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Interface, Inc. (TILE)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. And welcome to the Q3 2020 Interface, Inc. Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Christine Needles. Thank you. Please go ahead.

Christine Needles
Senior Director-Global Communications & Public Relations, Interface, Inc.

Good morning, and welcome to Interface's conference call regarding third quarter 2020 results, hosted by Dan Hendrix, Chairman and CEO; and Bruce Hausmann, Vice President and CFO.

During today's conference call, any management comments regarding Interface's business, which are not historical information, are forward-looking statements within the meaning of federal securities laws. Forward-looking statements include statements regarding the intent, belief or current expectations of our management team as well as the assumptions on which such statements are based.

Any forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties that could cause actual results to differ materially from any such statements, including risks and uncertainties associated with the ongoing COVID-19 pandemic and those described in our SEC filings. The company assumes no responsibility to update the forward-looking statements.

Management's remarks during this call also refer to certain non-GAAP measures. Reconciliation's of the non-GAAP measures to the most comparable GAAP measures and explanations for their use are contained in the company's earnings release and Form 8-K furnished with the SEC today.

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Lastly, this call is being recorded and broadcasted for Interface. It contains copyrighted material and may not be rerecorded or rebroadcasted without Interface's expressed permission. Your participation on the call confirms your consent to the company's taping and broadcasting of it. After our prepared remarks, we will open the call for questions.

Now, I'd like to turn the call over to Dan Hendrix, Chairman and CEO.

Daniel T. Hendrix

Chairman, President & Chief Executive Officer, Interface, Inc.

Good morning and thank you for joining us today. Before we discuss financial results for the quarter, let me first talk about the status of our business and what we're seeing in the marketplace.

Thank you to our Interface team for your hard work this quarter as we continue to manage through COVID-19 pandemic and the ongoing impacts on our business. We remain focused on managing the things that we can control while continue to invest in the initiatives, specifically our product innovation pipeline and selling system that will set us up for long-term success. I'm very proud of the team for providing best-in-class service levels while ensuring the safety of our people.

Our net sales were down 20% in the third quarter versus last year. I'm encouraged by some early bright spots in the business. Third quarter orders increased 11% sequentially compared to the second quarter, potentially signaling stabilization. We saw modest sequential improvement across all product categories.

We're beginning to see modestly improving trends in Europe. In particular, we're having a standout year in our nora rubber business in Germany. And our business in China has returned to growth. Australia seems to have a better handle on COVID-19 than most of the world, and more people returning to the office in Asia-Pacific, where work from the home is less common. This is a positive signal for us with half of our revenues outside the United States.

We maintained healthy adjusted gross margins of 37% in the third quarter despite a 31% decline in carpet tile production. This reflects the strong capabilities of our supply chain and operation teams and the flexibility of our 70% variable manufacturing cost structure.

We remain committed to rightsizing the business to maintain our profitability when necessary. We have taken actions to realize $80 million of annual run rate cost reductions in response to the pandemic and anticipate full year 2020 adjusted SG&A expense of approximately $310 million. Overall, we have made progress expanding our product lines.

In 2016, carpet tile made up nearly 100% of our revenue. Today, it is only two-thirds of our sales. We've quickly grown our LVT business since launching in 2017 and we acquired our rubber business in 2018. We believe rubber and LVT have doubled Interface's total addressable market from about $4 billion to approximately $9 billion. And there's an opportunity for additional reach in the $10 billion commercial soft floorcovering market with the ongoing conversion of broadloom to carpet tile.

To further strengthen our competitive position, we also continue to expand our market presence in end markets beyond the corporate office. This includes healthcare, education, life sciences, hospitality, retail, consumer and multi-family where we compete on design, innovation, service, price and sustainability. In the past few years, these efforts have resulted in major shifts in our revenue composition.

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The commercial office market, which used to represent the majority of our revenue, is now less than half our business. This diversification helps us to adapt during times of economic and market volatility.

In the current environment, we are capitalizing on opportunities in hospitality where hotels are renovating and remodeling, while limited capacity. And we see the same trends in healthcare and education, especially K through 12. In addition, the direct to consumer e-commerce platform of our FLOR business is having an exceptionally strong year, growing double digits.

With COVID-19, we're seeing a change in design needs in schools and offices. Renovations and remodel compared to new construction make-up about 80% of our commercial business. And we expect to get traction accommodating redesigns that address social distancing measures as large companies and businesses begin to reopen. Our products can help to address these challenges with design elements like pattern and shading to guide traffic direction, zoning and other visual cues.

Ultimately, companies still view office space as a necessity for culture and innovation. As they say culture beats strategy every time. We anticipate demand to pick up in the coming quarters and we believe there will be a recovery in office market in the second half of 2021.

According to a recent Gensler study, 44% of employees prefer to be back in the office full time, while 44% prefer a hybrid office home arrangement. This bodes well for the comeback of the office market.

We're also increasing our focus on the US commercial dealer discretionary market through value engineered product and increasing selling focus from our sales force. Our objective is to take our fair share of this $2 billion market opportunity by focusing on the dealers and offering high design products at low to mid price points.

I'm also very excited to share an important milestone in our sustainability journey. In October, we rolled out our first carbon negative carpet tile, measured cradle to gate. We launched this new product as part of our latest global collection called Embodied Beauty along with our new non-vinyl bio-based CQuest Bio and CQuest BioX backings. These new backings are our first non-PVC product offerings in the United States, expanding our market opportunity with a growing customer base that prefer a non-PVC option.

The Embodied Beauty styles are currently available in the United States and we expect to launch them globally in 2021. We are encouraged by early demand from our customers, many of whom care about embodied carbon in their built space and have made their own commitment to be carbon negative in the future. We firmly believe that the demand will only increase as more companies set carbon reduction targets and is a big step toward our commitment for Interface to be carbon negative enterprise by 2040.

With that, I'd like to turn the call over to Bruce to discuss the financial results for the third quarter.

Bruce A. Hausmann

Chief Financial Officer & Vice President, Interface, Inc.

Thank you, Dan, and good morning, everyone. As we closed out the third quarter, orders were down 21% compared to the prior year, with orders down 25 % in Americas, 16% in EMEA and 15% in Asia-Pacific. That said, orders increased 11% over the second quarter, potentially signaling stabilization in demand.

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Net sales in the third quarter 2020 were $279 million down 20% compared to the prior year period, but up 7% sequentially compared to Q2. Declines in carpet tile were somewhat moderated by lesser declines in LVT and rubber. Sales in the Americas were down 29%, with declines across all product categories.

In EMEA, sales were down 17% in local currency and down 12% in US dollars, again, with declines across all product categories. And sales in Asia-Pacific were down 10% in local currency and they were down 8% in US dollars. Declines in carpet tile were offset by solid performance in both LVT and rubber.

In our global market segments, we continued to see growth in living, which includes student housing, senior living and multi-residential. We also saw growth in public buildings and transportation in the quarter.

Third quarter adjusted gross profit margin was 37.2%. While this was down 270 basis points from the prior year period, it was still a very healthy outcome when carpet tile production was down 31% year-over-year. This is a testament to our strong supply chain, strong plant operators and our ability to flex our plants and cost structure with changes in demand.

SG&A expenses were $88 million in the third quarter or 31.6% of net sales, while adjusted SG&A expenses were $75 million or 27.1% of net sales in the third quarter of 2020. The company has implemented several cost reducing initiatives to align with reduced customer demand and anticipates full year 2020 adjusted SG&A expenses of approximately $310 million.

In the third quarter, we recorded $8 million of severance charges related to payments for our voluntary and involuntary separation program. And we've benefited from approximately $3.5 million in various wage support and employee retention programs around the world. We continue to realign the company's cost structure while investing in innovation to keep the company strong and agile for the medium to long-term.

The third quarter operating income was $16 million compared to operating income of $44 million in the prior year period. And third quarter 2020 adjusted operating income was $28 million versus adjusted operating income of $46 million in the third quarter of last year.

We recorded net income of $6 million in the third quarter of 2020 or $0.10 per diluted share. And third quarter 2020 adjusted net income was $17 million or $0.28 per diluted share and adjusted EBITDA was $37 million. Please refer to our press release for reconciliations of GAAP to non-GAAP numbers.

Turning to our balance sheet and cash flows, we generated $65 million of cash from operations and had $378 million in liquidity at the end of the quarter. We effectively controlled costs and closely managed our cash flow during this ongoing period of softened demand.

Inventory was down $18 million or 7% year-over-year, driven by a decline in carpet tile. Notably, finished goods inventory decreased 25% year-over-year. Managing our working capital metrics continues to be a top priority.

We ended the quarter with $104 million of cash and repaid $43 million of debt during the quarter. Net debt or gross debt minus cash on hand was $482 million and the last 12 months of adjusted EBITDA was $162 million at the end of the third quarter, resulting in a leverage ratio of 2.9 times net debt to adjusted EBITDA.

Interest expense was $5 million in the third quarter compared to $7 million in the third quarter of last year, and depreciation and amortization were $12 million in the quarter versus $11 million in the third quarter of last year. Capital expenditures were $11 million in the third quarter compared to $19 million in the third quarter of last year.

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And we anticipate capital expenditures to be approximately $60 million for the full year 2020 and approximately $30 million for the full year 2021, as we have moderated capital spending plans this year and plan to reduce them further next year.

While we are seeing indications of stabilization in our end markets, a high level of uncertainty created by the global pandemic still remains. As a result, Interface is not providing fiscal year 2020 guidance. That said, based on everything we know today, we anticipate Q4 2020 will be similar to Q3 2020 in terms of the year-over-year revenue decline and gross profit margins.

And now, I'll turn the call back to Dan for concluding remarks.

Daniel T. Hendrix

Chairman, President & Chief Executive Officer, Interface, Inc.

Thank you, Bruce. We are encouraged by some of the recent data points and trends we're seeing in our end markets. And we believe that a broadened portfolio, coupled with a more focused segmentation strategy, will bolster our share growth.

We're committed to innovation and have a strong pipeline of exciting new products for 2021. And we will continue to right size the organization to meet demand and focus on strong liquidity and cash flow generation. Most notably, Interface will continue to be successful, resilient and agile during these changing times as we always have been.

Thank you to the entire Interface team around the world for your resilience and dedication to our company and our customers. Your health and safety remain our top priority and we truly value your hard work and commitment. I am proud of the way our company is navigating this challenging year with COVID-19.

Thank you also to our customers and shareholders for your continued support. We remain focused on keeping our business strong and well-positioned for long-term success.

With that, I'll open it up for questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: At this time, we would like to take any questions you may have. [Operator Instructions] Our first question comes from Kathryn Thompson with Thompson Research Group. Your line is open.

Brian Biros
Associate Equity Analyst, Thompson Research Group

Q

Hey. Good morning. This is actually Brian on for Kathryn. Thank you for taking my questions. I wanted to start with the outlook for Q4 and [ph] kind of help (00:14:23) bridge the gap between the two statements of Q3 orders were up 11% sequentially, but Q4 is – track similar to Q3. And I guess what I thought if orders are up a little bit more, then maybe Q4 would be up a little bit more, but it sounds like should be down to a similar extent in Q3. So I guess how do we bridge the gap between those two?

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Yeah. Good morning, Brian. This is Bruce Hausmann. So the way we're thinking about Q4 based on everything we know today is that, if you think about year-over-year top line growth, it'll be really similar to what we saw in Q3. And if you think about gross profit margins, we're thinking that they'll be very similar to what we saw in Q3. And if we think about full year SG&A, it'll be about $310 million approximately for the full year. And of course, we have three quarters banked so far, so you can pretty much back into the Q4 number.

And so the good news is that we're seeing stabilization in the business. The good news is that orders sequentially are up, but based on all the puts and takes of the numbers, that's kind of how we – how our best estimate of where Q4 would probably come out.

Brian Biros
Associate Equity Analyst, Thompson Research Group

Q

Okay. And then, I guess maybe on the gross margins in the quarter down 270 basis points. I think that was a little more than Q2 was down. I guess what are the drivers for that in the quarter? And it seems like volume production should have been a lot higher in Q3. Hopefully, we would have seen some lower input costs from the – lower input costs that were in the first half of 2020, 2020 kind of flowing through the income statement in the back half of the year. So I guess how we think about the puts and takes for the margin performance in the quarter?

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Yeah. Good morning, Brian. This is Bruce Hausmann again. So in Q2, our production was down about 36%, and in Q3, it was down about 31%. In Q4, we're anticipating a similar level. There are – as you said, there are a lot of puts and takes in that. We felt really good about where the gross margins landed for the quarter based on great operators in our plants, great supply chain organization and a strong ability to manage the costs.

We're not necessarily seeing – this is not an inflationary environment from an input inflation standpoint, but it's not necessarily a heavy deflationary environment either. So you kind of bake in all those factors. And again, where the GP landed, we thought it was a great outcome and we're anticipating a similar outcome for Q4.

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Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Yeah. And we continue to bring down finished goods inventory as well.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Yeah. That's a really good point. I don't know if you heard that point. But finished goods inventory was down 25%, which is – so we continue to be very focused on our working capital.

Brian Biros
Associate Equity Analyst, Thompson Research Group

Q

Yeah. Thank you.

Operator: Your next question is from Keith Hughes with Truist Securities. Your line is open.

Keith Hughes
Analyst, Truist Securities, Inc.

Q

Thank you. Given some of the shifts in the market, you talked about towards soft surface [ph] from carpet material (00:17:40) you're addressing. And given the downturn with the carpet tile now, are you looking to permanently take some carpet tile capacity out and given this production rate you discussed earlier?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Not right now. We're not. We continue to look at capacity in Asia. We have a lot of capacity there. And we're going to – we want to capture the China market and we have a plant in China that services the Chinese market, and our Thailand plant services the rest of Asia. And we have an Australian plant. So we're not looking to take it out today, but we'll continue to look at it and flex it as demand ebbs and flows.

Keith Hughes
Analyst, Truist Securities, Inc.

Q

Okay. And you discussed $80 million run rate of cost savings. Can you talk about how much of that will be realized in 2020 and how much in 2021?

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Keith, this is Bruce Hausmann. I was wondering if you're going to ask that question. We're still working through our AOP or our annual operating plan process and we're going department by department, line by line, and grinding through all the numbers. And so we don't have any forward guidance on that number for this call, but we will provide that on our next call.

And – but I would just say that we're going to continue managing the cost structure of the business in line with our current demand. And I'm sure you've noticed our SG&A is way down year-over-year, and I think that we're doing a good job of controlling that line and making sure that that's in alignment with our current top line.

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Keith Hughes
Analyst, Truist Securities, Inc.

Q

Is it fair to say the majority of it will be seen in 2021?

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

There will be some things that'll happen in 2021, like, for example, merit increases will come back. For example, bonuses, all sort of get reset based on new targets and things like that. So that's all the math that we're working through.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

And the furloughs.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

And the furloughs will come back. We had a number of furloughs. We also had some wage support programs this year, principally in Europe, where there are government sponsored programs that we get reimbursed. And we're just not sure if those will be recurring next year because that's country-by-country, government-by-government, so they have to approve those. So...

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

But we have taken out some permanent structural costs as well, Keith.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

We have.

Keith Hughes
Analyst, Truist Securities, Inc.

Q

Okay. That's part of the $80 million [ph] largely, (00:20:07) correct?

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Yes it is.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Yeah.

Keith Hughes
Analyst, Truist Securities, Inc.

Q

Okay. All right. And I guess just any kind of update for us on the CEO search. Where you stand on that process?

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Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

We're looking at doing that next year. It's sort of tough time to do a CEO search in this pandemic. So we're looking to kick it off next year.

Keith Hughes
Analyst, Truist Securities, Inc.
Q

Yeah. Okay. All right. Thank you.

Operator: Your next question is from David MacGregor with Longbow Research. Your line is open.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Yes. Good morning, everyone.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

Hi, David.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Hey, good morning. Just want to go back to the first question that was asked about the discrepancy between the observation on the order book and then the thought that 4Q will look a lot like 3Q. I guess the building in order is happening a little further out in the [ph] order book (00:20:54) is it? And I guess the question I wanted to ask on this point is, are you seeing any slowdown in the number of push-outs and revisions and deferrals? Is that what's giving you some sense of encouragement when you talk about the improving order patterns, or maybe you could just elaborate a little further on that?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

Well, we're not seeing cancellations, but we are seeing delays, David, in the order book. And I saw order book actually – I think has grown a little bit. And so we just don't know what the fourth quarter and next year is going to look like with the pandemic and even the second wave of the pandemic. So we're thinking that [ph] we've stabilized (00:21:34) where we are and it's down 20% today. And hopefully, we will see the office market come back. But we're not just sitting on the office market, we're actually going after a lot of other opportunities and trying to go after the health care market with our other business, trying to go after this dealer business that we've talked about on our last call, David. So we're trying to take share out there as well.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Okay. And then, I wanted to come back and ask you about the dealer discretionary business because it's kind of a new business for you, I think. Isn't it? And I'm just trying to understand how we should think about that with regard to the cash flow for 2021. Clearly, your CapEx is maybe down pretty sharply. It'd be interesting to know what your thoughts are in terms of maintenance CapEx these days. But my guess is, as you build out a discretionary – a dealer discretionary businesses, there's probably a bit of a burden to working capital.

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So could you just talk about how we should think about 2021? And I realize you haven't provided 2021 guidance yet. But just conceptually, how we should think about the moving pieces directionally in the cash flow model for next year.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

Well, let me see if I can answer it. For the CapEx maintenance, we're around $30 million next year in CapEx and we're going to hold it to that line. We're really focused on paying down debt.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Yeah.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

As far as that – it's the US business we're focused on this – on the dealer business. 90% of our business goes through the dealer, but we specify almost all of our business and we hold the spec and we pull it through the dealer, but the dealer has discretionary business that they also control. And we've really never focused on that discretionary piece of the market with those dealers because we've always focused on end user and A&D communities.

So we're going to pivot and really focus on the dealer and show them some love with products and with technology and with our salespeople actually cal them and treat them like a customer.

David S. MacGregor
Analyst, Longbow Research LLC
Q

So, how should we think about that in terms of just the inventory build that's required?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.
A

There's not an inventory build on that at all.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.
A

Yeah, David, this is Bruce. We don't anticipate any sort of meaningful increase to working capital to go and capture that piece of the market. There is going to be some new product development around the mid to low end pricing that goes after that dealer market.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Right.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.
A

But it won't be inventory-related.

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David S. MacGregor
Analyst, Longbow Research LLC

Q

Right. So it is going to be somewhat – to the extent you're successful, this is going to be a little bit of a headwind to gross margin I would guess for next year?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

We'll engineer the product to go after that market where we have pretty healthy margins in there.

David S. MacGregor
Analyst, Longbow Research LLC

Q

Okay. And then finally for me, just how should I think about [indiscernible] (00:24:09) paying down a little bit of debt in the quarter. But how should I think about deleveraging goals for the next 12 to 18 months?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Well, my goal is to be under 2. I've always been under 2 is my goal and we're going to take all our available cash to pay down debt.

David S. MacGregor
Analyst, Longbow Research LLC

Q

How quickly can you get to there, Dan?

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Two years, I think. I'm looking at my CFO, but two years, that's right, for sure.

Bruce A. Hausmann
Chief Financial Officer & Vice President, Interface, Inc.

A

Yeah. Our number one capital allocation policy, David, is to pay down debt first. And as we mentioned, we're going to decrease CapEx materially next year, which will free up a lot of the additional free cash flow in order to do that.

David S. MacGregor
Analyst, Longbow Research LLC

Q

Okay, great. Thanks very much, guys.

Daniel T. Hendrix
Chairman, President & Chief Executive Officer, Interface, Inc.

A

Sure.

Operator: [Operator Instructions] And we have no further questions. I'll turn the call back to presenters for closing remarks.

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Daniel T. Hendrix

Chairman, President & Chief Executive Officer, Interface, Inc.

Yeah. Well, thank you for listening to our third quarter call and I'm looking forward to talking about in the fourth quarter call. And please, everybody, be safe. Thank you.

Operator: This concludes this conference call. You may now disconnect.

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