REFINITIV STREETEVENTS

EDITED TRANSCRIPT

LECO.OQ - Q3 2021 Lincoln Electric Holdings Inc Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2021 / 2:00PM GMT

OVERVIEW:

Co. reported 3Q21 YoverY consolidated sales growth of approx. 21%, operating income of $116m and diluted EPS of $0.53.

CORPORATE PARTICIPANTS

Amanda H. Butler *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

Christopher L. Mapes *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Gabriel Bruno *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

Bryan Francis Blair *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Dillon Gerard Cumming *Morgan Stanley, Research Division - Research Associate*

Robert Stephen Barger *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

PRESENTATION

Operator

Greetings, and welcome to the Lincoln Electric 2021 Third Quarter Financial Results Conference Call. (Operator Instructions) And this call is being recorded.

It is my pleasure to introduce your host, Amanda Butler, Vice President of Investor Relations and Communications. Thank you. You may begin.

Amanda H. Butler - *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

Thank you, Angelica, and good morning, everyone. Welcome to Lincoln Electric's Third Quarter 2021 Conference call. We released our financial results earlier today, and you can find our release as an attachment to this call's slide presentation as well as on the Lincoln Electric website at lincolnelectric.com in the Investor Relations section.

Joining me on the call today is Chris Mapes, Lincoln's Chairman, President and Chief Executive Officer; and Gabe Bruno, our Chief Financial Officer.

Chris will begin the discussion with an overview of our results and business trends, and Gabe will cover our third quarter financial performance in more detail. Following our prepared remarks, we're happy to take your questions.

But before we start our discussion, please note that certain statements made during this call may be forward-looking, and actual results may differ materially from our expectations due to a number of risk factors. The discussion of some of the risks and uncertainties that may affect our results are provided in our press release and in our SEC filings on Forms 10-K and 10-Q.

In addition, we discuss financial measures that do not conform to U.S. GAAP, and a reconciliation of non-GAAP measures to the most comparable GAAP measure is found in the financial tables in our earnings release, which again is available in the Investor Relations section of our website at lincolnelectric.com.

And with that, I'll turn the call over to Chris Mapes. Chris?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Thank you, Amanda. Good morning, everyone.

Turning to Slide 3. I'm pleased to report that we generated record sales and earnings in the third quarter. Our team continues to do an excellent job servicing strong underlying demand from our global customers, while navigating a challenging operating environment and advancing our long-term strategic commercial and operational initiatives.

Our third quarter sales increased 21%, led by 18% organic growth. Profitability increased on a year-over-year basis and sequentially, with a 15.2% adjusted operating margin and a strong 28% incremental margin. Volume growth, price management, expense control and benefits of our structural cost reduction actions delivered strong results.

We also improved our return on invested capital, up 440 basis points to 22.8%. Cash flow generation remained strong, up 23% to $110 million with a 97% cash conversion. Capital allocation was balanced in the quarter with approximately $94 million invested in growth, led by $75 million in the Harris business.

We returned approximately $80 million to our shareholders, including $50 million in share repurchases and a $30 million in dividends. As previously announced, the Board approved a near 10% increase in our dividend payout, marking our 27th -- our 26th consecutive annual increase. So despite near-term headwind, the business is performing at or near record levels across key metrics, and we're focused on capitalizing on an industrial expansion and our higher standard strategy.

Turning to Slide 4, to cover underlying growth trends in more detail. Third quarter organic growth of approximately 18% remained solid across all our product areas and regions. Both consumables and equipment system organic sales increased approximately 20% and our automation portfolio increased at a high single-digit percent pace, with a portion of automation revenue pushed out in the late fourth quarter or early 2022 due to robotic arm supply delays.

With customers accelerating capital spending in this space, we continue to see strong order activity and backlog levels in automation. Geographically, growth rates slowed internationally due to challenging prior year comparisons as that region rebounded faster than Americas last year.

Looking at end markets. Underlying demand remains strong across all of our end sectors, with organic sales now flat to growing in the third quarter despite challenged automotive production levels and a slow recovery in energy.

Heavy industry sector growth accelerated in the third quarter by a low to mid-30% rate, while automotive, general industries and construction and infrastructure organic sales increased in the mid-teens to 20% rate. Energy was steady with the prior year as comparisons eased, oil and gas fundamentals improved and customers cautiously began to reinvest in the sector. This segment should trend positive as we move into 2022.

While there is some choppiness in our end markets due to supply conditions, we see healthy underlying demand in backlog. In our operations, we expect inflation and tight supply chain conditions to persist through mid-2022 and are managing the business accordingly with elevated inventory levels. We're leveraging our international footprint and supply network for increased agility to maintain ample product availability. Our customer-first approach has positioned us well in the market.

We're also continuing to operate safely given COVID risks and launched a vaccine incentive program in the quarter across our U.S. operations to encourage employees to be fully vaccinated. We believe this is a good investment in our business, employees and for our communities.

Our operations around the world have managed through and migrated to a more flexible work environment. As an example, we rolled out our work appropriately program across our headquarters campus, which provides managers and employees with a more flexible work approach at Lincoln Electric. I believe programs like these, commitment to our employees and our strong culture are why Lincoln Electric was recognized again this month by Forbes as one of the world's best employers in 2021.

So as we finish the year, we continue to expect growth in our business with standard volume seasonality in our segments as well as accelerated contributions from our acquisitions. We also expect pricing to remain elevated due to additional actions that we've announced to recover rising raw material costs and achieved neutral price cost by year-end.

As we look into 2022, we expect continued favorable demand trends as the industrial cycle remains positive. We're well positioned to excel in this environment.

And now I'll pass the call to Gabe to cover the third quarter financials in more detail.

Gabriel Bruno - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Thank you, Chris. Moving to Slide 5. Our consolidated third quarter sales increased approximately 21%, driven by 11% higher price and a 7% increase in volumes, a 2% contribution from acquisitions and a 30-basis-point favorable impact from foreign exchange.

Our gross profit margin increased 110 basis points to 33.3% as benefits from volumes, pricing and cost reduction actions offset higher input costs, including raw material and freight costs and an $11 million LIFO charge. LIFO charges for the first 9 months were approximately $24 million, and we expect an additional $8 million charge in the fourth quarter due to continued inflation. Price cost is slightly positive year-to-date, and we anticipate it will be neutral for the full year due to inflation and LIFO charges.

Our SG&A expense increased approximately 14% or $18 million to $149 million in the quarter. Higher incentive compensation and acquisitions represented substantially all of the increase. SG&A as a percent of sales decreased 110 basis points to 18.5% due to higher sales.

Reported operating income increased approximately 49% to $116 million or 14.3% of sales. Operating income included approximately $7 million of special items. Excluding special items, adjusted operating income increased 46% to $123 million or 15.2% of sales, a 260-basis-point increase versus the prior year on improved volumes, cost reduction benefits and diligent price/cost management, which generated a 28.1% incremental margin.

We continue to expect a full year incremental margin in the high 20% range with an expected fourth quarter incremental margin in the mid-20% range. We incurred a $71 million expense in other income substantially related to a $74 million settlement charge associated with the termination of a frozen U.S.-defined benefit pension plan. We expect an additional noncash settlement charge of approximately $35 million to $45 million in the fourth quarter.

Our third quarter effective tax rate was 17.3% or 21.3% on an adjusted basis due to our mix of earnings and discrete items. We continue to expect our full year 2021 effective tax rate to be in the low 20% range, subject to the mix of earnings and anticipated extent of discrete items.

Third quarter diluted earnings per share decreased 45% to $0.53 compared with $0.97 in the prior year. Excluding special items, adjusted diluted earnings per share increased approximately 42% to a record $1.56 in the quarter.

Now moving to our reportable segments on Slide 6. Americas Welding segment's third quarter adjusted EBIT increased 43% to approximately $85 million. The adjusted EBIT margin increased 220 basis points to 16.9% from benefits of higher volumes and price cost management, which offset higher inflation and an $11 million LIFO charge. Americas Welding organic sales increased approximately 24%, led by 11% higher volumes and a 12% benefit from pricing actions. Organic sales increased across all product areas and end markets in the quarter, led by an acceleration in heavy industry demand.

Moving to Slide 7. The International Welding segment's adjusted EBIT increased 116% to $29 million. The adjusted EBIT margin increased 570 basis points to 12.4% on higher volumes, the benefits of structural cost saving initiatives and price cost management. Organic sales increased approximately 15%, reflecting continued price management to mitigate inflation and volume growth, notably in equipment systems. Approximately 80% of International Welding's end markets grew in the third quarter, led by heavy industries and automotive, while energy compressed slightly due to tough prior comparisons in the power generation sector. The segment also benefited approximately 2% from the Zeman acquisition.

Moving to The Harris Products Group on Slide 8. Third quarter adjusted EBIT decreased approximately 9% to $16 million. Adjusted EBIT margin decreased 390 basis points to 13.3% on a challenging prior year record margin and less favorable mix lower retail volumes and acquisition integration costs. We expect similar margin performance in the fourth quarter with margins increasing in 2022 once our acquisition is fully integrated.

Organic sales increased approximately 7%, led by pricing actions to mitigate raw material costs. Volumes compressed slightly on lower retail channel sales due to challenging prior year comparisons. Excluding retail, Harris volumes increased in the quarter on continued growth in HVAC and industrial applications.

Moving to Slide 9. We generated approximately $110 million in cash flows from operations and achieved 97% cash conversion. Working capital remains intentionally elevated to support the recovery and mitigate supply chain constraints as we expect to maintain that posture into 2022.

Moving to Slide 10. We invested approximately $94 million in growth, including $75 million for the Harris acquisition and approximately $19 million in capital expenditures. We now expect to spend approximately $65 million to $70 million in CapEx this year. We returned $80 million to shareholders in the quarter, including $50 million in share repurchases. For the first 9 months, we repurchased approximately $104 million in shares.

Return on invested capital remains strong, up 440 basis points to 22.8%. We maintained ample liquidity with $718 million in the third quarter and remain within our target leverage range. With no near-term debt maturities and strong cash flows, we'll remain focused on growth investments and returning cash to shareholders.

With that, I would like to turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Bryan Blair from Oppenheimer.

Bryan Francis Blair - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Chris, you've sounded pretty bullish on industrial demand runway in recent quarters with some understandable call-outs today about the unique operating environment. Just curious if you can provide some more color how you're thinking about the impact of supply chain dynamics and whether there is any real fear that inflation and price response may lead to demand destruction and take away some of that attractive runway that we've talked about in the recent past?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Yes. Well, I'd say a couple of things around that, Bryan. One is that, I think that our decision as a leadership team to have confidence that this is a positive industrial cycle that we made very early in the year and then investing in the business behind that from a supply chain as well as from a strategic standpoint has well positioned us as we've seen this demand move into the marketplace.

I think what's important is that, look, our teams, I think, are executing very well. It's not that we don't have supply chain challenges. You saw some of that supply chain challenge that we called out relative to some of the concerns around the availability of robotic arms in the marketplace that had an impact in our automation business in the quarter. So I don't want to signal that those challenges aren't there. It's just that our teams have done a very good job of managing them, and I've got confidence that we'll be able to manage them as we move forward.

We've seen real strong demand within the business, and we're seeing that in our backlog. And we certainly haven't had any indication to date that inflation or any other variable is impacting that backlog negatively. And we're beginning to see those backlogs out there in those various segments and those major customers that we have within those segments as they're starting to talk about their business. So I think just accelerated confidence in the industrial cycle in a demand model that we see in front of us. And as I stated in my comments, I think we're well positioned to execute on that as we move through the rest of the year and into 2022.

Bryan Francis Blair - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

That's all great to hear. And international margin was again a highlight in the third quarter. If we look at the second, third quarter margin rate, is there anything that structurally speaking would drive margin lower on a go-forward basis? Or is 12-plus percent kind of the structural jumping off point as we think of the volume incrementals going forward?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Well, it certainly was exciting to see the performance of our international business in Q3, which is traditionally has had some cyclicality associated with it, especially in the European businesses where you have usually some shutdowns, and we saw some shutdowns during this past quarter. Our teams there have executed on our higher standard strategy. In our higher standard strategy, we said we want to get that business to double-digit margins and show consistency in those double-digit margins. And they've achieved that.

And I think what you'll see from Lincoln Electric and myself is that, as we're migrating into 2022, you'll see us updating our higher standard targets for this business and a couple of other areas of the business as we look at then what we can achieve in that area of our business in executing our longer-term strategy. But it was a very positive result for us in Q2. And we need to be able to show we can execute on that through the cycle, but it certainly was a very positive sign of what we achieved there in the market in Q2 and Q3.

Operator

(Operator Instructions) Our next question comes from the line of Mr. Dillon Cumming.

Dillon Gerard Cumming - *Morgan Stanley, Research Division - Research Associate*

Great. I wonder if you could start talking about deal integration quickly for a second. Obviously coming off of a bit of a heavier kind of M&A quarter for you guys, and it sounds like that was partially driving a bit of margin dilution in the Harris segment. Just curious if you can kind of talk to how those recent deals have been progressing? When you would expect any margin multiplied the business, is that trending back towards the segment average?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Yes. So look, great question. Not necessarily unexpected for us. When we acquired that business, we'd identified that they were having some supply chain challenges, multiple locations, probably didn't have the process strength that we would like to see to be able to support that business longer term.

Our Harris team has just been doing an exceptional job of getting in and assisting those businesses. We found some really good talent. We found people that have really -- want to be part of the larger business longer term.

So as it relates to the integration, I think, on path, but certainly not surprised by the fact that we've had some challenges with the integration portion of that.

As Gabe mentioned, I think we'll see that moving into Q4, and then we would expect more favorability of that as we're moving into 2022. And look, I think that's probably been a drag for us somewhere between 50 and 100 basis points just in that business. With the noise around supply chain, it's hard to feel exacting relative to that target. But kind of -- as we had expected, we love the strategy. We love the products. We found some great people. We'll continue to work hard on that integration as we're exiting '21 and get that positioned well for us as we're moving into '22.

Dillon Gerard Cumming - *Morgan Stanley, Research Division - Research Associate*

Okay. Yes, that certainly makes sense. And then maybe if I can switch over to automation for a second. Obviously, your tone there is still very much upbeat. It sounds like there's some modest push outs in the first quarter into next year. But I'm just curiously, more broadly, to what extent do you feel like the conversations there and you're kind of associated quoting activity are becoming more need-based versus lot-based? I mean I think we're all reading the same headlines about labor challenges in the market. So just curious to what extent of your customers are still doing that payment on the labor side and starting to look to automation as a solution?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Yes. It's interesting that need versus want, at the end of the day, I believe that most of the automation has always been need-based. So look, when I think about the customers that I'm talking to and when I go through our operations on the automation side and talk to our employees and about the interactions they're having. When I think about productivity, when I think about process improvement, when I think about quality enhancement, when I think about labor mitigation, those have always been need-based for manufacturers. So I'm seeing people continue to be energized around those discussions.

There may have been a window that we experienced certainly in 2020, where you might say even though they wanted it because it was need-based, they didn't want to go down that path because of challenges associated with working through their employee groups in a COVID environment and how could they do some of that activity. But we've seen really strong engagement, really strong early order activity as we're migrating into Q4. So just a lot of confidence in the business, but we do see some choppiness on the supply chain there specifically or about the robotic arm supply chain.

We're working very close with our key strategic partners. But that is the one area that we need to continue to make improvements in. But you're right. I'm still very confident in the demand profile. And again, when I think about that, I see that as need-based decision-making. There's a lot of challenge over productivity. They've got challenges over demand. It's going to continue to drive people towards more automated solutions in the marketplace. And I believe those individuals will look to Lincoln Electric.

Dillon Gerard Cumming - *Morgan Stanley, Research Division - Research Associate*

Okay. Got it. That's really helpful color. And then maybe if I can just sneak in one last one here. Gabe, it was on your comments on the price cost side. I think you said that you were still planning to kind of end the year at price cost neutral versus kind of positive year-to-date. I guess that would kind of imply that you're planning to run slightly negative in the fourth quarter. I guess, what's that kind of imply about the exit rate kind of going into next year, like would that still imply that you're planning to taking the ride of price increases entering '22 do you still maintain that level of neutrality? Or how should we kind of like inside the comments in terms of like the implied fourth quarter negative price cost versus wanting to maintain the neutrality into next year?

Gabriel Bruno - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Yes. Dillon, that's a great question, and I just want to anchor on our consistent discussions around how we've migrated the year, right, that is to maintain a price cost neutral position. We started the year a little bit negative. We progressed a little bit positive. We're slightly positive over the 9 months, but that's our strategy, right, to maintain a neutral position and be very responsive to how we see input costs. And we enter the fourth quarter with another round of price increases because we see some additional material costs and freight challenges, and that's how we manage the price cost management.

Operator

Our next question comes from the line of Mr. Nathan Jones from Stifel. Mr. Jones?

Amanda H. Butler - *Lincoln Electric Holdings, Inc. - VP of IR & Communications*

Maybe we can pass to the next queue -- the person in queue.

Operator

Yes, ma'am. Our next question comes from the line of Mr. Steve Barger.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

I know it's really tough to make predictions about next year given the environment. Just -- like, Chris, given the order strength and the backlog that you see, are you preparing for double-digit growth next year?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

You're right, Steve. It's awfully hard to make that prediction. I mean at the end of the day, I'll foundationally go back to what we've had a lot of confidence in. Confidence in our business, confidence that we're in a positive industrial cycle, confidence that we're seeing very strong order demand and reaction from our industry segments. The fact that now all the industry segments that we are -- we believe are critical to our business are trending positively, seeing energy start to turn a little bit. All those things create a very good environment for us. But probably not willing to say that necessarily or set a target as to what that rate will be as we're moving into 2022, but certainly believe '22 is setting up as a favorable demand environment for Lincoln Electric.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Got it. And Gabe, your prediction for incremental margin for the year was right on. Does inflation or supply chain make you think differently about incremental going forward, whether it's high single or low double-digit growth next year?

Gabriel Bruno - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

That's actually a great point. I would just anchor on our model, right? So we're tracking higher at the high 20s. Beyond that, when we're talking about mid-single digit to high single-digit type growth, our traditional models in that mid- to high 20s. So that's how I think about it. And we're going to manage supply chain, we'll execute, as you've seen and we'll manage pricing and material cost inflation as we've done. So we are very disciplined, as you know, in being able to navigate in those challenging operating environments.

Robert Stephen Barger - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Got it. And if I can just ask a short one. Chris, are you getting any pushback on price, where buyers just basically price insensitive right now based on end market optimism, the same kind of optimism you're reflecting in your comments?

Christopher L. Mapes - *Lincoln Electric Holdings, Inc. - Chairman, President & CEO*

Yes. Look, they're never insensitive to pricing. So it just takes us continuing to work with those customers very closely and making sure that they recognize what we're trying to accomplish. And I think, look, we also have very -- we have very educated customers. Our large OEM base is seeing a lot of the similar issues that we are challenged with. So there might not have to be as much of a discussion centered around what's going on within the market. But I assure you, that those conversations still need to happen. And quite frankly, we're working with those customers.

But I think as you've seen for us throughout the year, we've been able to effectively manage those conversations and move that through our business. And one of the things that we're talking to our customers about, Steve, which I think is very important is that, we're telling them that we're taking a customer-first approach to our business. We're going to bring in the inventories on the supply chain side. We're going to make the expenditures that we need to make in managing the supply chain to support them. And I think that's a great way for us to utilize our balance sheet in this market.

It will probably impact us some, and it has impacted us some. I'm not sure that we'll make the cash targets that I'm looking for out of the business as we're exiting 2021, but I absolutely believe it's the right investment in the business and the utilization of our balance sheet to support our customers in this market at this point in time. So I do believe that our customers appreciate the efforts that we're making and the decisions we're making around supporting them so that they can support their demand.

Operator

This concludes our question-and-answer session. I would like to turn the call back to Gabe Bruno for closing remarks.

Gabriel Bruno - *Lincoln Electric Holdings, Inc. - Executive VP, CFO & Treasurer*

Thank you, Angelica. I'd like to thank everyone for joining us on the call today and for your continued interest in Lincoln Electric. We look forward to discussing the progression of our strategic initiatives in the future. Again, thank you very much.

Operator

This concludes today's conference call. You may now disconnect.
