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Quad/Graphics, Inc. (QUAD)

Q4 2020 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to Quad's Fourth Quarter 2020 Conference Call. During today's call, all participants are 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, please 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] (00:35) link. Please also note that this event is being recorded.

I would now 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 fourth quarter and full-year 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. I am pleased to report that our consistent and strong operating performance delivered solid year 2020 results. We achieved increased adjusted EBITDA margin and cash flow despite unprecedented challenges from the pandemic that significantly impacted sales. We drove these results through segment share growth, disciplined cost management, and productivity improvements across our organization. At the same time, we continue to pay down debt, protect the health of our balance sheet, and enhance our competitive position.

Turning to slide 3, our team demonstrated incredible speed and agility in 2020. Early on, we took swift action to offset the impacts of the pandemic so we could maintain our focus on running the business well, including maintaining the health and well-being of our employees, providing high quality on-time delivery for our clients while continuing to innovate marketing solutions, and ensuring the long-term financial health and stability of the company through operational excellence and realigning our cost structure.

Over the last few years, we have focused on our Quad 3.0 transformation as a marketing solutions partner. We strengthened and expanded our existing marketing, consulting, creative and technology capabilities, and added experienced talent within the marketing and consulting expertise. Having achieved our Quad 3.0 transformation, we are focused on advancing our competitive position as a worldwide marketing solutions partner on a go-forward basis.

Our integrated marketing platform is unique, and that it helps brands and marketers reduce the complexity of working with multiple agency partners and vendors, increase efficiencies through process optimization and content production, and improve marketing spend effectiveness across all media channels through solutions that identify and segment key target audiences, strategically plan and constantly measure marketing spend effectiveness, and strategize to create and activate holistic campaign.

Our success is driven by five strategic priorities, as outlined in slide 4. Our first priority is to walk in the shoes of our clients. We listen to their needs and then develop solutions that address their marketing and process challenges. Our second priority is to grow our business profitably by expanding existing account relationships through our integrated marketing offering, expanding in key growth vertical industries, including consumer technology, consumer packaged goods, finance, insurance, healthcare and direct-to-consumer, growing print segment share through dependable on-time performance and ongoing investments in our manufacturing capabilities, and making disciplined investments, including continuing to hire talent than further differentiates our offering.

Slide 5 shows that our revenue diversification strategy to defend against print industry headwinds is working. As you can see, integrated solutions increased from 21% of net sales in 2019 to 24% as a portion of our net sales in 2020. This includes an increase in agency solutions, from 8% of net sales in 2019 to 10% in 2020.

Targeted print now represents 38% of our net sales in 2020 versus 37% in 2019. Our direct marketing, packaging and in-store product lines increased as a portion of net sales and partially offset the decline in catalogs. The combination of integrated solutions and targeted print now represents 62% of our net sales versus 58% in 2019 as a result of our integrated marketing platform.

The category [ph] in largest (05:50) decline is large scale print, which includes retail inserts, magazines, and directories. This category declined from 32% of net sales in 2019 to 28% in 2020. The decline was primarily due to weakening demand for retail inserts, the print product line that has experienced the most secular decline over time and has been most impacted by the COVID-19 pandemic. Retail inserts now represent just 15% of our net sales in 2020 as compared to 20% in 2019. However, large scale print remains core to our business strategy, as it provides the scale and cash flow necessary to support future value-creating products and services. It also provides opportunities for clients looking to flexibly adjust their media mix to include high-performing personalized print.

Our third priority is to strengthen the core. We will continue to leverage our unique platform to deliver integrated solutions, from marketing strategy to creative solutions and media deployment, across offline and online channels. Our fourth priority is empowering our employees to create a better way, from incremental productivity improvements to product, service, and technology innovations that address clients' marketing and process challenges. And last of all, we manage all aspects of our business to enhance financial strength and create shareholder value over the long term. In 2021, we will continue to prioritize revenue growth, deleverage the company's balance sheet through debt reduction, and retain financial flexibility for changing circumstances.

Turning to slide 6, we show the three key competitive advantages that distinguish us as a marketing solutions partner: commitment to integrated marketing platform excellence, commitment to innovation, and commitment to culture and social purpose. Through our integrated marketing platform, we help clients strategically plan, produce, deploy, manage, and measure content across multiple channels rapidly at scale and without the [ph] handoffs (08:01) that compromise quality, consistency, and timeliness. Our client on-site and near-site locations act as the gateway to our platform, with Quad employees serving as natural extension of the clients' internal marketing department.

Another distinguishing feature of our platform is our industry-leading printing and distribution capabilities for a wide range of consumer-facing products, including retail inserts, catalogs, direct mail, consumer packaging, in-store displays, and signage. No other agency holding company or organization offer these capabilities integrated with digital, mobile, and broadcast channels.

Due to our commitment to platform excellence and innovation, we are winning work from some of the worlds most valued and valuable brands across consumer technology, healthcare, finance, consumer packaged goods, and more. These brands, admired for the trust they have built with their clientele, have placed their trust in us to help solve their marketing and process challenges. As a result, we have been able to expand into higher value areas of our clients' businesses, which also have higher margins.

For example, we recently helped a 25-year print client validate the effectiveness of its catalog and marketing spend efforts. This client, a well-known international toy brand, has long used catalogs to drive traffic online and to brick-and-mortar stores. It wanted analytics to support its seasonal strategy. We engaged our data analytics team to build a series of dashboards for reporting campaign performance, geographic distribution, solicitation history, quantity and type of items purchased, and performance by audience segment. These dashboards enabled the client to see the results of its program in a more comprehensive and interactive way.

The client was thrilled, saying I love it. This is the kind of data we need to support our business growth across stores, e-com, CRM and brands team, and illustrates the importance of our catalog to our business. As a result of our data analytics work, the client asked us to participate in its Annual Strategic Planning Summit to share our insights on the future of marketing.

Turning to slide 7, one-to-one personalization is another area in which we continue to innovate. Brands and marketers know that personalization drives consumer engagement, and we continue to leverage our leadership in print personalization into all forms of media. One personalization innovation I want to highlight is QDMX, the Quad Direct Marketing Exchange. We launched QDMX last fall to deliver 100% personalized direct marketing campaigns at a fraction of the cost and a greater speed to market. QDMX is a real game changer, not only for our clients who regularly use direct mail as part of their marketing mix, but just as important to the next generation of great brands that are looking for alternatives to the overly-saturated online channels.

To increase the effectiveness of QDMX, we paired with another innovation, Quad's Accelerated Insights, an online proprietary virtual testing platform that allow clients to rapidly test creative formats and identify precisely what combination will be most successful, regardless of media channel. Accelerated Insights takes targeting and personalization to new levels based on demographic, cultural and emotional factors, among others, and continues to drive significant number of new client engagements.

On slide 8, we shared information about Quad's commitment to culture and social purpose, a commitment that goes back 50 years to our company's founding. We have always sought to conduct business with meaningful purpose, knowing it's possible to do well as a company while doing good in our communities and for the environment.

For example, at this time of heightened awareness about social issues, we have elevated our commitment to diversity, equity, and inclusion. In 2020, we launched the multifaceted learning and development program for leaders and employees on this important topic. We also continue to support the expansion of employee-led business resource groups. These groups provide a safe space for personal support and professional development. We also rely on our [ph] BRGs (12:18) to guide us on company policies and practices. As we look to the future, we are focused on operationalizing diversity, equity and inclusion into everything we do. We not only want to catalyze change within QUAD but across the marketing and advertising agencies as a whole. Just last week, QUAD and my family's foundation, the Windhover Foundation, announced a three-year, $1 million commitment to The BrandLab, an organization dedicated to changing the face and voice of the marketing industry by creating opportunities for young people from diverse, ethnic and socio-economic backgrounds.

This partnership will enable The BrandLab to expand into the Milwaukee community and bring the region's marketing and advertising agencies together with local students. We could not be more proud to make this investment which aligns directly with our longstanding purpose to create a better way while also enhancing QUAD's long-term talent pipeline. Our partnership with BrandLab builds on a recent contribution to the Brandcenter at Virginia Commonwealth University which is dedicated to developing the next generation of creative talent. Our contribution supports a new scholarship program that provides needs-based assistance to diverse students looking to make an impact in the fields of advertising, marketing, branding and communications.

In 2021, we also look to enhance our narrative around corporate social responsibility including how we are advancing our work as a good corporate citizen and proactive environmental steward.

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 they made in 2020. We ask a lot of them and they continue to be resilient in the face of unprecedented challenges. They have my sincerest appreciation for the work they do each and every day. As we enter 2021, our milestone 50th anniversary year, we will continue to build on our established track record of navigating change and disruption. We have faced challenges before and know how to manage through adversity. We are confident in our team, our strategy and our future as a marketing solutions partner to our clients.

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

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 fourth quarter and full year financial results. We faced unprecedented challenges head-on in 2020 with great agility to improve our adjusted EBITDA margin and drive higher cash flow and debt reduction. We were unwavering in our commitment to find new ways to drive segment share gains, improve productivity, reduce fixed and variable costs and maintain liquidity while keeping our employees safe and serving our clients well.

We also optimized our product portfolio by completing the divestiture of our book platform. This divestiture supports our strategy as a marketing solutions partner to shift from standalone product lines that don't lend themselves to an integrated marketing solutions offering for our clients. The result is a more focused approach to our transformational strategy and better capital allocation.

Optimizing our products and services portfolio helped generate $69 million in cash from divestitures of non-core assets. When combined with our strong operating and cash flow performance, we reduced debt by $184 million in 2020. Our significant liquidity and balance sheet focus helps ensure we have the financial flexibility to navigate the pandemic and continue to advance our strategy as a marketing solutions partner.

Net sales were $843 million in the fourth quarter, down 21% from 2019. For the full year, net sales were $2.9 billion, down 25% from 2019, both the quarter and full year variances are primarily due to the economic impact from the COVID-19 pandemic as well as ongoing print industry volume and pricing pressures. Our fourth quarter net sales trend, while a 21% decline, represents the second straight quarter of sequential revenue improvement during the pandemic as compared to a 28% decline in the third quarter and a 38% decline in the second quarter at the height of the pandemic's impact on our net sales.

Adjusted EBITDA was $64 million in the fourth quarter of 2020 as compared to $96 million in 2019. The adjusted EBITDA variance primarily reflects the impact from the decline in net sales partially offset by savings from cost reduction initiatives. Adjusted EBITDA for the full year ended December 31, 2020 was $260 million as compared to $335 million in 2019, while adjusted EBITDA margin improved to 8.9% as compared to 8.5% in 2019. The adjusted EBITDA variance to primary -- to prior year primarily reflects the impact from a 25% decline in net sales, a $12 million decrease in paper byproduct recoveries, and an $11 million increase in hourly production wages due to strategic investments we made to increase starting wages that helped favorably impact productivity throughout our platform.

These impacts were partially offset by savings from productivity and cost reduction initiatives. A $15 million net reduction in workers' compensation expense from improved production safety performance and a $9 million net non-cash benefit from a change of vacation policy. Adjusted EBITDA margin increased by 35 basis points due to our cost savings initiatives. Free cash flow was $129 million in 2020, an increase of $23 million from 2019 primarily due to a $50 million decrease in capital expenditures partially offset by a $27 million decrease in cash earnings. Free cash flow benefited from the CARES Act in 2020 including [ph] $40 million (18:43) in income tax refunds received during the third quarter as well as a $28 million deferral of Social Security tax payments of which we will repay [ph] $14 million (18:54) in 2021 and the remainder in 2022.

Slide 10 includes a summary of our debt capital structure as of December 31. We ended the fourth quarter with debt leverage of 3.35 times as compared to 3.09 times in 2019. While this leverage ratio is above our long term targeted leverage range of 2 times to 2.5 times, we were able to reduce debt by $184 million during 2020 despite the economic headwinds caused by the pandemic. As of December 31, our blended interest rate is 4.9% and our debt capital structure was 70% fixed and 30% floating. QUAD's nearest debt maturity is our 7% senior unsecured notes due May of 2022 which has $239 million outstanding. We are reviewing whether we will pursue refinancing this amount during the coming year or choose to pay it off at/or prior to maturity with our ample liquidity under our $500 million revolving credit agreement which matures in January of 2024 and available cash on hand.

We believe our significant liquidity, strong lender relationships, our agile approach to cost management and our ability to help clients now and after the pandemic as a marketing solutions partner will help provide substantial financial flexibility.

Slide 11 shows our commitment to debt and pension liability reduction. Regarding our pension obligations, the company assumed various frozen pension plans as part of the acquisition of World Color Press in 2010. We've improved the funded status of those frozen plans by $470 million since the acquisition and the pension plan is now 89% funded. This includes a $31 million liability reduction during 2020 due primarily to higher than expected asset returns and pension contributions despite a historically low discount rate.

In total, we reduced debt and pension obligations by $215 million during 2020. I'm extremely proud of the QUAD team for all of their efforts to ensure our strong financial position. As we look forward into 2021, we'll continue to prioritize the use of cash to reduce debt and further strengthen our balance sheet.

As it relates to the financial outlook for 2021, as shown on slide 12, given the ongoing lack of full year visibility due to the pandemic, it's not practical to provide specific financial guidance at this point. However, we expect to see continued sequential improvement in our quarterly net sales trends in the first half of 2021 due to the improving impact of the pandemic's impact on net sales and [ph] print (21:58) segment share gains. We expect free cash flow to decrease in 2021 as compared to 2020 due to the non-recurring nature of the CARES Act income tax refund received in 2020. We expect this to be partially offset by improvements in working capital, lower pension contributions and lower capital expenditures. We'll use our free cash flow and cash generated from asset sales to reduce debt and we expect to end 2021 at a lower debt leverage ratio than we ended 2020.

As always, we will continue to serve our clients well, advance our strategy as a marketing solutions partner, drive productivity improvements and sustainable margin improvement, all of which will generate strong free cash flow to further fuel QUAD.

And now, I'd like to turn the call back to Katie who will facilitate our question-and-answer session.

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 have three top questions that were submitted.

The first question is regarding client trends. Can you speak to a recent customer trends you've seen through the fourth quarter and in early 2021?

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

A

Yeah. Katie, thank you. Yeah. As everybody knows, it was a crazy year to train -- track customer trends. And as Dave said, with the bulk of our hit when the pandemic happened, we sort of got to the trough across all markets in the second quarter, some around April, May. But if I kind of look at the fourth quarter and project forward, when we look at retail inserts as Dave said, is the one that got most heavily impacted. I'd say that by the way since we hit that trough in the second quarter, we had seen incremental gains in all areas of our business.

Retail inserts to start with, which was the hardest hit, was off about 42% in the Q4 which is fairly in line with overall retail inserts. I think we'll continue to sort of see some ebbs and flows on this because retail inserts will continue to be very sensitive to how we come out of this pandemic. And we also look as people had cut back on holiday, we'll readjust their future trends and so more to come on that.

Catalog which was the next one that was most affected is off double-digit in the teens. So call it about somewhere in the in the mid-15 percentage which is in line with the industry. Again, we saw incremental improvements through the year. And I think that as the pandemic kind of runs its course here, we'll see that continue to settle down.

The third one is publications, again, I think a lot of people got hit with number of pages in terms of advertising pages or even some titles going out of business and circulation trends. But because of market segment share wins, in fourth quarter, we were only off about 4% versus an industry average of about 15%. And so, again, we've got a great platform for publishers and we've been able to really continue to perform for them. When I look at direct mail, that's a great story, we're actually in the fourth quarter up a couple of percent with I'd say the USPS DM estimate for fourth quarter was off about 4%. So we're actually up 2%. And this is important. There is definitely some tailwind from political mailings and things like that. But the way that we're approaching direct mail is really about more of a value add, and so trying to go from non-personalized, non-data intensive and driven to data-driven as well.

And so when we look at direct mail, it continues to be a place that we think will grow. And then finally, when I look at packaging, we were up as well about 3% in the fourth quarter which sort of follows trends that have happened in packaging and also the other areas of growth have been in-store. And so still a lot of challenges in seeing the future and very hard to predict. But, again, we expect to see continued incremental improvements.

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

A

Thanks, Joel. That was a great overview. Okay. Our second question is for Dave. Dave, you mentioned QUAD's 2022 senior unsecured notes earlier in the prepared remarks. Can you please expand further on QUAD's plan to address this maturity?

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

A

Sure. Sure, Katie. And just as a reminder, those senior unsecured notes, there's $239 million outstanding as of December 31 and those will come due in May of 2022. Our continued focus on margin improvement and free cash flow as we showed, despite the pandemic in 2020, that we can continue to perform well with that, as well as just a significant amount of liquidity that we have. At the end of the year, we had nothing drawn under our $500 million revolver. We had $55 million in cash on hand. So we have significant liquidity in which to have flexibility and optionality regarding what we plan to do with this upcoming tranche of debt that will be due in May of 2022. At this point, we're considering all options. And as I walked through in the script, those options are we could refinance that tranche of debt. We could wait to maturity and pay it off then or we could just pay it off early. So, we're just going to continue to watch as the year unfolds and determine what's the best option for the company and for the debtholders as we move forward, and we'll make sure we took a pretty balanced approach at that.

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

A

Okay. Thanks, Dave. Our final question relates to non-core asset sales. Dave, you also mentioned that Quad will continue to focus on non-core asset sales in 2021. Can you and Joel give more detail on what types of assets those might be?

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

A

Sure. I guess, Joel, if you don't mind, I'll start, and you can build off of what I have to say. We had a really productive year in 2020 in addressing our product portfolio. And I walked through the divestiture of our Book plants. That was done in two separate transactions. We sold three facilities and we also sold a packaging facility in Omaha, Nebraska. These transactions, as well as selling other non-core assets such as vacant facilities and real estate, helped generate $69 million of debt reduction during 2020. This is really consistent with how we've managed the business and the balance sheet. In fact, I think over the past four years, this has provided us about $150 million, a little bit over $150 million of cash from asset sales in order to deploy to reduce debt. So, it's been very successful for us. And we'll continue to look at ways in which we can manage the balance sheet well from that standpoint.

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

A

Yeah. And Dave, sort of adding on to that, I mean, keep in mind that as we've transformed this company, and I will tell you that we've talked about this 3.0 transformation, we're really saying that the transformation is done. We've made investments where we've had to to round it out in terms of other capabilities such as with Periscope, Rise Interactive, et cetera, and as we look at our portfolio of assets, it's really about where does the customer need us to be and where are they willing to go.

And when we – when I look at the Book segment, I look at the one packaging plant we had both – in both those cases, it wasn't really the customer base that could really use our expanded service as an offering. And so, we saw that – we're not going to be able to add that much value there. They were underperforming. And so, that's where we parted ways. But a lot of – since our transformation is done and we've kind of built out these offerings, we'll continue to go where the client asks us to go. And right now, because of the success of the transformation that [ph] slowly will (30:48) be showing you an offset in prints decline, there's a big demand for us to bring in really top level talent. And so, we're actually investing a lot in new talent in – heavily into the analytics and in the creative and campaign planning and all of the things that kind of enhanced the rest of the product lines.

But – so, watch us continue to look at it, and of course, we'll always look at other assets that can be sold if we're managing the platform because of volume decline. We'll have real estate to get rid of and things like that. But that's how we view it, and really, as we look forward post-transformation and in sort of the new Quad, it's really going to be about making sure that we go where our clients who depend on us for being more than just a product supplier, and that's where we'll go.

Katie Krebsbach

Investor Relations Lead, Quad/Graphics, Inc.

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.

J. Joel Quadracci

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

Yeah. Thanks, Katie, and thank you, everyone, for joining today's call. I want to close by reiterating my thanks to our employees for their hard work and sacrifices during 2020 and their commitment to continue performing well in 2021, as we focus on managing what is within our control. We know our clients are depending on us and we are here to help them with a unique integrated marketing platform that helps them solve their marketing and process challenges. Again, to all my employees, from the bottom of my heart, from my family, from the board of directors, thank you so much for all the hard work that you did. And to everybody else, have a great day. We look forward to speaking with you again next quarter. Take care.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time.