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Quad/Graphics, Inc. (QUAD)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

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

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

Anthony C. Staniak
Chief Financial Officer, Quad/Graphics, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen and welcome to Quad's Second Quarter Conference Call. During today's call, all participants will be in listen-only mode. [Operator Instructions] A slide presentation accompanies today's webcast and participants are invited to follow along, advancing the slides themselves.

To access the webcast, follow the instructions posted in the earnings release. Alternatively, you can access the slide presentation on the Investors section of Quad's website under the Events & Presentations link. Please note this event is being recorded.

I would now like to turn the conference call over to Katie Krebsbach, Quad's Investor Relations Manager. Katie, please go ahead.

Katie Krebsbach

Investor Relations Manager, 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 Tony Staniak, Quad's Chief Financial Officer. Joel will lead off today's call with a business update and Tony will follow with a summary of Quad's second quarter 2022 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, adjusted diluted earnings per share, free cash flow, net debt, 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, everyone. Beginning on slide 3, I am pleased to report our results were in line with our expectations, delivering a fifth consecutive quarter of sales growth, achieving a 14% increase in net sales, when excluding divestitures. This strong growth included print segment share gains and net sales growth across all of our offerings. Throughout the quarter, we continued to face macroeconomic headwinds such as an ongoing supply chain constraints that impacted productivity and cost inflation on labor and other areas. We worked diligently to mitigate these impacts, including implementing an additional price increase in mid-May in response to inflationary cost pressures, while continuing to make investments to prepare for our seasonally busier second half of the year, including increasing inventory levels for paper and other key manufacturing materials, and hiring and training employees for our manufacturing operations far earlier than usual. As a result, our net earnings and adjusted EBITDA during the quarter were negatively impacted. However, we are poised to grow sales and profitability in the second half of the year due to these proactive measures. High inflation, ongoing supply chain disruptions, geopolitical tensions and other factors are creating economic uncertainty. We remain nimble, ready to adjust our operations, if necessary, while continuing to serve our clients well.

Slide 4 shows how we continue to diversify our revenue into higher value and higher margin offerings, while growing net sales 14%. For example, our integrated solutions and targeted print segments grew from the second quarter of last year to the second quarter of this year. At the same time, we continued to manage for expected organic declines in large scale print.

Turning to slide 5, we are proud of our company's transformation and continue to evolve how we operate and communicate our unique value as a marketing experience company. We help brands reimagine their marketing to be more streamlined, impactful, flexible and frictionless. We do this through a discipline-led integrated marketing platform that includes business strategy, insights and analytics, technology solutions, managed services, agency and studio solutions, media, print, in-store, and packaging.

On slide 6, we highlight our three key competitive advantages, integrated marketing platform excellence, innovation, and culture and social purpose. We continued to strategically invest in our platform, which includes creative analytic print, and production capabilities. These investments include advancements in data signals, insights and analytics, including solutions that account for new data privacy restrictions and regulations. Next gen printing capabilities with 100% variable print at the speed and scale required by today's marketers and expanded costs saving solutions, like our merge mail program. This unique solution combines multiple marketers' direct mail piece production into a single run. It delivers poster savings, while maintaining content personalization.

To strengthen our brand as a market experience company, we continue to make investments in how we market ourselves, including introducing Quad to new and expanded audiences, as shown on slide 7. In June, we attended the Cannes Lions International Festival of Creativity, where we conducted more than 50 meetings in three days, sharing our expertise and through-the-line marketing. We strengthened existing client relationships and uncovered new partnership possibilities for applying our unique technology and scalable solutions to help drive and support any brand's growth agenda. Also in June, we sponsored and presented at CommerceNext 2022 in New York City, a two-day event for retailers and direct-to-consumer brands. Quad Media's performance marketing agency, Rise Interactive presented ways to maximize marketplace dollars focusing on Amazon, the biggest e-commerce engine. Rise laid out exactly how marketers can understand the truly value of their digital spend in an increasingly complex landscape. During the quarter, we also continued to facilitate thought leadership discussions among senior brand marketers from Fortune 500 and other leading companies. For example, we recently participated in talks for the Brand Innovators community about challenger brands at next-gen D2C companies.

Turning to slide 8. Through our discipline-led approach, we are growing our presence with brands' incredible expansion categories such as technology, finance, healthcare, retail, 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 market their products and services through targeted, personalized channels.

Moving on to slide 9. Quad Creative's advertising agency, Periscope, recently launched a brand design practice called Favorite Child. The mission of this practice is to make brands a favorite through inspired consumer action and reaction, enhanced connections and growth. Favorite Child services include brand positioning, design strategy, brand identity systems, packaging, experiential and adaptive design, retail environments and content services such as cross-channel content creation. Favorite Child just helped Mostly Made, a provider of meal starter kits, updated its brand look and packaging as it prepared to move from the grocery freezer aisle to the refrigerated deli case. We created the brand strategy, refreshed the brand mark and designed a new packaging, creative and structure. We also engaged our package insight research team, which specializes in brand packaging performance to test concepts with consumers in our simulated shopping environment, and then printed the final product. Follow-up research shows that this brand work is generating tremendous results. Consumers are noticing the new packaging design twice as fast as the former design, looking at it twice as long and buying Mostly Made's meal-starter kits 2.5 times more frequently.

On slide 10, we show how we helped a large food retailer with more than 2,400 US supermarkets, streamline weekly signage kits for communicating essential pricing and promotional information. The retailer sends out more than 100 unique in-store signage displays each week across 19 different brands and in more than 160 different configurations. We invested in the state-of-the-art Landa digital press that enables our in-store team to take friction out of this complex implementation, increasing speed to market and customization options by region and store. Despite aggressive timelines and a stressed supply chain environment, we are delivering high quality signage on-time across the country each and every week. This client has praised us for a seamless transition.

Another way in which we are helping our clients reimagine the marketing experience is through their sustainability efforts. As momentum behind extended producer responsibility grows and as consumer demand and regulatory requirements multiply, product manufacturers increasingly will be held responsible for reducing waste and creating a more efficient, circular supply chain. Quad believes retailers in their own brands programs will be the tipping point of this movement and we are committed to helping retailers rewrite the rules of engagement with capabilities from brand creation through packaging printing, Quad is uniquely equipped to help retailers lead game changing sustainability initiatives.

For example, our national home improvement retailer that we have a 25-year relationship with recently engaged us to help improve the sustainability of its private label packaging as shown on slide 11. Our work for this client started with collecting data on the different types of materials used in more than 3,200 SKUs of its private label packages. Our analytics team interviewed approximately 100 global vendors and conducted multiple store visits and then organized the data into an easy-to-access repository and provided insights, including trend intelligence and ideas of how to design out waste from a variety of packaging. With this information, the retailer was able to make high-impact changes. We look forward to growing this relevant and profitable area of our business.

On slide 12, we address our commitment to culture and social purpose, which includes an enduring focus on ESG matters. When it comes to the environment, we are uncompromising in our focus to reduce our impact. For example, when it comes to printed products and packaging, we choose suppliers with care, looking for reliable chains of custody and challenging ourselves to discover more sustainable materials and responsible sources. In the social space we are advancing on our goal to build a more comprehensive and sustainable DEI strategy that not only benefits our employees, but also our industry and the communities we call home. Just last month, our DEI task force kicked off the implementation phase of a multi-year action agenda. This agenda features multiple projects that continue to promote and foster a culture of inclusion at Quad and includes measurement and monitoring to hold ourselves accountable.

Several projects are tied to attracting and retaining new talent with diverse social identities and experiences. For instance, our commitment to the BrandLab, an organization committed to changing the face and voice of the marketing industry, is thriving. This summer, the BrandLab has placed 30 high school and college students from diverse ethnic and socioeconomic backgrounds in internships at agencies and corporations throughout the Milwaukee area, including several here at Quad. Next year, the organization seeks to double the number of placements in Milwaukee, while also continuing to grow its existing programs in Minneapolis and Kansas City.

I also want to recognize our very own Cari Bucci-Hulings, President of Periscope for recently being named one of Adweek's Women Trailblazers for elevating and empowering under-represented voices. According to Adweek Cari leads with empathy and flexibility, emphasizing a people first approach that empowers employees to do their best work. So congratulations, Cari. I'm also proud of our employees, who have given generously to the Quad community fund for Ukraine relief, an internal fundraising campaign to help individuals and families ravaged by the ongoing war in Ukraine. Together with a $1 for $1 company match, our employees donated nearly $75,000, which will be directed to humanitarian relief efforts in Ukraine and Poland, where we have a major operation. I sincerely thank everyone, who opened their hearts and wallets to help those in need.

I will now turn over the call to Tony for a review of our financial results, as well as share our financial objectives, including how we are providing long-term shareholder value through share repurchases. Tony?

Anthony C. Staniak

Chief Financial Officer, Quad/Graphics, Inc.

Thanks, Joel, and good morning everyone. Slide 13 provides a snapshot of our second quarter 2022 financial results. As Joel mentioned, we achieved net sales growth of 14%, excluding divestitures, representing a fifth consecutive quarter of net sales growth. We are anticipating continued sales growth and increased profitability in the second half of 2022. We are closely monitoring the economy and are prepared to adjust as necessary to continue acting on our financial objectives, including reducing debt and driving shareholder value. During the second quarter, these actions included paying off the remaining $209 million of our unsecured 7% senior notes and thereby lowering our blended interest rate by over 80 basis points to 3.8%. Additionally, we demonstrated Quad's value as an investment by repurchasing 1.7 million shares of Class A common stock for $5 million through August 1, 2022, which we believe represents strong value at today's prices. We were also pleased to be added to the small-cap Russell 2000 Index in June. We will remain disciplined with our capital allocation by focusing on debt reduction to continue enhancing our financial strength, while making investments to accelerate our growth as a marketing experience company.

Net sales were $758 million in the second quarter, up 9% from 2021. Excluding the June 2021 divestiture of QuadExpress, a third-party logistics company that was a small part of our overall logistics business, net sales increased 14% from 2021. On a year-to-date basis, net sales were $1.5 billion, up 7% from 2021 and excluding the QuadExpress divestiture, net sales increased 12% compared to 2021. Net sales growth was achieved across all of our offerings due to increased pricing in response to inflationary pressures, print segment share gains and onboarding new clients in Agency Solutions.

Adjusted EBITDA was $56 million in the second quarter of 2022, as compared to $63 million in the second quarter of 2021. And adjusted EBITDA was $105 million in the first half of 2022, as compared to $133 million in the first half of 2021. These declines were primarily due to the negative impact of supply chain disruptions on our productivity, investments in hiring and training labor in advance of the peak production season during the second half of the year, and cost inflation, which were partially offset by net sales growth. In response to increasing costs to service our clients, we implemented an additional price increase effective May 15, 2022.

Adjusted diluted earnings per share was $0.13 in the second quarter of 2022, consistent with the second quarter of 2021. Year-to-date adjusted diluted earnings per share was $0.17, compared to $0.31 in the same period last year. The decline in the year-to-date period was primarily due to the supply chain challenges, investments and cost inflation previously mentioned, partially offset by net sales growth, lower depreciation and amortization and lower interest expense due to the debt reduction. Free cash flow was negative $57 million in the first half of 2022, a $119 million decrease compared to 2021, primarily due to higher working capital and lower profitability in the first half of the year. We also invested $34 million year-to-date in capital expenditures, consistent with our long-term automation strategy. We will continue to invest in our business to seize opportunities, including accelerating our growth or reducing our costs. As a reminder, the company historically generates the majority of its free cash flow in the fourth quarter of the year.

Slide 14 includes a summary of our debt capital structure. Net debt increased by $60 million to $684 million in June 30, 2022 as compared to $624 million as of December 31, 2021. And the debt leverage ratio increased 56 basis points to 2.95 times at the end of the second quarter. The increase in net debt and the debt leverage ratio was primarily due to the investment in working capital in preparation for our peak production season. As a reminder, our long-term targeted leverage range is 2 times to 2.5 times and with seasonally strong fourth quarter cash flows, we planned to achieve 2.25 times by the end of the year. During the second quarter, we paid off the remaining balance of $209 million of our unsecured 7% senior notes, resulting in a lower blended interest rate of 3.8% as of June 30 compared to 4.6% as of March 31. We also maintained our strong liquidity with up to $286 million of availability under our revolving credit agreement and $12 million of cash on hand. Our near significant debt maturities $88 million, occurring in January 2024 with the remainder of the significant debt maturities not due until late 2026.

Our 2022 guidance is unchanged as shown on slide 15. Our annual net sales growth has the potential to exceed the guidance range. However, we remain cautious in the current macroeconomic environment and are not increasing the net sales guidance range at this time. We anticipate our adjusted EBITDA and free cash flow in the second half of 2022 will be higher than the first half of the year, as well as compared to the second half of last year, due to the strategic, proactive investments we have made in working capital, talent and equipment to drive higher profitability during our seasonal peak production period. We will also continue to be nimble with our pricing to mitigate the negative impacts of supply chain disruption and cost inflation.

Our financial objectives remain unchanged and include: driving earnings through sales growth; effective cost management and productivity improvements; investing in our business to fuel growth; reducing debt through the generation of strong free cash flow; as well as driving shareholder value by continuing to pursue opportunities with our share repurchase program. All of these efforts will further strengthen our balance sheet liquidity, enhancing our financial flexibility to accelerate and scale our strategy as a marketing experience company, while driving shareholder value.

With that, I'd like to turn the call back to Katie for questions.

QUESTION AND ANSWER SECTION

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

A

Thank you, Tony. 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 four top questions that were submitted. Our first question relates to industry and segment trends. It asks, can you discuss what trends you're seeing across the business, and are there certain segments that might be seeing an impact from a slowdown in consumer spending due to the current macro environment?

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

A

Yeah, Katie, what – I'll walk through our different segments and I usually start with the most challenged segments of retail inserts and magazines. That's our large scale print portion of our business. And retail inserts, as we said, we expect to continue to be under pressure and decline because of the carrier of the newspaper declining as well. However, I also remind people that the retailers are the ones who buy it – are heavy users, and buy a significant amount of the rest of our product lines beyond the retail insert. So that was off about 9% for the, for the quarter and about 18% in the trailing 12 months, which again was expected.

On the magazine side, we are offered the trailing 12 months, about 8% and about 12% for the quarter. This was actually due to some – partially due to some significant titles being closed as companies have been acquired and have reshuffled their decks, but also continued pressure on ad pages. However, if you look at the catalog side for the quarter, we're actually down 10%. But that's misleading because we've had pressures from a shortage of paper supply and so some of this volume didn't go away, it just moved. And so if you actually look at the trailing 12-month of catalog, we're up 5%.

On the direct mail side, we're up about 3% in line with the industry. On packaging, we're up significantly, 22% for the quarter. Some of this is due to picking up some great work in producing the COVID packages that are all out there for the test kits. In-store, due to significant client wins, we're up over 46% for the quarter. And then our Agency Solutions group is up 4% based on new client wins. And so those are the different segments. And I'd just remind people that, yeah, that some of the pressures that we felt last year and everyone felt were due to paper shortages that the industry is dealing with. And we feel that we're managing that relatively well. I'll remind you that about 50% of the paper that goes through Quad is supplied by us, the other 50% is supplied by our customers. And so we're doing a lot of work this year to make sure that part that we supply it is available and doing well.

And the other part, that's been a challenge and a pressure is – for us in getting these product lines up is labor. Last year, everybody, just about everybody I talked to an industry, was struggling from shortage of labor both from the low unemployment environment, but also due to COVID, but this year we're doing much better. And so that's really kind of a look at the different segments here and some of the pressures we talked about.

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

A

Thanks, Joel. Our next question is regarding peak production in the second half of the year. It asks, are you doing anything differently to prepare for the second half of the year this year compared to previous years to maximize productivity, given the current state of the economy and headwinds you've had to deal with?

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

A

Yeah, I think, I just touched on the headwinds, which is it was the paper shortage and labor, not to mention inflation, which everyone's dealing with. And we dealt with that. We've had to pass on surcharges to our clients just to keep up with it and feel that we're managing as best we can. On the paper side, again, we've had to order paper earlier for the part we supply for a lot of our customers because the industry is just, quite frankly, out of capacity. And so it's had – it's caused us to kind of have to shift the buying, having more cash tied up in inventory earlier on, before things are printed. But we feel very ready for the second half in terms of paper availability for the clients that we supply.

And then on the – again, on the labor side, we started hiring much, much sooner than ever. And so there was a lot of investment in paying people earlier coming onboard because we're very second half busy. And not to mention we had to invest a tremendous amount in training to make sure that they're up to speed by the time the busy season comes. And I'm very happy to report that we feel very, very good at the labor, we've been able to hire through all the various programs we've done. So my hats off to everybody that we are ready for the busy season and ready for our customers as even with the segment share gains that we've had. And then finally, we did – we continue to invest in other things to kind of offset some of these challenges long term, especially labor with more investment in automation.

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

A

Great. Thanks again, Joel. Our next question is on free cash flow and asks, given that you've had negative $57 million in free cash flow in the first half of the year, what gives you the confidence that you will still be able to hit your guidance of $70 million to $100 million?

Anthony C. Staniak
Chief Financial Officer, Quad/Graphics, Inc.

A

Yeah. Thanks, Katie. I'll take that one. So we're at – we're a seasonal business. Our highest sales and most production are from August to November. So we have to ramp up inventory levels leading into that period to be able to meet the client demand. And so then as the fourth quarter comes, we're reducing those inventory levels, we're also then collecting from the invoices we send to customers and that ends up being strong free cash flow in the fourth quarter and then Joel has talked about how we ramped up paper and inventory levels even more this year due to the supply chain disruption. So that means that the first half of our year is more negative, but then we're going to have stronger free cash flow at the end of the year, when we realize the collections from all of that inventory and that's how we'll meet the guidance range for free cash flow.

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

A

Great. Thanks, Tony. Our last question is regarding stock buybacks. It asks, this is the first quarter you executed against the buyback program that has been in place for many years. Can we take this as a new signal that you'll use this program more often to drive value moving forward?

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

A

Katie, you're right. We've had an outstanding – the buyback program that we haven't used as of late. But just now we looked at the value and one of the efforts we're trying to do too is be able to buy back some of the dilution that we've incurred over the years by making sure we attract the best management team and using equity because we believe that's a great way to motivate people for the long term. So you'll see us over time, when we see the right opportunity and feel it's a great use of capital. You'll see us do some of this.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

Thanks, Joel. And 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.

Thanks, Katie, and thank you all for joining us today. I want to close by reiterating my thanks to our employees for their continued hard work and ability to adapt and adjust to change. I'm confident in our team, in our strategy and in our future as a marketing experience company that helps brands reimagine their marketing to be more streamlined, impactful, flexible and frictionless.

With that, thank you again and have a good day. We look forward to speaking with you again next quarter.

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