03-Nov-2021

Quad/Graphics, Inc. (QUAD)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. Welcome to the Quad's Third Quarter 2021 Conference Call. During today's call all participants will be in a 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 and recent presentations linked. Please also note today's event is being recorded.

And at this time, I'd 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 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 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, everyone. Our third quarter results were strong, with higher print volumes, including print segment share gains for new clients, as well as continued positive trend in Agency Solutions, all of which contributed to year-over-year organic growth of 7% in net sales. These results validate our business strategy as a marketing solutions partner and reflect the strength of our integrated marketing offering to deliver more value.

Right now, businesses around the globe are experiencing disruption from unprecedented supply chain issues and mounting inflationary pressures that began with the COVID-19 pandemic and intensified over the past 20 months due to natural disasters and labor shortages.

At Quad, we are working thoughtfully and diligently to mitigate these effects on our business, while successfully maintaining the high quality, responsive service on which our clients have come to depend. While we expect supply chain issues and inflationary pressures to continue for some time, we will remain nimble and proactive to adapt to ongoing changes and challenges. At the same time, we will continue our disciplined approach to managing all aspects of our business to enhance financial strength and create shareholder value.

We are working hard to secure the necessary labor, materials and transportation required to meet client demand. And to offset higher commodity freight and operating costs, on October 1, we introduced a price increase for select materials as well as a manufacturing surcharge.

Notably, we continue our focus on debt reduction. Over the past 12 months, we have reduced net debt by approximately 15% or $140 million, and we will have reduced the net debt by approximately $350 million or 33% over the past two years by the end of 2021. Also, as just announced, we are pleased to have extended our $1 billion bank debt agreement to November 2026. Our healthy banking relationships and balance sheet make it possible for us to continue to strategically invest in the talent, technology, products and services to accelerate our position as a marketing solutions partner.

We are pleased to continue bringing on board experienced marketing talent. For example, during the third quarter, we welcomed Kris Persons, a former Merkle and Epsilon executive, as our new Senior Vice President of Direct Marketing. Kris' extensive experience in outcome-based marketing, strengthens our ability to help brands and marketers reach and engage consumers through highly personalized data-led programs coordinated across both, online and offline channels.

We also continue to invest in our data and analytics offering to help our clients maximize impact for our ability to precisely target an audience, create and place compelling content for the audience in the right channels at the right time, and then continuously optimize campaign performance, including real time measurements across digital channels using Connex, our award winning platform that helps marketers identify the specific value driving actions they need to take, increase revenue and grow their business.

Clients value our ability to gather, analyze and interpret data to inform the marketing strategy, along with our ability to deliver content and campaigns at the speed and scale required by today's marketers. We continue to differentiate ourselves through investments in data driven capabilities. These investments include print technology with full scale personalization capabilities that can produce direct mail pieces that are truly relevant to the recipients and therefore more likely to drive response and revenues. Direct mail remains one of the most effective ways to reach today's busy consumer, who is constantly bombarded by messages. Further, it is cost effective, especially in light of recent substantial price inflation in digital advertising marketing and avoids the contentious privacy restrictions borne by social media. We continue to advance our position as a marketing solutions partner by leveraging our key competitive advantages to create more value for our clients. These advantages shown on slide 3, include our commitment to innovation, platform excellence and culture and social purpose.

On slide 4, we share an example of our commitment to innovation helped a large, well known food retailer with whom we have had a long-term, strong partnership. The nationwide retailer sought our help with its customer loyalty program across its 20-plus store banners, specifically improving the effectiveness of how it executed its personalization strategy. Our innovative solution featured our integrated client technology portal that allows the clients marketing team to assign personalized offers and content to loyalty members and then automates campaign execution across digital and print channels. As a result, the client was able to extend and grow customer relationships and create additional revenue for its banners.

On slide 5, we show another example of how we innovate for clients in the packaging space. For many years, our packaging division has provided clients with Sustainable Packaging solutions, with a recent focus on sustainability logos and labels. There is an abundance of different graphics, icons, sustainability claims, making it confusing for brand owners and consumers alike.

Our Package Insight group, which specializes in studying brand packaging performance, consumer attention and shelf impact, conducted research in its simulated shopping environment using biometric technology such as eye tracking and facial coding. The research data enabled us to identify best practices for brands and how to make sustainability logos on packages more effective and improve results. Now we are taking a research one step further, partnering with Walmart and the Sustainable Packaging Coalition to understand how consumers respond to messaging and on packaging as part of an effort to address the growing food waste problem, a high priority for many of our clients.

The first stage of the study examines how consumers perceive food freshness labels and how packaging could be improved to reduce waste. Additional stages will provide insights into how suppliers, vendors, manufacturers and retailers all collaborate to reverse worsening food waste trends. For additional information, I invite you to read our whitepaper in the resources section of quad.com.

Turning to slide 6, we provided an update on our labor management strategy given the continued nationwide labor shortage. As I shared with you last quarter, due to increased volumes at our print manufacturing facilities from organic growth as well as new business wins, we have intensified our hiring and retention efforts to support our platform and growth objectives.

Since mid-May when we started ramping up hiring for the busy second half of the year, we have hired several hundred employees into our US manufacturing platform. Our strategy here is two-fold to attract new employees by offering interesting work with competitive compensation and benefits while providing a safe and inclusive environment. And, to retain employees through positive coaching and training and development programs, so they understand the next step on their career journey with us. Our strategy has proved successful due to our well-established people first culture and value system that reflects our commitment, creating a more diverse equitable and inclusive workplace.

On slide 7 we highlight our third competitive advantage, our commitment to culture and social purpose. We take seriously our role in creating a better way through our approach to environmental, social and governance matters, and are releasing a comprehensive ESG report later this month that details how we've been driving positive sustainable change in our business since our founding 50 years ago.

For example, when it comes to the environment, we have multiple initiatives in place to reduce our environmental impact. We are proud of our emissions capture rates and recycling rates, including recycling 100% of all manufacturing wastepaper and 98% of other general waste in our facilities. We're even exploring our up-cycle waste streams, like paper dust from the printing process into viable commercial products.

In the social space, we continue to build our diversity, equity, inclusion strategy, which includes specific goals for creating a more inclusive, open culture to benefit employees, as well as the clients who trust us with their business and the communities we call home.

Additionally, we have upped our commitment to employee health and wellness with a newly expanded program that provides full circle support for employees, physical, emotional, financial and social wellbeing.

As far as how we run our business, we remain committed to effective governance and have programs and policies in place that reflect our culture of high ethical standards, legal compliance and reduce risk to the company and all stakeholders. Quad's ESG report will be available for viewing and can be downloaded on our quad.com site later this month. I encourage you to check it out.

Before I turn the call over to Dave, I want to thank our employees once again for rising to the occasion and performing well for our clients during a time of unprecedented disruption and challenges. I also thank them for supporting each other through these busy and unusual times. I am proud of how we have been able to successfully navigate the pandemic, remaining nimble, to adapt to changes, including supply chain issues and managing our labor to accommodate growth.

With that, I will turn the call over to, Dave, for a review of our third quarter's financial results.

David J. Honan

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

Thanks, Joel, and good morning everyone. Slide 8 provides a snapshot of our third quarter financial results. As Joel mentioned, we delivered strong financial results while navigating a tight labor market supply chain disruptions, especially with paper supply and inflationary pressures across all cost inputs.

Despite these challenges, we are confident in our trajectory of the business and we're reaffirming our 2021 outlook which includes revenue growth and significant net debt reduction. We are also pleased with the ongoing long-term support and partnership with our bank group and completing the extension of our $1 billion bank debt agreement to November of 2026.

The commitment from our banks as well as our business momentum provides us with increased financial flexibility as we continue to invest in our talent, technology, products and services to accelerate our position as a marketing solutions partner to our clients.

Net sales were $706 million in the third quarter, up 4% from 2020. Excluding QuadExpress, a third-party logistics business we divested last quarter, organic net sales increased 7% from 2020. The increase was due to a 10% growth in print product sales and an 8% growth in agency solution sales. Both print and agency sales growth was driven organically with existing clients, as well as print segment share gains from new clients.

Year-to-date net sales were $2.1 billion, up 1% from the same nine month period in 2020. And on an organic basis, which excludes recent divestitures year-to-date net sales increased recent divestitures, year-to-date net sales increased 2% compared to 2020. The increase was due to a 13% growth in our logistics business and a 9% increase in agency solution sales.

Print product sales were flat between years. However, this includes a 14% decrease in the first quarter of 2021, due to year-over-year impacts from the COVID-19 pandemic. Over the past six months, after annualizing the first year of the pandemic's impact on our business, organic net sales have increased 13% over 2020, primarily from organic growth from existing clients and print segment share gains from new clients.

Adjusted EBITDA was $64 million in the third quarter, up $3 million or 6%, and adjusted EBITDA margin improved to 9.1% compared to 8.9% in 2020. The increase in adjusted EBITDA and margin during the quarter was driven by higher profit from increased net sales and a $9 million net gain from property insurance claims. These were partially offset by labor and material cost inflation and $9 million of temporary COVID-19 pandemic related cost savings in 2020, primarily from furloughs and wage reductions.

To help offset rising costs in this inflationary environment, we announced price increases effective October 1, 2021 and January 1, 2022. We believe these price increases are necessary to adjust to rising costs. We'll continue to closely manage supply chain constraints and make necessary investments in labor, products and services to deliver well for our clients in this difficult operating environment.

Year-to-date, adjusted EBITDA was $190 million, a $6 million or 3% decrease from $196 million in 2020. And adjusted EBITDA margin was 9.0% in 2021 as compared to 9.4% in 2020. The decline in adjusted EBITDA end margin was due to $39 million of COVID-19 pandemic related temporary cost savings in 2020, a $12 million benefit in 2020 from a change in vacation policy and the negative impact of cost inflation. These were partially offset by higher profit from increased net sales and a $9 million net gain from property insurance claims.

Free cash flow was negative $20 million for the first nine months of 2021, a $76 million decrease versus the same period in 2020, primarily due to lower net cash provided by operating activities from higher working capital to support the seasonal net sales growth and strategically investing in paper and material inventory to serve our clients during the period of worldwide supply chain disruption. And $40 million of income tax refunds received during the third quarter of 2020 due to the CARES Tax Act. These were all partially offset by a $9 million decrease in capital expenditures. As a reminder, we generate historically the majority of our free cash flow in the fourth quarter of the year.

Slide 9 includes a summary of our debt capital structure as of September 30. We have reduced net debt by $74 million since the end of 2020. And over the past 12 months, we have reduced net debt by $140 million or 15%. We ended the quarter with improved debt leverage at 3.14 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. And by year end, we expect to further improve the debt leverage ratio to be approximately 2.75 times.

As of September 30, our blended interest rate was 5% and we maintained our strong liquidity position with up to $463 million of availability under our revolving credit agreement and $27 million of cash on hand.

As mentioned earlier, we're pleased to have completed the amendment of our $1 billion bank debt agreement this week, which extends the existing maturity to November of 2026. Quad's newest debt maturity continues to be our 7% senior unsecured notes due May of 2022, which has $239 million outstanding. We believe, we are well-positioned to address the notes at or before the maturity in 2022 with our ample liquidity.

As previously mentioned, and as shown on slide 10, we continue to make progress on reducing net debt, through use of our strong free cash flow as well as cash generated from asset sales. This is part of our disciplined strategy to optimize our product 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. This optimization includes the recent divestitures of our Book business in 2020 and most recently our QuadExpress business last quarter.

In addition, during the third quarter we completed the sale and leaseback of our West Allis, Wisconsin facility for net proceeds of $32 million. In total, we have generated over $120 million of cash from asset sales during the past 12 months to advance our transformational strategy and reduce debt.

Furthermore, by the end of 2021, we expect net debt will be approximately $350 million lower than it was two years earlier. This represents a 33% reduction over the past two years, despite challenges from the COVID-19 pandemic. Due to our strong financial performance, as well as our continued sales momentum in the fourth quarter, I'm pleased to reaffirm our financial outlook for 2021 on slide 11. This outlook includes organic growth of 1% to 3% for the full year of 2021, as well as full year adjusted EBITDA guidance to be in the range of $240 million to $260 million.

Finally, we expect to generate strong cash flow from operations to further reduce our debt leverage to be at approximately 2.75 times by the end of the year. Our clients continue to embrace our integrated marketing offering and our financial objectives remained unchanged, including driving earnings and increased margins through revenue growth, effective cost management and productivity improvements, as well as reducing debt through the generation of strong free cash flow. All of these efforts will further strengthen our balance sheet liquidities, enhancing our financial flexibility to accelerate and scale our strategy and drive shareholder value.

With that, I'd like to turn the call back to Joel.

Joel Quadracci

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

Thank you, Dave. And before we start the Q&A session, I want to take a moment to acknowledge and congratulate Dave Honan on his promotion to Chief Operating Officer, which will be effective January 1 of 2022. As part of a planned executive transition, Dave succeeds Tom Frankowski, who is retiring as COO after an incredible 42-year career here at Quad. And so on behalf of the board of directors and the entire company, I thank Tom, for the integral role he has played in Quad's strategic growth and establishing our reputation and enhancing it for operational excellence. We wish him well.

As Dave transitions to COO, we welcome Tony Staniak as Chief Financial Officer also effective January 1st of 2022. Tony has been a member of our executive team for 12 years, most recently serving as our Vice President of Finance. We have tremendous confidence in Tony and know his experience, knowledge and focus on growth will serve us well. You will be hearing from Tony soon. Katie, with that, we'll turn the call back to you.

QUESTION AND ANSWER SECTION

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

A

Thank you, Joel. We will now begin the Q&A session 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 the question. We have three chat questions that were submitted. Our first question relates to industry trends. It asks, as Quad approaches what has seasonally been the most important quarter, what trends are you seeing from marketers as it relates to the holiday season?

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

A

Well, I'd say first and foremost, it's been a little bit of a crazy year, because people coming out of the pandemic trying to figure out which way is up when it comes to marketing and spend. And I'd say on top of it just not as much visibility on a regular basis, because people are comparing the trends from prior years [ph] that were prolonged (00:22:46). And add to that, supply chain challenges that our customers have experienced, it's been rather exciting in terms of trying to follow which way they're going.

But I'd say that, the main thing is that retail inserts, which we always talk about is the one that's been in biggest decline, one we expect to continue to decline, did experience what was expected a double-digit decline in the quarter, but no different than what we've seen.

Remember that the retail relationships we have are very important, because they use all sorts of other channels for marketing, including catalog, including direct mail, packaging in-store and lots of our services offer really helps drive revenue to those other streams. At the same time then you might be seeing and continue to see decline in the retail side, so it's an important category for us and we'll continue to be.

On the publication side, we had in earlier quarter shown some pretty good segment share wins. I'd say that the trends right now are just about flat to a little bit down from an advertising standpoint. But you know, again, we've taken quite a bit of market share and that's an important category for us from a consistency of volumes throughout the year that layer into our platforms.

And then catalog, I think it's been interesting to see reinvestment here as the world has opened up. Year-to-date, we're well ahead of where the industry is at – we're up over 4%. But if you look at the quarter because of segment share gains, number of books and catalog are up 14%. And then number of pages per book is up 19% and so a lot of that's from reinvestment but also from segment share wins as we've seen the rest of the industry quite frankly struggle a little bit more than we have in supply chain and in labor to be able to perform for their clients.

And then direct mail. We're in line with single-digit growth year-to-date. But, remember a lot of our other packaging lines have benefit from our offering such as QAS our Agency Solutions group was in growth and a lot of the other product lines such as in-store marketing that benefit from those holistic approaches.

But we're watching it closely and, you know, it's been interesting for some retailers are struggling to keep product on the shelves and others are struggling with getting paper. I think, our growth actually would have been greater if we didn't have the same shortage in paper that some of our clients were seeing. So which Dave can expand on later.

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

A

Well, that leads into our next question. It talks about supply chain and labor it asks, can you elaborate on what you have observed during this period of supply chain challenges, with inflationary pressures driving increased supply chain and labor costs, how do you think about interruptions looking ahead?

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

A

Well, I'll take that, Katie. And Joel has mentioned it, you know, our biggest challenge is supply chain wise that really centered on paper and shortages of many grades of paper and as well as labor is a very tight labor market. And that all combined in driving significant inflation across most of our cost inputs. So, we're addressing these issues as if it's not transitory, so that we're building it into our ongoing operating environment and we'll continue to operate as if these challenges are with us into the near-future, that will ensure that our platform, as Joel has referenced, will remain what we believe is the industry's most modern and efficient print production and distribution platform out there. So paper has been the biggest challenge thus far, as industry-wide shortages of many grades of coated paper have impacted our ability to grow net sales further into certain product categories, as Joel's mentioned. We're fortunate to have very strong relationships with our paper suppliers who have done their best to meet much, but not all of our clients demand for paper. It's important to note that we don't supply all the paper to our clients. As over half of the paper that's used in printing for us is supplied by our clients themselves outside of Quad purchasing, and therefore we can't control or have the ability to help some of our clients obtain that paper. Also, just as you might...

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

A

David, I would add to that. Just...

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

A

Yeah.

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

A

...for note that with the amount of paper we buy, we've been able to do it very efficiently and we really work closely with the mills to try and buy in much larger chunks, so they can really create efficiency on their side. And what we're seeing is through the supply chain disruption, there's a lot of clients who provided their paper before suddenly kind of switching and asking us to do it because the supply chain world has gotten more complicated and it's paper assets have been taken out of the market. And so, we actually think that will end up increasing the amount that we supply, which in turn will help us manage the paper inventories and space it requires in our plant, as well as help create efficiency across the paper supply chain.

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

A

Exactly. And, the other important reminders from a pricing standpoint paper is a pass through costs for us to many of our clients. So for the most part, we're not bearing pricing risk on paper as that passes through to our customers. And really, in the case of paper supplied by Quad to our clients, we've been really effective in working with the vendors, as Joel just mentioned, to help mitigate supply issues. However, to deal with overall paper shortages, client orders have been shifted to alternative paper grades or different production dates for when the paper is more available. And in some cases, we've even reduced or cancelled print runs due to the inability to obtain paper. So that goes right to Joel's point about how our net sales were held back this quarter, somewhat by shortages across the industry in paper.

I think the other thing to focus on is labor. There's a very tight labor market, but labor is more within our control than that of, say, paper is. And so we've been very proactive in trying to navigate the tight labor market. And one of the main things we've done is, we've invested an incremental $25 million on an annualized basis and that's on top of normal wage increases.

We do and benefit increases for our employees that's all on top of that, and this is really mostly been in the form of higher starting wages and then increased wages throughout our REGS and then incentives to help drive more hiring and retention of employees. So these are best, the best efforts to help mitigate some, but not all of our hiring needs, as Joel had mentioned in his remarks about our ability to hire hundreds of new employees in a very tight labor market. However, we've been able to augment our hiring with also with increased levels of overtime and temporary labor. So our print production team has just done an outstanding and amazing job of doing what it takes to deliver for our customers in a very difficult operating environment. So, I'm extremely proud of that dedication and hard work on behalf of our client.

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

A

And I think the important thing that I want to note is we've done quite well when it comes to managing labor at this time, but some of that comes from our consistency of investing in our platform from an automation standpoint. So when you look at us compared to a lot of the industry, we've really reduced the amount of call it lower skilled demand for workers because we've put automation and it's what we're starting, in this environment from a different pace than most. And so that really that investment long-term strategy really helped us manage the labor in addition to just the investment in wages and coaching and all that stuff. That's really important because this investment does pay off over time.

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

A

Okay. Great. Thank you both. Okay. Our last question is regarding Quad dividend policy. It reads your 2021 guidance reflects significant continued debt reduction with lower debt and increased business momentum, what are your latest thoughts on reinstituting a dividend?

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

A

Well. To us the biggest lesson we learned in the pandemic was we put the brakes on hard and we saw things happen as the pandemic started in the second quarter and the board and management both agreed right away to suspend the dividend because we didn't know where this thing was going and as well as being in a disrupted industry so that's really paid well for us. We do want to get back to a dividend, but we want to make sure that we're -- our operating environment is sustainable to support a sustainable dividend.

And so getting back into that leverage range of 2 times to 2.5 times is one marker. But the other is, that our operating environment has stabilized post-pandemic and sort of seeing where the water level sort of seeks its proper point and I'd tell you that I think that us performing through this like we have with the $350 million of debt paid down in the last two years along with a lot of segment share due to performance issues that are playing out throughout the industry. It really gets us towards that point.

So we're not announcing anything, but I think the markers are as we got it, we want to be back in our best leverage range but also make sure that we're consistently able to stay there, net of any kind of other opportunities which we don't see at the moment.

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

A

Thanks, Joel. 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.

Well, I just want to thank everybody for joining us. It's been an interesting time of this industry and I'm very proud of the hard work that everyone's done and once again, I want to thank them for that. We're almost through the busy season and we'll be talking to you again after the fourth quarter. Thank you all for joining.

Operator: Ladies and gentlemen, that does conclude today's conference call. We do thank you for attending. You may now disconnect your lines.