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Earnings Call

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Call Participants

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VP & CFO

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ANALYSTS

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Keith Brian Hughes
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Presentation

Operator

Thank you for standing by, and welcome to the Q3 2023 Interface, Inc. Earnings Conference Call.

I would now like to welcome Christine Needles, Corporate Communications, to begin the call. Christine, over to you.

Christine Needles
Global Head of Corporate Communications

Good morning, and welcome to Interface's conference call regarding third quarter 2023 results, hosted by Laurel Hurd, CEO; and Bruce Hausmann, 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 described in our most recent annual report on Form 10-K filed with the SEC. The company assumes no responsibility to update forward-looking statements.

Management's remarks during this call also refer to certain non-GAAP measures. Reconciliations 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.

Lastly, this call is being recorded and broadcasted for Interface. It contains copyrighted material and may not be rerecorded or rebroadcasted without Interface's express 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 up the call for questions.

Now I will turn the call over to Laurel Hurd, CEO.

Laurel M. Hurd
President, CEO & Director

Thank you, Christine, and good morning, everyone. I want to start by thanking the Interface team for their hard work in a dynamic environment. Our results in the quarter reflect the resiliency of our global diversification strategy and effective execution in a relatively sluggish market. Despite lower volumes in the quarter, we expanded our operating margin and delivered strong cash generation.

There were 2 primary factors that impacted our revenue growth in the third quarter, but we also expect to continue in the fourth quarter. First, the retail sector, which had an outsized impact on our third quarter sales for a good portion of our year-over-year decline. We don't often talk about the retail segment as it's about 4% of our year-to-date annual sales. However, this sector has been pressured, as you know, and we have seen significant unplanned deferrals of store remodel projects due to the macroeconomic uncertainty these retailers are facing. They're being cautious in their capital budget, pushing out projects and in some cases, closing locations and we're feeling the impact of that.

Second, while we have seen broad-based resilience in a dynamic market, including several bright spots and our order rates have held up fairly well. We have started to see industry-wide sluggishness begin to develop across the commercial market.

Turning to our segments in more detail. We saw notable strength in health care with billings up 13% in the quarter globally and up 21% in the Americas. As the health care industry continues to evolve, architects and designers are recognizing our right to win in this growing segment. I recently spent time in

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the Midwest and visited 3 major health care systems. They're making impressive investments to build new facilities as well as renovate their existing facilities.

Health care spaces are typically thought of as primarily sterile, clean environment, which is incredibly important, especially in the operating theaters. Our customers are now also increasingly focused on creating environments that prioritize patient and caregiver well-being and serenity.

As these health care systems expand across the country and, in some cases, around the globe, other spaces are designed become a representation of their brands. Design matters more and more in this segment in addition to performance, and our brands of nora Rubber and interface flooring and the integrated system that we offer is truly resonating.

We also continue to see strong activity in education, both from K-12 and higher education. On a year-to-date basis, education is up across most of our major markets and up 5% for the total company. I also met with 2 of our important higher ed customers while in the Midwest. Sustainability matters to these customers. Often, we'll meet not only with the head of facilities or head of design, but also their head of sustainability. Many universities have made carbon commitments and are drawn to Interface because we have the lowest embodied carbon in the industry, and their students care and hold them accountable to deliver on their commitments. Often Interface is used as a case study in their university curriculum for our advancements in sustainability. So of course, they use our products in their floors. It also struck me how dynamic these higher ed customers needs are across classrooms, storms and student unions, where they expect our LVT and carpet to their labs and health centers where nora Rubber is the solution. Again, is our integrated system of flooring solutions that our customers truly appreciate.

Corporate office remains relatively steady, where we see continued renovations with more and more companies modifying their spaces as they bring people back to the office. Americas corporate office billings are up 3.5% year-to-date. Australia is up 2.4% with Europe fairly close to last year levels and continued softness in Asia.

Moving to orders. Orders were stable in the third quarter with consolidated currency neutral net orders roughly flat year-over-year. Currency-neutral orders in the Americas were down 4.2%, driven by softness in the retail sector, while EAAA was up 4.5%. Strong order growth in EMEA more than offset softness in Asia, and our backlog remained solid, declining slightly in the third quarter, but up 8% since the beginning of the year.

Despite lower volumes in the quarter, adjusted gross profit margins increased 217 basis points year-over-year. Our team did an excellent job maintaining price and driving favorable mix, enabling us to capture the benefit of raw material price relief despite lower fixed cost absorption. We remain focused on SG&A control, investing in customer-facing activity, design and innovation to drive long-term growth coming out of this more challenging cycle, while driving efficiencies in all other areas of our business. We also effectively managed our working capital and use our strong cash flow to reduce debt ahead of our expectations. Our balance sheet is in great shape.

Before I turn the call over to Bruce to go through the financial results, I want to take a moment to talk about One Interface and the progress we are making. On October 10, we launched our Past Forward carpet tile collection which is the first time we launched a global collection at the same time around the world. Past Forward draws on decades of iconic design. It brings a vintage deal and retro charm to modern design thinking and celebrate our 50th anniversary. It's also a great example of the power of One Interface and demonstrates how we're operationalizing our new strategy across our global business. I am confident we will continue to harness our talent across the globe to bring new products and designs to market faster and amplify our brand messaging consistently.

Overall, we continue to navigate the challenges in this dynamic market. We feel good about the way our brand and products continue to resonate with customers. We've come a long way as an organization over the last 50 years. As we look ahead, we will continue to honor our guiding principles by pushing the limits on design, innovation and sustainability while leveraging the power of our global organization. We believe we are uniquely positioned to capitalize on growth opportunities as they arise and as market conditions improve, which will help deliver profitable growth and return value to our shareholders.

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With that, I will turn it over to Bruce to go through the financials. Bruce?

Bruce A. Hausmann
VP & CFO

Thank you, Laurel, and good morning, everyone. Third quarter net sales totaled $311 million, a decrease of 5.1% versus last year's third quarter. FX-neutral net sales declined 6.6% year-over-year compared to double-digit growth in the same period last year. FX-neutral net sales in the Americas were down 8.2% year-over-year compared to last year's double-digit growth in the third quarter. FX-neutral net sales in EAAA were down 4.3% and overall strength in health care was offset by softness in the retail sector, driven by project deferrals as well as general macroeconomic conditions.

Third quarter adjusted gross profit margin was 35.9%, an increase of 217 basis points from prior year's third quarter, primarily due to raw material cost deflation as well as higher pricing and favorable product mix, partially offset by lower fixed cost absorption. As we move into Q4 of 2023, we anticipate continued year-over-year raw material deflation.

Adjusted SG&A expenses were $79.2 million, flat compared to third quarter last year and a successful outcome given all the inflation we've had to offset in SG&A through strong cost controls.

Third quarter adjusted operating income was $32.4 million, up 3.6% compared to adjusted operating income of $31.2 million in the third quarter last year. The increase is due to higher gross profit margins in the quarter.

Third quarter adjusted EPS was $0.28 versus $0.30 in the third quarter last year. Adjusted EBITDA was $43.7 million versus $42.9 million in the third quarter last year. We generated $66.3 million of cash from operating activities in the third quarter. Liquidity was strong at the end of the quarter, totaling $412.1 million which consisted of $119.6 million of cash and $292.5 million of revolver capacity. We repaid $30.6 million of debt in the quarter, resulting in net debt or total debt minus cash on hand of $324.8 million at the end of the third quarter. The last 12 months of adjusted EBITDA totaled $151.1 million our net leverage ratio dropped to 2.1x calculated as net debt divided by adjusted EBITDA.

We are very pleased with our focused efforts to pay down debt and continued strengthening of the balance sheet.

Capital expenditures were $5.9 million in the third quarter of 2023 compared to $4.2 million in 2022.

Moving to our outlook. We are focused on winning business, taking share, paying down debt and disciplined cost management. And for the full year of 2023, we are anticipating the following: net sales of $1.245 billion to $1.265 billion, adjusted gross profit margin of approximately 34.4%, adjusted SG&A expenses of approximately $329 million, adjusted interest and other expenses of approximately $35 million, an adjusted effective tax rate of approximately 29.5%, fully diluted weighted average share count of approximately 58.3 million shares and capital expenditures of approximately $32 million.

Now I'll turn the call back to Laurel for concluding remarks.

Laurel M. Hurd
President, CEO & Director

Thank you, Bruce. Our team executed well this quarter, and our solid results are exemplary of our constant drive to volatile market conditions and uncertainties. I'm proud of our accomplishments so far and we remain focused on the execution of our disciplined strategies as we close out the year. Thank you. With that, I'll open it up for questions. Operator?

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Kathryn Thompson with TRG.

Brian Biros
Thompson Research Group, LLC

This is actually Brian Biros on for Kathryn. Maybe can you just talk more broadly about the setup here into 2024, 2023 kind of end down a little bit, EAAA segment, maybe inflecting up a little bit based on orders here, but Americas maybe going backwards a little bit. So volumes, I don't know, mix, raw looks like they're trending better, the internal initiatives going on that seem to be providing some benefits there. So just any thoughts on the 2024 outlook in setup here would be helpful.

Laurel M. Hurd
President, CEO & Director

Yes. Thanks, Brian. As you know, we'll provide guidance on '24 when we report Q4 earnings, and we're really watching everything as you are. I would say that our core markets are holding up really well. I'm really pleased with our corporate performance globally year-to-date, we're down just over 1 point corporately. And with all the headlines you're reading about office, we're really holding up well in that market. Health care and education continued to do well. The retail segment was a change for us this quarter, and I'll talk just a minute about that. Our revenue in the quarter was down 5%, we were down 4% from retail. And so that's something that we're watching as we continue to watch the dynamic market.

Brian Biros
Thompson Research Group, LLC

Got it. Helpful. And then maybe just on LVT, can you just give us an update on your strategy there? I know you've been sourcing out of South Korea historically. Some competitors are making adjustments to LVT production setups. Retailers are seeing various trends and pricing pressure on the low end, as customers trade down but it's kind of more resi focused, and I know you have a higher-end product overall. But first, in the current environment here, how you're thinking about your LVT strategy would be interesting to hear.

Laurel M. Hurd
President, CEO & Director

Yes, it's a great question. In our LVT, we do source our LVT, and we've got a great partner and our business has held up really well in LVT. We were up double digits for the quarter in LVT, continuing to see growth. We're specking that very effectively with our carpet. So we're not seeing any slowdown there, and we're pleased with the progress that we've got in LVT.

Operator

Our next question comes from the line of David McGregor with Longbow Research.

David Sutherland MacGregor
Longbow Research LLC

Yes. Good morning, everyone. I wanted to just start off by asking about the global launch and just what are the lessons that you've learned from that? And then I'd like you to maybe talk a little bit, if you could, about how that impacted operating expense and the overall margin performance in the quarter and how we should think about that because as we head into 2024, I'm guessing you've got more global launches coming just from a modeling standpoint, how we should be approaching that?

Laurel M. Hurd
President, CEO & Director

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Yes, great question. So Past Forward, I would say this, it was an unbelievable launch. I don't know if you've seen some of the marketing and the brand initiatives. But it's really been a successful launch in the market to do that in the same day around the world, that wasn't in the plans at the beginning of the year. The team pulled that off in a 6-month window. And I'm really impressed. I think what it taught me is the speed and the agility that we can work as 1 team. And when we're all aligned together, we can really bring great things to life. I think you'll see more of that for sure going forward. I'm very excited about the progress that we're making in One Interface and how that's going to enable us to brings really strong brand messages to life to strengthen our brand around the world. And honestly, the new designs that we're working on that you'll see over the next couple of quarters will be -- it's some of the best work I've seen. So I'm really excited. And as you said, we're driving efficiencies that way because we're launching all together around the world, we're seeing some good margin progress and being really efficient with our spend. So I'm pleased so far.

David Sutherland MacGregor
Longbow Research LLC

So beneficial to operating expense leverage?

Laurel M. Hurd
President, CEO & Director

Yes.

David Sutherland MacGregor
Longbow Research LLC

Okay. And I also was going to -- I'm sorry. go ahead.

Laurel M. Hurd
President, CEO & Director

No, go ahead.

David Sutherland MacGregor
Longbow Research LLC

No. Okay. I also wanted to ask you about your comment that commercial markets were turning more sluggish just in general. And I think that's probably the general sense amongst most people. But could you elaborate a little further in to -- maybe offer up some specifics in terms of what you're seeing in terms of forward visibility, in terms of order flow, in terms of competitive behavior? Just if you could elaborate a little further, a little more granularity would be helpful.

Laurel M. Hurd
President, CEO & Director

Yes, of course. And again, I feel like sluggish is the right word. We're seeing a lot of -- our markets are holding up well. But we're really watching some of the project delays and things pushing out a bit and watching order rates, primarily in corporate office. But again, it's, I would say, sluggish not a dramatic trend change. The big trend change for us is the retail segment.

And Bruce, do you want to elaborate on that at all?

Bruce A. Hausmann
VP & CFO

Sure. I mean, David, I would just say that we're really putting the pedal down on our diversification strategy. So while office is hanging in there stronger than I think any of us had anticipated quite frankly, we're putting the pedal down on education and health care, which is doing extremely well. What hurt us the most this quarter, as Laurel mentioned, was the retail sector, which, to be fair, is only 4% of our revenue, but it did have an outsized impact on Q3's results.

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Laurel M. Hurd
President, CEO & Director

And we're just watching the macro indicators. As you said, we're seeing some -- the headlines, I think we're being cautious looking into Q4 to make sure we're not naive to the market conditions.

David Sutherland MacGregor
Longbow Research LLC

I mean 1 of the things in striking is you're talking about retail, our revenue is down 5% and 4% of that was related to retail, but it's only 4% of your total mix. So [less than] it's really gone off the air. I guess my question would be more with respect to 2024 and what's the opportunity to accelerate progress on health care and education and any forward visibility you have into that as an offset to further to the challenges in retail and office?

Laurel M. Hurd
President, CEO & Director

Yes. First, I'd say, on retail, I will say that it was substantially 1 customer in the U.S. So we're -- it's a bit more widespread, and we've seen some softness in Europe as well. But as retailers have had challenges, they've postponed a lot of their planned remodeling efforts. The good news is those floors do get worn and the stores will get remodeled. So we do think that, that will come back. We've won the business. We feel good about that. It's a matter of when that will hit. So I just wanted to hit.

Bruce A. Hausmann
VP & CFO

That's a really good point that Laurel is making. We haven't lost that business. We haven't lost that customer. It was really just a deferral in year. We think that, that business will come back because those stores will need to be refurbished.

Laurel M. Hurd
President, CEO & Director

And then we continue to see strength in health care and education. And again, as the examples in the prepared remarks, we really are selling systems. Our nora business is doing incredibly well, and we continue to focus more and more on the health care segment with the nora brand. And we're adding feet on the street in the U.S. to continue to accelerate that growth and push our diversification strategy. We're also finding that product doing well in data centers and labs, which are also growing as well as airports. So we're focusing to continue to push our diversification beyond just health care and education.

Bruce A. Hausmann
VP & CFO

And David, I would just add, there's just so much pent-up spend still coming around education. There's still a lot of federal money that has not been -- the shovels haven't been to the ground yet. So a lot of that spend is still to come, and we're incredibly well positioned to get that business, particularly with our sustainability story and our differentiation around sustainability with our products.

Operator

Our final question comes from the line of Keith Hughes with Truist.

Keith Brian Hughes
Truist Securities, Inc., Research Division

What was -- what did units do in the quarter? And what's the expectation with this fourth quarter guidance, what units are going to be year-over-year?

Bruce A. Hausmann
VP & CFO

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Yes. So Keith, for the quarter in Q3, units were down around 12%. So if you think about growth, units versus price, units down around 12%, price up around 6%, and that gets you to roughly what you see on the P&L. I think -- we don't know for sure. I think it will be a similar mix in Q4. But to be fair, we don't know for sure.

Keith Brian Hughes
Truist Securities, Inc., Research Division

Yes, sure. And the implied pricing there, I know you -- lot of things have been raised price last year. Is that going to start to abate in future quarters? Or are you still able to put some pricing in on the selling goods?

Laurel M. Hurd
President, CEO & Director

Yes. Keith, I'd say that I feel good that we were able to hold price in the quarter. We're still continuing to see that in Q4. And the other thing we've done is we've got some focused initiatives on new products that are actually priced more aggressively. So rather than taking price down on our more premium products. We're actually able to hold our margins but offer more aggressively priced products. So we've got a great example of that in carpet tile with our open air collection, and we've launched that in rubber as well with [indiscernible]. So we can continue to hit the project budgets that are needed, but not take price down in our most premium levels.

Keith Brian Hughes
Truist Securities, Inc., Research Division

Yes, I wouldn't really talking about in price down. I mean just anniversarying the increases, just some of the increases just sort of fade the math, like to fade away. Is that going to be occurring?

Bruce A. Hausmann
VP & CFO

Keith, I'd say in the first half, we don't think that, that will be an issue. The back half remains to -- sort of remains to be seen. We'll have to see what the market conditions are. As you know, we have been really good at getting price and holding price. We are so pleased with how well we've held price in this market. And it gets back to our differentiation in who we are as a company and people buy our products for certain reasons around design and sustainability.

Keith Brian Hughes
Truist Securities, Inc., Research Division

Okay. And just switching to nora, you said some positive things. Can you tell us how -- was nora up actually in the quarter? And what is it year-to-date?

Bruce A. Hausmann
VP & CFO

Yes. nora is up, nora is up in the quarter and year-to-date. It's incredibly -- it's incredible to us how strong and resilient the nora product is and the nora brand is, particularly in health care, and in some markets in education. Nora also does very, very well in big infrastructure projects around transportation and airports. And it's just a highly differentiated product that has very special applications. And it's -- the product line that's doing great for us.

Keith Brian Hughes
Truist Securities, Inc., Research Division

Right. That's great. And nora is running about 1/4 of the company's sales around the [indiscernible]?

Bruce A. Hausmann
VP & CFO

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That's rough number is rounding that's pretty close.

Operator

I would now like to turn the call over to Laurel Hurd for closing remarks.

Laurel M. Hurd
President, CEO & Director

Great. Thank you. I just want to take a minute to thank the entire Interface team for the continued great work this quarter and your ongoing really great efforts to drive our strategy. And thanks, everyone, for listening to the call today.

Operator
I would like to thank our speakers for today's presentation, and thank you all for joining us. This now concludes today's call. You may now disconnect.

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