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Quad/Graphics, Inc. (QUAD)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Quad Second Quarter 2021 Earnings Conference Call for Analysts and Investors. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to the Quad management team. Please go ahead.

Katie Krebsbach

Investor Relations Lead, Quad/Graphics, Inc.

Thank you, operator, and good morning, everyone. With me today are Joel Quadracci, Quad's Chairman, President, and Chief Executive Officer; and Dave Honan, Quad's Executive Vice President and Chief Financial Officer. Joel will lead off today's call with a business update, and Dave will follow with a summary of Quad's second-quarter and year-to-date 2021 financial results, followed by Q&A.

I would like to remind everyone that this call is being webcast, and forward-looking statements are subject to Safe Harbor provisions as outlined in our quarterly news release and in today's slide presentation on slide 2. Quad's financial results are prepared in accordance with generally accepted accounting principles. However, this presentation also contains non-GAAP financial measures, including adjusted EBITDA, adjusted EBITDA margin, free cash flow, and debt/leverage ratio. We have included in the slide presentation reconciliations of these non-GAAP financial measures to GAAP financial measures.

Finally, a replay of the call and the slide presentation will be available on the Investors section of quad.com shortly after our call concludes today.

I will now hand over the call to Joel.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Thank you, Katie, and good morning. We are very pleased with our second-quarter operating and financial performance which exceeded our expectations. Net sales increased 19% driven by higher print, logistics, and Agency Solutions sales, which rebounded compared to the pandemic period in Q2 of 2020. Our services offerings alone were up 33% in the quarter and 15% year-to-date. These positive trends, which included organic growth as well as print segment share gains from new clients, reflect our employees' hard work and agility, the strength of our business strategy, and the success our integrated marketing offering is having in the marketplace. Thanks to the strong performance and higher cash flows, we were able to significantly reduce net debt by approximately

25% over the past 12 months. We will continue to focus on maintaining a healthy balance sheet, while simultaneously making strategic investments in talent, technology, products, and services to accelerate our position as a marketing solutions partner.

On slide 3, we highlight key competitive advantages that distinguish Quad as a leading marketing solutions partner and create more value for our clients. These advantages reflect our commitment to innovation, integrated marketing platform excellence, and culture and social purpose. I will spend some time today discussing these advantages starting with how we are driving innovation and growth through new talent we're bringing on board.

Turning to slide 4. In July, we welcomed Josh Golden, former President and Publisher of Ad Age, as our Chief Marketing Officer. Josh has incredible insight into what is important and relevant to marketers and is an advocate for an uncomplicated approach to addressing those challenges. The energy and expertise he brings to Quad is key to highlighting our singular place in the market, where we offer through-the-line marketing solutions with the ease of engagement of a specialized agency. Josh will work closely with me; Eric Ashworth, our Executive Vice President of Product & Market Strategy and President of Agency Solutions; and Julie Currie, our Chief Revenue Officer, to accelerate our visibility and drive growth across our entire solutions portfolio. This includes continuing to this – position Quad as a strategic industry partner with deep expertise in helping brands and marketers create big ideas along with reducing complexity, increasing efficiency, and improving marketing spend effectiveness. We're excited about the future with Josh as part of our team.

Turning to slide 5. We continue to invest in our long-term growth platform which includes [ph] martech (00:04:31) solutions that help clients optimize their marketing efforts. Rise Interactive, our tech-enabled performance marketing agency, just won Product of the Year for its innovation, Connex, at the prestigious Sales and Marketing Awards, or Sammys. Connex is a cross-channel media optimization platform that helps marketers know where to allocate their digital marketing budget to achieve their business goals. This type of [ph] martech (00:04:59) solution has become increasingly important as the number of marketing channels expand, each with its own ROI measurement, leaving brands with silo technology and without a solution that informs where to spend their next dollar based on which investments are driving the performance.

With the sheer volume of data, marketers need to know which opportunities to focus on and be able to take immediate action. Connex brings cross-channel media management to life, at scale, with performance transparency unavailable anywhere else. This innovation eliminates the noise of disparate data sets and helps marketers identify the specific value-driving actions they need to take in real time to drive revenue and grow their business. As an example of the power of this platform, Rise recently helped a national retail chain secure more co-op budget from its brand partners by identifying real-time opportunities to capitalize on strong sales performance.

By focusing digital ad spend on times when demand for particular brands and their products are performing well, we help the retailer drive incremental sales while also positioning it as a proactive partner. This was a win-win-win. Brands won by getting proactively notified when their products were selling well; information that was historically more challenging to get from the retail partners. The retailer won because they could do more advertising with co-op dollars. And we won by demonstrating our value as a true partner for integrated marketing solutions.

Turning to slide 6. The retail and e-com spaces have evolved dramatically in recent years, exposing significant workflow challenges for marketers. Additionally, the pandemic and work-from-home requirements have forever shifted how marketing teams collaborate on a daily basis. In light of these disruptions, clients are increasingly demanding a more automated approach to managing their marketing efforts. This is where Quad's Client

Technology team excels. Our team of software developers and UX experts help our clients optimize their processes with highly configurable and scalable workflow solutions designed to address their unique challenges.

Currently, more than 200 clients leverage our technology with more than 150,000 users. Our Client Technology experts are presently helping a leading global, retail, and e-commerce company optimize and deploy highly regionalized advertising and in-store promotion signage as it expands its grocery footprint over the next year. We deployed our content management workflow solution to centralize and organize all this client's in-store marketing efforts and simplify regional complexity. Our team is also assisting with the business process implementation and change management. As a result of our integrated solution, the client is transitioning its in-store signage production to our platform.

We also introduced this client to our analytics solution to dynamically track the effectiveness of each campaign. It is through these types of innovations that we are able to extend and grow client relationships beyond limited engagements and create additional revenue for our clients and our company. We also continue to strengthen our commitment to platform excellence to align with our holistic strategy as a marketing solutions partner.

At the end of June, we divested our 3PL brokered freight business, QuadExpress, for a total consideration of $40 million to the Mullen Group, a leading Canadian logistics provider. This divestiture, which represented a small portion of our global logistics business, supports our established strategy to optimize our product-and-service portfolio and invest in those parts of our business that accelerate our position as a marketing solutions partner and create more value for our clients and other stakeholders. We are pleased to have found a great home for the QuadExpress team.

Given recent nationwide labor shortages, combined with increased volumes at our print manufacturing facilities, we have intensified our focus on attracting and retaining employees through a holistic approach to – designed to ensure we have the talent needed to support our platform and offering and growth objectives. While I continue to be concerned about labor shortages, I am pleased with the traction we are getting with our recent hiring efforts especially as we continue to ramp up for the historically busier back half of the year. These hiring initiatives complement robust retention efforts that include our accelerated career training program and the expansion of Quad's Business Resource Groups, which connect employees with shared backgrounds, interests and issues, and create a more inclusive environment. We continue to be a strong and dependable employer and are well regarded in the industry and among our clients for operating stability, reliability, and agile performance.

Turning to slide 7. Through our commitment to innovation and platform excellence, we continue to attract new clients from existing verticals while simultaneously growing our presence in critical expansion categories like technology, consumer packaged goods, and direct-to-consumer. These brands, admired for their excellence and the loyalty they have built with their customers, have placed their trust in us to help solve their most urgent marketing challenges. As the ad market and broader economy continue to recover and return to growth, we will continue to focus on attracting new clients as well as growing share through our expanded marketing services offering.

On slide 8, we address our commitment to culture and social purpose, a commitment that goes back to our company's founding 50 years ago. Our strong culture and values include an enduring focus on environmental, social, and governance matters. For example, in the social space, we are building a more comprehensive and sustainable DEI strategy, which not only benefits our employees, but also our industry and the communities we call home. When it comes to the environment, we have always sought to minimize the impacts of our business operations by conserving raw materials, minimizing waste, and recycling and reusing whenever possible.

In 2020, we recycled nearly 300,000 tonnes of paper along with 3,000 tonnes of metals and 500 tonnes of plastics. Currently, we recycle 98% of all material byproducts from our manufacturing processes and have multiple initiatives in place to increase that amount to 99.5%. We take seriously our role in creating a better way through our social, environmental and economic contributions.

Before I turn the call over to Dave, I want to thank our employees for their continued hard work and dedication and congratulate them on our 50 year milestone anniversary which we marked on July 13. The team has been resilient in the face of a truly dynamic environment and unprecedented challenges. And I thank them for supporting each other in managing through disruption in its many forms to continue to serve our clients well. I am proud of how we have been navigating the pandemic and with ad spending and the wider economy now recovering, we are focused on growth.

As always, we will remain nimble so that we can adapt to changes in the demand landscape.

With that, I'll now turn the call over to Dave.

David J. Honan

Chief Financial Officer & Executive Vice President, Quad/Graphics, Inc.

Thanks, Joel. And good morning, everyone. Slide 9 provides a snapshot of our second quarter financial results. As Joel mentioned, we delivered strong operational and financial results that exceeded our expectations for the quarter. Our business is clearly building momentum and our clients are growing more confident in their own recoveries. And as a result, we are raising and expanding our financial outlook for 2021 net sales, adjusted EBITDA and debt leverage. Net sales were $694 million in the second quarter, an increase of 19% from 2020, significantly better than our previous outlook for the quarter of 10% to 13% net sales growth.

Net sales increased by $109 million year over year which included gains across all of our businesses, print, logistics and agency solutions which rebounded compared to the pandemic impact to the second quarter of 2020 as well as print segment share gains from new clients. As importantly, we converted the net sales growth into strong free cash flow and in combination with proceeds from asset sales, we reduced net debt by $120 million in the first six months of 2021.

Our focus on our balance sheet has resulted in approximately a 25% reduction in net debt over the past 12 months despite challenging business conditions. On a year-to-date basis, net sales were $1.4 billion, down 1% as compared to 2020, primarily due to the impact from the COVID-19 pandemic in the first quarter, which represented the final quarter of annualizing that pandemic impact on our net sales. The net sales growth in the second quarter of 2021 nearly offset the first quarter's net sales decline due to strong rebounding growth in print, logistics and agency solutions sales and new client wins.

Adjusted EBITDA was $60 million in the second quarter, flat with 2020 primarily due to higher earnings from the 19% net sales increase, offset by non-recurring benefits in 2020, primarily related to approximately $30 million in temporary cost reductions implemented in 2020 in response to the pandemic's abrupt impact on our net sales. Adjusted EBITDA margin was 8.6% in the second quarter as compared to 10.2% in 2020. This was in line with our expectations as we noted during our first quarter earnings call that second quarter margins would be somewhat pressured due to the nonrecurring nature of the temporary cost savings measures implemented in the second quarter of last year, which included initiating furloughs, temporary wage reductions and hiring freezes and temporarily suspending production at several of our manufacturing facilities.

We've worked diligently over the past year to convert a majority of these temporary cost savings into permanent savings. However, some of these temporary cost savings were subsequently reinstated in the back half of 2020 to support the recovery in net sales from the pandemic's peak impact during the second quarter of 2020. Year-to-date adjusted EBITDA for the six months ended June 30, 2021 was $126 million, a $9 million or 7% decrease as compared to $135 million in 2020. Adjusted EBITDA margin was 9% in 2021 as compared to 9.6% in 2020. The strong second quarter net sales growth and related adjusted EBITDA impact partially offset the full year impact of non-recurring benefits in 2020 primarily related to approximately $30 million in temporary cost reductions and a $12 million benefit in 2020 from a change in vacation policy.

Free cash flow with $62 million in the first half of 2021, an increase of $33 million versus the same period in 2020 primarily due to higher net cash provided by operating activities driven by working capital improvements and lower costs restructuring costs and $11 million decrease in the capital expenditures.

Slide 10 includes a summary of our debt capital structure as of June 30. We've reduced net debt by $120 million since the end of 2020. And over the past 12 months, we've reduced net debt by $225 million or nearly 25%. This is the outcome of our continued disciplined approach to managing our balance sheet to allow for stability during uncertain times as well as to provide more capital allocation flexibility to take advantage of opportunities. During the past year, we divested two of our business units, our book printing business in 2020 and our QuadExpress 3PL brokered freight business in this past quarter. These divestitures are part of our established strategy to optimize our product and service portfolio and invest in those parts of the business that accelerate our position as a marketing solutions partner and create more value for our clients and other stakeholders.

The QuadExpress 3PL logistics business had approximately $135 million in revenue and represents a small part of our global logistics product offering and was sold for $40 million, representing an attractive price with a multiple of over 8 times adjusted EBITDA. In addition, during the second quarter, we also completed a sale and leaseback of our Chalfont, Pennsylvania production facility for [ph] $20 million (00:18:15). All in over the past 12 months, we've realized approximately $100 million in proceeds from asset sales and have generated $160 million of trailing 12-month free cash flow from our business operations.

The result was $260 million of cash to allow more focus on transformational strategy, better capital allocation and further debt reduction. Our debt leverage improved to 3.0 times compared to 3.35 times at the end of 2020. While this leverage ratio is above our long-term targeted leverage range of 2 times to 2.5 times, we will continue to significantly reduce debt during 2021, as we expect to further improve our debt leverage ratio to be approximately 2.75 times by the end of 2021.

As of June 30, our blended interest rate was 4.9% and we maintained our strong liquidity position with up to $463 million of availability under our revolving credit agreement and $98 million of cash on hand. [ph] Quad nears (00:19:24) debt maturity is our 7% Senior Unsecured Notes due May of 2022 which has $239 million outstanding. As it relates to the Senior Unsecured Notes' upcoming maturity, we believe we are well-positioned to address the notes at or before their maturity in 2022 with our ample liquidity. As we review our financial outlook for 2021 on slide 11, we remain optimistic and confident. We have strong sales momentum heading into the second half of the year and we are increasing our full year net sales outlook for organic growth of 1% to 3% in 2021, which excludes the impact of our June 30 QuadExpress divestiture for the back half of the year. In addition, we expect full year adjusted EBITDA to be in the range of $240 million to $260 million.

Finally, we expect to generate strong free cash flow from operations in combination with proceeds from asset sales to further reduce our debt leverage to be an approximately 2.75 times by the end of 2021, which is significantly below our previous outlook of 3.0 times. Our clients continue to embrace our integrated marketing offering, which is helping us meet our financial objectives of driving earnings and increased margins through revenue growth, effective cost management and productivity improvement as well as reducing debt to the generation of strong free cash flow in cash generated from asset sales. All of these efforts will continue to strengthen our balance sheet and liquidity to ensure we have the financial flexibility to continue to accelerate and scale our strategy and drive shareholder value.

With that, I'd like to turn the call back to Katie who will review questions compiled in advance of today's call.

QUESTION AND ANSWER SECTION

Katie Krebsbach
Investor Relations Lead, Quad/Graphics, Inc.
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Thank you, Dave. Because we compiled questions in advance of today's call, we will not ask for callers to enter the queue. Thank you to everyone who submitted a question. We have three top questions that were submitted. The first question is on print segment revenue. It reads, you've been highlighting print segment share wins more often than you have in the past. What are you seeing from a competitive standpoint?

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.
A

Well, Katie, I'll take that. Clearly, there has been a lot of disruption in the past year in pretty much every business, but specifically in the legacy print business, there's been a lot of challenges. But I'm very proud at how we've managed through this as we've just shown you and actually continue to shore up our balance sheet in a very positive way. And so what we're seeing now is just a lot of people looking for stability. And so we've seen an uptick of whether it's current clients asking us to do more or new [ph] logos (00:22:16) coming into the fold looking for stability. And what's great about that as we've been able to bring on those clients is that they get exposed to all the other stuff we're doing just like our current [ph] logos (00:22:30) that have relationships with us. We show them that not only can we be efficient and reliable in putting their workout but also that we can actually work with them to help them sell more product.

And so we look forward to not only the work we're picking up as part of this sort of disruption from existing clients, but the new [ph] logos (00:22:52) coming in I'm very excited about because we can prove to them that we can be that partner and not only provide them stability of the legacy platform, but actually help them grow their businesses. So we're very excited about what we're seeing and again, I think we've always done a very good job of managing through tough times to be able to come out on the other side stronger than we were at the beginning.

Katie Krebsbach
Investor Relations Lead, Quad/Graphics, Inc.
A

Thanks, Joel. That's great to hear. Okay. Our second question is regarding QuadExpress. It asks, can you give more detail on why QuadExpress was sold, and how does QuadExpress differ from the broader logistics business that Quad will continue to run?

David J. Honan
Chief Financial Officer & Executive Vice President, Quad/Graphics, Inc.
A

Thanks, Katie. It's Dave, I'll take that one. QuadExpress and this is a reminder, it was a non-asset based third-party broker of logistics services for customers that we acquired as part of the World Color acquisition back in

2010. So over time, we've really grown this business nicely with a combination of expanded services they can offer and innovative technology including the development of our Silver Express Transportation management system. So, technology was a key part of growth for this business. However, QuadExpress is a much smaller part of our overall logistics offering. We're not selling our logistics business. We're just selling the brokered freight portion of it as part of our established strategy to optimize our product and service portfolio as we position ourselves as a marketing solutions partner and create more value for our clients and shareholders.

So, we're going to continue to operate a much larger and broader in-house global logistics business which includes Quad Transportation Services and our trucking group to Plainville Transport to provide logistics services directly to our clients as compared to the more brokered model of what QuadExpress was.

And I think the final thing I would say is we're really were pleased by the outcome of the sale process. We realized that really attractive sales price of $40 million as I said before that represents over an 8 times multiple of adjusted EBITDA and I think as importantly, we found a buyer who can strategically grow and nurture the business like we had in the past and take it to different levels. So, that's really good for the business and for our employees who are part of QuadExpress. So, we really thank those employees for over their past [ph] decade of service to Quad had (00:25:25) really been successful for us. I think it's a great outcome for QuadExpress. I think it's a great outcome for those employees and for Quad and we can better now allocate that capital to accelerate growth in our marketing solutions group and a further decreased debt.

Katie Krebsbach
Investor Relations Lead, Quad/Graphics, Inc.

A

Great. Thanks for that additional detail, Dave.

David J. Honan
Chief Financial Officer & Executive Vice President, Quad/Graphics, Inc.

A

Absolutely.

Katie Krebsbach
Investor Relations Lead, Quad/Graphics, Inc.

A

Okay. Our final question relates to the 2021 outlook. It reads, can you speak more to client trends and what you are seeing going into the second half of the year that gives you confidence in raising your target?

David J. Honan
Chief Financial Officer & Executive Vice President, Quad/Graphics, Inc.

A

Yeah. I think confidence is the key word here. I think what we saw building throughout the last few quarters that we've been exiting out of the peak impact of the pandemic is growing confidence, growing improvement, and rebound in demand for advertising and marketing products and services of our business and as our clients have been improving, so have we. And so we have a lot of confidence coming out of the second quarter where we were significantly above our net sales at 19% growth versus what we thought of 10% to 13% heading into the quarter.

So really that strength gives us a lot of confidence in how we've put out increased guidance for the rest of the year. And again, a reminder, the guidance for the back half of the year, in the full year guidance, excludes the impact of the QuadExpress divestiture I just walk through. And so increasing organic net sales growth from slight down to flat to increasing amount of 1% to 3% growth in 2021 is really, really good; really important for the momentum of our business. Adjusted EBITDA in the range of $240 million to $260 million, so that's new guidance for us. And that also takes in consideration the EBITDA on the back half of the year that we lose from the sale of QuadExpress.

So – but I think – and also in particular what we're really pleased about is the tremendous progress we've made on the debt side. We've essentially, in the first half of this year, accomplished what we thought we could accomplish at the back – at the end of the year, so getting to 3.0 times leverage was a big deal for us and was earlier than we thought we could do it because we previously guided we thought we could get there by the end of the year. And so, we're happy [ph] you're (00:27:44) early on that, and what's great is the momentum of the business is carrying it forward, aided by some additional asset sales. Well, we think we'll get to 2.75 times leverage by the end of the year at a $250 million midpoint of our adjusted EBITDA guidance. So, really positive developments on the balance sheet and for our business, where it puts us in excellent position to continue to strengthen that balance sheet, which we believe is one of the healthiest in the industry, in the product segments in which we compete – many of those – and provides further capital for accelerating our transformation.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

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Yeah. And let me add some commentary because we do like to walk through the various categories we're in, just to give you some color. But using sort of 6.5% GDP growth in the second quarter is sort of the context and the backdrop. Retail inserts were actually flat for us. That will – that has been and will continue to be the more challenged part of the portfolio, primarily due to the carrier of newspapers, etcetera. But if you look at the rest of the categories, we really exceeded our market segment metrics in every category of what those specific categories we're doing as a whole. So, if I look at publications, periodical volume for the USPS in the quarter was down like 5%. We're actually up 7% in [ph] Quad (00:29:06) press pages for the publication market. And so, that's a combination of, I'd say, the quality of the clients that we have but also continued segment share wins as people look for stability.

On the catalogs side, the industry as a whole had a nice bounce-back of about 19% in the quarter. Quad was up over 26%. And, again, what we're seeing there is segment wins that we've been accumulating, but also there's quite a few clients who have been increasing counts and even several of them to above pre-pandemic volumes as the health of their business and the health of print as a part of the overall marketing mix proves itself.

Direct mail, the industry had a nice rebound of about 39%. We were up 41%. And then packaging, which saw a pretty healthy growth through the pandemic because of the change in a lot of the habits that – how people were purchasing, the industry was up between 5% and 10%. Our packaging sales were up 11% in the quarter. So, excited by that. And one of the things I'm very proud of is that, in the second quarter, our entire services offering, the place we've been investing in a lot of the Agency Solutions and things I've been talking about for a long time, were up 33% in the quarter and 15% year-to-date. And so, again, that really adds to my comment about building momentum for [ph] the new mobiles (00:30:36) we have and showing them that we're very capable of helping them become even better as brands.

Despite this momentum, I do remain cautious about the Delta variant. We talked about the labor shortage. We've done a good job of [ph] being – to (00:30:52) hire people and retain people. But we're keeping an eye on the impact of the Delta variant as it kind of goes through this country. The other thing that's interesting is – many of you know that the Post Office is increasing their rates pretty dramatically here in August. The good news is we haven't seen much of an impact yet, and hopefully we won't. But a lot of times, when it gets announced, and those increases come in, you'll see a immediate reduction. But because of the comments I made before about segment share and rebounding and all of that, we haven't seen a big impact from that yet. But we'll keep an eye on it. And so, despite of all those headwinds, we're very confident in our outlook and very excited about what we're doing, and we will continue to be very focused now on growth and true growth. And so, with that, we'll continue to update you on how we see the world play out.

Katie Krebsbach
Investor Relations Lead, Quad/Graphics, Inc.

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Great. Thank you, both. Well, this concludes the Q&A portion of today's call. And now I would like to turn the call back to Joel for closing remarks.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Thank you, everyone, for joining today's call. I again want to congratulate our employees on our company's milestone 50th Anniversary and our legacy of creating a better way every day. I'm confident in our team, in our strategy, and in our future as a marketing solutions partner that helps brands and marketers solve their marketing and process challenges. As the ad market and broader economy continue to recover and return to growth, our innovative team remains committed to creating new revenue from our expanded marketing services offering. Thank you, and we'll talk to you next quarter.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.