performance primarily reflects the higher gross margin compared to last year in addition to lower operating expenses, excluding legal settlement and loss contingencies.

Adjusted diluted earnings per share in the quarter were $0.29 compared to $0.31 in the same period last year on a similar share count. Adjusted net income for the third quarter and first 9 months of 2019 excludes also non-cash exchange rate differences as a result of the implementation of the new lease accounting standard.

We ended the third quarter of 2019 with a strong balance sheet, including cash, cash equivalents and short-term bank deposits of $116.8 million, with no financial debt.

Moving to our outlook. As we discussed today, we expect soft global market condition and the competitive environment to persist in many of our region outside the U.S. through year-end. We continue to expect the most significant impact of this pressure in Australia and Canada as well as in most of our indirect markets. In addition, since the last update to our outlook, currency headwinds have continued as the U.S. dollar continued to appreciate against our other main currencies with an estimated impact of approximately $2 million on the second half of 2019 expected revenue.

Accordingly, we now expect our full year 2019 results to be at the low end of our previously communicated outlook ranges for both revenue and adjusted EBITDA. For the fourth quarter, we anticipate higher adjusted EBITDA margin year-over-year, mainly attributable to operational efficiencies and cost control despite a continuation of market pressure on revenue outside the U.S. and less favorable currency exchange rates. As a reminder, the financial impact of our Global Growth Acceleration Plan is included in our outlook for 2019 and is intended to support additional growth in revenue and adjusted EBITDA over the long term.

To formulate our outlook, we have used current FX rates and raw material prices. Changes to FX or raw material prices may impact our outlook.

In summary, we are encouraged with the improvement in gross margin and adjusted EBITDA in a challenging environment during the third quarter. The execution of our Global Growth Acceleration Plan allowed us to generate additional efficiencies throughout the organization, helping create a strong base to achieve our long-term objectives.

Now I would like to turn the call back to Yuval for closing remarks.

Yuval Dagim - *Caesarstone Ltd. - CEO*

Thank you, Ophir. While we expect our core U.S. business to remain strong and our ongoing operational initiatives to positively impact results, the competitive environment in most of the other regions is likely to persist into coming quarters.

We recognize that we are shifting the fundamentals of our organization, and it will take time to fully recognize the benefits that we are bringing into the organization beyond recent margin improvements. We are still in the early stages of this initiative, and based on our progress so far, we are confident that our new leadership team is taking the right actions to deliver on our objectives and to improve our operating performance over the coming years. I look forward to updating you further on our progress next quarter.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Dillard Watt with Stifel.

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

Maybe wanted to talk a little bit about the core business in the U.S. Saw a somewhat measurable deceleration in terms of the year-over-year growth from the second quarter, but I don't -- I'm not sure if there's some other -- some year-over-year things that you guys are lapping or anything that might explain that.

Yuval Dagim - *Caesarstone Ltd. - CEO*

Thank you for the question. I think all in all, we do see quite interesting increase of the quartz penetration in the U.S. And we are quite encouraged by the continuous penetration of this category in the U.S., in which we are continuing to -- with our efforts to have a better go-to-market platform. We continue to invest behind our sales team, and actually, all the initiatives that we put in our Global Growth Acceleration Plan are in place regarding the U.S.

I think all that has been kind of manifested itself in this quarter increase in -- sorry, growth in our revenue with 4.6% in our core business.

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

Okay. And on the sales team, I know that that's sort of a process to get everyone hired and ramped up. How far along are you in terms of either the number of people or the markets you're targeting or any of those type of metrics?

Yuval Dagim - *Caesarstone Ltd. - CEO*

All in all, it's a few years' journey. We are really building new foundations for our business in the U.S. We are in line with our expectations for manpower and capacity this year. And I think we have quite a robust plan for next year. All our recruitments are going quite well, and we are, I think, bringing quite a lot of new talent to our business.

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

Okay. And then, I guess, IKEA. I know it's tough to answer questions about specific customers. Do headwinds from a year-over-year standpoint start to ease, whether it be due to their changes in their promotions or their comps or anything like that? What should we expect over the next couple of quarters in terms of the stuff that you cannot control as it relates to IKEA?

Yuval Dagim - *Caesarstone Ltd. - CEO*

So maybe just to repeat the numbers again. Our core business actually grew by 8% and altogether with IKEA, it's only 4.6%. We kind of have a very close relationship with IKEA, but we can't say if it's been flattened out or not. All in all, I think we continue with our relationship with IKEA, supporting them in their journey. And I hope that numbers will come up again.

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

Okay. And then, I guess, internationally, sort of a similar story that you've seen in the past in the United States now playing out in Europe once the dumping duties have, of course, been put in place and that volume needs to go elsewhere. Is there anything you've learned from the U.S. that makes you feel like you can put together some sort of defensive strategy or protect yourselves or anything like that, that you basically have the benefit of some hindsight here that you can use to your advantage as this dynamic is playing out in other markets?

Yuval Dagim - *Caesarstone Ltd. - CEO*

I think we referred in the past to the fact that I think most of the initiatives we should be taking are within our company to improve the way we do business. If there is a learning, this is the learning which upon that we are putting our plans going forward. It's the same to other regions as well, competition will be existing and will be in all our regions. And we're mostly focused on what we can do better, how we can service our customers with new innovative products and services and just to make sure that we are at our best in each and every market.

Operator

(Operator Instructions) There are no more questions at this time. I would like to turn the call back to Yuval for closing remarks.

Yuval Dagim - *Caesarstone Ltd. - CEO*

Okay. Thank you for your attention this morning. We look forward to updating you on our progress next quarter. Thank you very much.

Operator

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