Corrected Transcript

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Quad/Graphics, Inc. (QUAD)

Q3 2020 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen and welcome to Quad's Third Quarter 2020 Conference Call. During today's call, all participants will be in a listen-only mode. [Operator Instructions] A slide presentation will accompany today's webcast, and participants are invited to follow along advancing the slides themselves. To access the webcast, follow the instructions posted in this morning's earnings release. Alternatively, you can access the slide presentation on the Investors section of Quad's website under Events & Recent Presentations (sic) [Events & Presentations] (00:00:41) link. Please also note today's call is being recorded.

At this time, I'd like to turn the conference call over to Katie Krebsbach, Quad's Investor Relations Lead. Katie, 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 third quarter 2020 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.

J. Joel Quadracci

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

Thank you, Katie, and good morning, everyone. Despite significant volume declines due to the pandemic, our third quarter performance was strong. We continued to aggressively manage our cost structure, treating almost all costs as variable. At the same time, we continued to drive productivity improvements and protect the health of our balance sheet. We also achieved higher profit margins for the quarter and on a year-to-date basis generated positive cash flow and continued to pay down debt. We were also able to maintain our leading competitive position and grow segment share providing stability for our clients while we continue to drive our transformation strategy at a time of significant industry and economic disruption.

As outlined on slide 3, during the quarter, we continued to proactively manage through the impacts of the pandemic with the focus on maintaining the health and well-being of our employees, providing high quality on-time delivery for our clients and ensuring the long-term financial health and stability of the company. We remain committed to our Safe-at-Work program providing frequent employee communications on how to stay healthy both inside and outside of work. The number of confirmed cases at Quad remains relatively low, even during this fall's significant increasing cases countrywide and has not negatively impacted operations; however, we continue to monitor the situation closely.

We also continued to take actions to protect the company's long-term financial health. While client demand remained below last year's levels, volumes came in stronger than expected due to the economy reopening and some segment share gains. As we look to the future, we continue to accelerate our transformation as a marketing solutions partner to drive new revenue sources outside of traditional print and at higher margins.

We are focused on the three key areas outlined on slide 4, optimize our product portfolio to focus the company on the greatest revenue generating opportunities that are consistent with our Quad 3.0 strategy, invest in talent and technology to drive new business and further expand our offerings; and innovate new integrated solutions that help our clients simplify their executional requirements to deliver content and campaigns more efficiently and effectively, especially important at this time of ongoing disruption.

In terms of optimizing our portfolio, on October 31, we completed the sale of our two remaining book manufacturing facilities to the Bertelsmann Printing Group USA. This completes the full divestiture of our Book platform, which supports our goal to stay focused on the products and services that advance our Quad 3.0 strategy and transformation as a marketing solutions partner. We are very happy to have found good homes for our Book plant employees and we thank them for all their hard work and wish them well.

We also continue to invest in our platform to strengthen our integrated marketing solutions offer. This includes the addition of experienced talent for the marketing and technology industries, who are helping us expand into different market verticals and develop new products and services. For example, we just announced the launch of QDMX, the Quad Direct Marketing Exchange. This suite of solutions delivers 100% personalized direct marketing campaigns at a fraction of the cost and with greater speed to market. QDMX is a real game changer not only for clients who regularly use direct mail as a part of the marketing mix, but also for clients who have yet to harness the power of direct mail.

Throughout the pandemic, we have continued to grow print segment share, thanks to our dependable on-time performance; operational, financial stability; and ongoing investments in our platform. For example, we were just awarded another multi-year magazine publishing contract valued at more than $17 million. This multi-titled work begins in January. We also recently secured 100% of the print work for Northern Tool + Equipment and its subsidiary The Sportsman Guide (sic) [The Sportsman's Guide] (00:06:25). This multi-year contract includes all catalogs, direct mail and retail inserts as well as business process optimization services and use of our Accelerated Insights virtual testing platform. This multi-million dollar contract builds on the work we already perform for Northern Tool which includes photo, video and page production as well as radio and radio creative and production. We look forward to discussing the other ways in which we can help Northern Tool advance its business objectives, including brand strategy, in-store marketing and digital and out-of-home advertising.

On slide 6, we show an example of how we've been able to expand our services and add value beyond print for a regional grocer with approximately 1,100 stores. For many years our engagement with this client included printing its weekly newspaper circular as well as direct mail. We have now expanded our relationship to include on-site client services to facilitate creative and campaign production, media planning and placement for print and broadcast, radio creative and production and technology to promote their circular online. We also conducted a media mix modeling study that showed the grocer how could benefit by increasing its digital ad spend and as a result, we were just awarded all of their digital media. We are now the grocer's sole agency of record for all print, broadcast and digital media and advertising spend that totals more than $40 million annually. This client values the simplicity, efficiency and effectiveness of working with Quad. We are one partner with one integrated approach for content creation, production and media placement.

Turning to slide 7, we continue to expand our offering to consumer packaged goods brands and recently helped an all-natural energy drink trusted by multiple professional sports teams to re-launch its brand. Very quickly we were able to conceptualize a brand re-launch for the client in just six days which we then quickly executed for a national drug store chain. The campaign included creative direction and execution of more than 1,800 in-store displays created by our in-store marketing group. The client's vice president for brand development said, and I quote, Quad's expertise guided us to a phenomenal end result. The team solved problems as they arose and were able to get our program completed on time and on brand. We look forward to working together as we expand to grocery and other channels. In our next steps, we will introduce this client to other retail clients with whom we do business to expand its product distribution and brand visibility in 2021. Our Quad 3.0 strategy and integrated marketing solutions offering is a true differentiator for us. Clients appreciate the value we provide by uncomplicating marketing and delivering more.

Turning to slide 8, I also want to remind listeners of Quad's ongoing commitment to diversity, equity and inclusion at this time of heightened awareness about social issues. We continue to enhance our DEI program and strategy including developing tailored learning and development programs for employees and reimagining how we conduct business from talent recruitment to sourcing services and supplies. I'm also proud that we continue to support the expansion of our employee-led business resource groups and recently welcomed [ph] Pride, a new group for our LGBTQIA and plus (00:10:05) employees. We continue to encourage the formation of other groups within our diverse population too.

In the end our DEI goals are clear, to achieve a workforce that reflects the communities where we live and work and the clients who trust us with their business to ensure that procedures, processes and distribution of resource creates equal opportunities and fair and just outcomes and to create a safe and open environment where all Quad employees can bring their truest and best selves to work every day which is consistent with our longstanding company values, especially the one that talks about believing in people.

Before I turn the call over to Dave I want to recognize and thank all of our employees for their tremendous efforts and many sacrifices during this unprecedented time. We have asked a lot of them and they have performed exceedingly well.

With that I will turn the call over to Dave.

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

Thank you Joel and good morning everyone. Slide 9 provides a snapshot of our third quarter financial results. Our third quarter operating and cash performance were strong due to our disciplined cost management during a time of continued headwinds from the COVID-19 pandemic, while advancing our Quad 3.0 transformation strategy. We're committed to ensuring the health and well-being of our employees while protecting Quad's financial health, providing great service to our clients and winning new work. We realigned our cost structure with current demand and reduced operating cost at a higher percentage than our net sales declining.

This resilient performance resulted in increased free cash flow, and combined with cash proceeds generated from recent asset sales, helped reduce net debt by $222 million over the past 12 months. Our strong balance sheet helps ensure we have the financial flexibility to navigate the pandemic and continue to advance our transformation as a marketing solutions partner. As Joel mentioned, we completed the sale of our two remaining book manufacturing facilities in Martinsburg, West Virginia and Fairfield, Pennsylvania. This transaction combined with the July 1, 2020, sale of our Versailles, Kentucky plant, completes our previously announced strategy to divest our Book platform. This strategy supports our goal of optimizing our product portfolio to focus on the greatest revenue-producing opportunities in support of our Quad 3.0 transformation.

Net sales were $679 million in the third quarter, down 28% from 2019. And on a year-to-date basis, net sales were $2.1 billion, down 27%. Both the quarter and year-to-date variances are primarily due to the economic impact from the pandemic, ongoing print industry volume and pricing pressures and a 2% impact related to the divestiture of our Omaha packaging facility in January of 2020. Since the pandemic began, we saw the largest decline in net sales during the second quarter as net sales decreased 38%. May represented the trough of the decline and since May, we've seen a sequential monthly improvement.

Our third quarter net sales improved by 10 percentage points versus the second quarter and we anticipate the pandemic's impact on print volumes to stabilize somewhat in the very near term. Therefore, we expect the fourth quarter net sales to decline at approximately the same rate as the third quarter. One additional item of note regarding the fourth quarter, historically our seasonal peak of print volumes occurs in the month of November. However, we believe that this year the peak will spread more evenly across late September and October as retailers began holiday selling promotions earlier than usual to help ease store traffic and shipping pressures. We continue to partner with our clients to help them flexible – flexibly manage their marketing solutions needs during this challenging time. Given the ongoing lack of visibility due to the pandemic, we are not providing further specific financial guidance.

Adjusted EBITDA was $61 million in the third quarter of 2020 as compared to $80 million in 2019 while adjusted EBITDA margin improved to 8.9% in 2020 as compared to 8.4%. The adjusted EBITDA variance primarily reflects the impact from a 28% decline in net sales partially offset by savings from cost reduction initiatives.

As a result of significant cost savings, adjusted EBITDA margin grew by 49 basis points in the quarter versus 2019, more than offsetting the relative percentage decline in net sales. Year-to-date adjusted EBITDA for the nine months ended September 30, 2020, was $196 million as compared to $239 million in 2019, while adjusted EBITDA margin improved to 9.4% in 2020 as compared to 8.4%. The adjusted EBITDA variance primarily reflects the impact from a 27% decline in net sales, a $13 million decrease in paper byproduct recoveries and $11 million increase in hourly production wages due to strategic investments we made in starting wages that helped favorably impact productivity throughout our platform. These declines were partially offset by cost savings and productivity initiatives, a $9 million net non-cash benefit from a change in vacation policy and a $6 million net reduction in workers' compensation reserves from improved production safety performance. Adjusted EBITDA margin grew by 101 basis points in 2020 due to cost saving initiatives more than offsetting the relative percentage decline in net sales.

Free cash flow was $57 million for the 9 months ended September 30, 2020, an increase of $91 million from 2019, primarily due to a $48 million decrease in capital expenditures, $40 million in income tax refunds received during the third quarter due to the CARES Tax Act which allowed Quad to carry back net operating losses to previous tax years and strong working capital and cost management. As a reminder, the company generates the majority of its free cash flow in the fourth quarter of the year.

We've successfully employed temporary and permanent cost savings measures and that was a key driver to the improvement in adjusted EBITDA margin and free cash flow. We were able to adjust our costs and cash spend which more than offset lower print demand while maintaining excellent on-time delivery rates and customer service. As we reported in the second quarter, we temporarily reduced costs by $325 million on an annualized basis. Since then, we've converted approximately 40% of these temporary savings into permanent savings while flexing temporary cost savings measures to match print volumes.

During the third quarter temporary salary reductions enacted in April ended in August and many of our employees were brought back from furloughs as print volumes improved and we began ramping up to our seasonal peak of print volume. We'll remain disciplined in our approach to ensure that proper balance of permanent and temporary cost reductions given the ever changing outlook for print and print-related sales and remain confident in our transformation strategy to take advantage of new opportunities as a marketing solutions partner.

Slide 11 includes a summary of our debt capital structure as of September 30. We reduced net debt by $222 million over the last 12 months due to strong free cash flow and $53 million in cash proceeds from asset sales including the sale of our Omaha packaging facility and our Versailles book manufacturing facility. We ended the third quarter with a debt leverage ratio of 3.22 times as compared to 3.09 times as of December 31, 2019. While this leverage ratio is above our long-term targeted leverage range of 2 to 2.5 times, we're pleased with our progress in reducing net debt level despite the economic impact of the pandemic. Our primary use of cash will continue to be debt reduction.

As of September 30, our blended interest rate is 4.8% and our debt capital structure was 63% fixed and 37% floating. We maintained significant liquidity at September 30 including $93 million of cash on hand and up to $465 million in unused capacity under our revolving credit agreement. Quad's next near debt maturity is our 7% Senior Unsecured Notes due May of 2022 which has $239 million currently outstanding. We believe our available liquidity, our strong lender relationships, our agile approach to cost management and our ability to help clients now and after the pandemic as a result of our Quad 3.0 strategy will help provide substantial financial flexibility to adjust to the current uncertainty in our operating environment.

I'm extremely proud of the Quad team for the speed and agility of their reaction to this pandemic. This agility was key to conserving cash and liquidity in an unprecedented time. It helped ensure strong financial position as of September 30.

And now, I'd like to turn the call back to Katie who will facilitate the Q&A session. Katie?

QUESTION AND ANSWER SECTION

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

A

Thank you, Dave. We compiled questions in advance of today's call and therefore we will not ask for callers to enter the queue. Thank you to everyone who submitted questions in advance. We've three top questions that were submitted.

The first question relates to client volumes. How did client demand impact Quad's volume in Q3 as the quarter progressed? And what are you hearing from clients regarding demand levels as the holiday shopping season begins?

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

A

Well, thanks, Katie. Look clearly it's a crazy year with what's going on, but as Dave said May was probably represented our trough, the lowest point of sort of the impact from COVID. And since then we've really seen sequential monthly improvement. And specifically if you think about Q3, which Dave mentioned, improved about 10 basis points versus prior quarter. But if I turn to sort of starting with the higher volume legacy products we have of retail inserts, publications and catalog, clearly retail inserts led the pack in deepest decline. So in the quarter was off about 43%, which is several points better than the industry. And we think that you will start to see – continue to see some stabilization calling for something in the closer to the 30s in the next quarter. Publication would be sort of a next one that the industry was off about 16%. We were off about 9% and that's a good trend specifically because that was a result of segment share wins.

And in the catalog area we were off about 20% which is fairly in line with what we saw in the industry. But again expect to continue to see that stabilization. But the interesting thing is, is that as we've really kind of focused on pushing forward with the transformation regardless of pandemic and economic shutdown, we've seen in packaging, which is a fairly new product line for us but one that really grabs hold of the rest of the 3.0 services to sell itself, was up 19% in volume for the quarter. The industry was – from a CPG standpoint was up about 9%. So 19% was a great number.

Direct mail, if you look at the industry was off about 25%. We were off only 12%. Some of that aided by political mailings but the real trend here, as we've talked about before, is that marketers are really looking to use their data more aggressively in whatever they're doing and direct mail, if you think about the legacy mail, the same thing to everybody, is the part that's gotten hit the most. And we've been investing in the part that's growing the most which is really driving that data to be very personalized. So, the two of those really resulted in a good trend there.

We also grew a great business in in-store which had a good quarter. It's up, it's not down. It's up a couple percentage points. And if you look at Rise Interactive, which is our digital component, they're having a very healthy pipeline demand right now with all the sort of disruption going on and people really pushing digital. And so they had a great quarter. But what I will say is that the customer base is very hard to predict where they're going right now because I think they're just fire-fighting. It's not just COVID but it's the unexpected impact of COVID in the supply chain. For a while, people were panicking about getting product through the West Coast ports. It was a mess. And quite frankly, it's still a challenge for a lot of folks out there. But also as Dave mentioned, it pulled the busy season forward a bit into September, October, partially offset by spreading out people in the stores, trying to understand the new patterns but also there is a real challenge in sort of the shipping world of FedEx and UPS and others because of the online demand. And so, that's been an interesting thing for us to try and follow and react to. But we've been able to do it and we've been able to perform. And so we look towards the rest of the year of keeping ourself focused. But the demand for the 3.0 stuff has really been heating up because as people are navigating all this, they've – they are sort of accelerating their need for simple answers for dealing with less suppliers and really trying to look at marketing as a whole from one standpoint and the fact that we're offering this integrated solution between the tangible print products of even retail insert, catalog, direct mail into in-store and integrating that in to the digital side of – with live interactive or online or radio broadcast, it's really resonating and people are acting quicker than I've seen before. So, all in all, that's the snapshot of what we're seeing with our clients right now.

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

A

Great. Thank you, Joel. Okay. Our next question relates to cost reduction. Could you give more detail on temporary versus permanent cost reduction and what types of cost reduction will be more permanent going into 2021?

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

A

Absolutely Katie. As Joel mentioned, we've historically tried to treat all of our costs as variable over the long-term and really try to match those costs to that of the changes in customer volume demand. So in our prepared remarks we discussed our approach to that cost control and that approach has been crucial in reducing cost at a higher percentage rate than our net sales decline and as we referenced the height of our pandemic, the net impact on the volume, at that point we had taken temporarily $325 million of cost out on an annualized basis.

So since that point we've adjusted our costs to match our net sales and we've really worked on converting a lot of those temporary savings into permanent savings which takes a bit of time. But at this point we're – just under 40% of our temporary savings have been converted into permanent. And what that really represents is permanent cost reductions for us is really looking at our head count and being able to right-size our head count and our head count's down by 1,100 employees as of the end of September and during that process we've closed over four – we've closed four of our facilities – manufacturing facilities in 2020. And so that helps us kind of over the longer term right-size our costs to match volumes. But also we'll continue to use temporary saving as a way to continue to also match in a very short period of time of what's happening with volume changes. And so going forward into 2022 – 2021, we're going to continue to display that discipline and manage our costs accordingly with what happens with print volume demands, but yet not starving the business for the investment that our clients are looking for in other channels with us as we do more and more for our clients as the marketing solutions partner.

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

A

And Dave I might add that when you think about temporary versus permanent, with the company like ours in this industry, you've got this huge infrastructure and capital base of equipment and plants, we actually, and I think Dave mentioned it, but we actually furloughed entire plants and one of them was well over 1 million square feet. That's easier said than done because you're taking this huge thing down, but then bringing it back up again, which we've since done for the busy season. And so, I think without the process focus we have and the technology investments we've made over the years in terms of our scheduling systems and how all the data flows to manage the platform that would've been very hard to execute on. So it's an important point when we think about continuing to manage through the crazy times right now.

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

A

Right. And thank you both. That was great detail. And our final question is, as you look to next year and start to think about the eventual economic recovery, how do you think the pandemic has impacted print's long-term role in the marketplace?

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

A

Well, I'm sure like everybody is trying to answer that question, it's – the crystal ball is very, very cloudy. A lot of people are still – lot of markets are still trying to navigate this year as I mentioned before, much less trying to look at, okay, what are they doing next year, when you're not sure the course of the pandemic. We're clearly in a big spike going on throughout the country in the world and so the question is, is what dampening will that have on economic recovery. Obviously, there's other things playing out, but I will say that the world is leap – leapt forward pretty good with use of technology, use of digital, the digital space and our investment and our sort of acceleration that we're doing now in the transformation, is very well-timed because I think it's really forcing people to streamline their processes between channels, really understand the data and analytics is a hugely important part right now.

We're seeing a lot of people scramble to do a lot better than before because when you have year-over-year patterns that are the same for the consumer, you can kind of just look at year-over-year what's going on. When all the patterns are changing, you've really got to rely on understanding how they're changing and in what sort of mix. And so part of our 3.0 strategy has been to aggressively grow our analytics capabilities, not just to tell people what can happen in print but to tell them what is the impact of everything on all the different channels. And so you'll see us, in the coming quarters, start sharing some examples of how that is playing out in one business and ways we're helping our clients sell more stuff.

So, I think the bottom line is stay nimble, be on your game, we have to manage costs. It's almost like A Tale of Two Cities, manage the cost side on print to deal with the ebb and flow of how people are going to decide on volumes, but at the same time, just put the foot to the pedal on our transformation and continue to bring in the really good talent we've found to really push and further design our offerings. We've done some acquisitions in the past to round this out. We feel we have most of the big pieces in place and so the next focus has really been on let's get some great talent that's available and the talent out there that's available understands the marketing disruption that's taking place today and understands why Quad's offering is perfectly timed for another disruption in the marketing world. And so with that clearly we'll talk to you next quarter and give you a update to it. But again I think anybody right now who's going to win it's going to be about really being nimble and also opportunistic at the same time.

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

Great. Great, thanks Joel. 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.

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

Thanks again Katie and thank you all for joining us today. I want to close by reiterating my thanks to our employees for their hard work and sacrifices during our seasonally busiest time of year while continuing to manage through the ongoing COVID-19 pandemic. The way the people on the floor have managed through the drop in volume with just a stellar performance on productivity and really managing costs has been second to none. All the employees have been resilient in the face of recent challenges and my sincere appreciation for the work they do each and every day as we create a better way for our clients of ourself. So thank you all. Have a good day. We look forward to speaking with you again next quarter. Take care.

Operator: Ladies and gentlemen, with that we'll conclude today's presentation. We do thank you for joining. You may now disconnect your lines.