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Rockwell Automation, Inc. (ROK)

Q2 2023 Earnings Call – Prepared Remarks

Corporate Participants

Blake Moret, *Chairman & Chief Executive Officer, Rockwell Automation, Inc.*

Nicholas Gangestad, *Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.*

Aijana Zellner, *Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.*

Operator

Thank you for holding and welcome to Rockwell Automation's Quarterly Conference Call. I need to remind everyone that today's conference call is being recorded. Later in the call, we will open up the lines for questions. If you have a question at that time, please press *1.

At this time, I would like to turn the call over to Aijana Zellner, Head of Investor Relations and Market Strategy. Ms. Zellner, please go ahead.

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thank you, Julianne. Good morning and thank you for joining us for Rockwell Automation's second quarter fiscal 2023 Earnings Release Conference Call.

With me today is Blake Moret, our Chairman and CEO, and Nick Gangestad, our CFO.

Our results were released earlier this morning, and the press release and charts have been posted to our website. Both the press release and charts include, and our call today will reference, non-GAAP measures. Both the press release and charts include reconciliations of these non-GAAP measures. A webcast of this call will be available on our website, for replay, for the next 30 days. For your convenience, a transcript of our prepared remarks will also be available on our website at the conclusion of today's call.

Before we get started, I need to remind you that our comments will include statements related to the expected future results of our Company and are, therefore, forward-looking statements. Our actual results may differ materially from our projections due to a wide range of risks and uncertainties that are described in our earnings release and detailed in all our SEC filings.

So, with that I'll hand it over to Blake.

Blake Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Aijana, and good morning, everyone. Thank you for joining us today.

Let's turn to our second quarter results on slide three. We had an outstanding quarter of strong growth in both sales and earnings. Our double-digit sales and margin growth continue to reflect Rockwell's strong execution and focus on business resiliency, as well as overall improvement in electronic component availability.

The demand for our differentiated offerings continued to be strong, even in this uncertain economic environment. Through the first half of this fiscal year, our total orders were $4.8 billion, spread evenly between the two quarters once we adjust for the estimated price-related pull-forward in our fiscal Q1. As expected, our order cancellation rates remain in the low single digits through April.

Total sales grew over 25% versus prior year. Organic sales were up over 27% year-over-year and were above our expectations. Currency translation reduced sales by about 3%, and acquisitions contributed over a point of growth this quarter. As in the prior quarters, the split of sales by business segment, region, and industry was largely driven by access to electronic components and the composition of our backlog.

In the Intelligent Devices business segment, organic sales grew 27% versus prior year, with broad-based growth across all businesses. We continue to see wider adoption of our Independent Cart Technology in new applications across Semiconductor, Food & Beverage, and Life Sciences. One example of a new application is wafer transport in semiconductor fabs. We continue to see increasing demand for this offering, including an important win with a large U.S. company this quarter. This customer is investing in modernizing and expanding its material handling systems, and our Independent Cart Technology helps increase wafer output and more efficiently utilizes existing fab space, leading to increased capacity and significant savings.

Software & Control organic sales increased over 40%. Strong growth versus prior year was led by Logix, where we continue to see the benefits of our resiliency investments and an overall improvement in supply chain.

Lifecycle Services organic sales were up 12% year-over-year. Book-to-bill in this segment was 1.27, led by strong order intake in our Sensia business.

Information Solutions & Connected Services sales grew about 10% versus prior year. We had another quarter of competitive multi-year wins across our software and cybersecurity services portfolio. Within Information Solutions, I am pleased with the increasing breadth of our new Plex customers as we continue to expand our SaaS smart manufacturing platform to new industries and geographies.

One of our Plex wins this quarter was with ABInBev, the world's largest brewing company and its start-up business, EverGrain, focused on upcycling grain byproduct into sustainable supply of nutritious food ingredients. Our modular and cloud-native Plex software is helping EverGrain quickly deploy mission-critical quality management capabilities today while providing the functionality for the business to scale in the future.

In Connected Services, we saw another quarter of customer demand for our recurring cybersecurity and infrastructure as a service offerings as customers across many industries are continuing to invest in safety and security of their operations. One of these wins was with Darling Ingredients, a food processing company focused on reducing food waste by collecting and repurposing animal-based products.

Our Annual Recurring Revenue grew 15% year-over-year in Q2. Segment margin of 21.3% was up over 560 basis points year-over-year and was better than expected. Adjusted EPS grew over 81% year-over-year. We also completed the acquisition of Knowledge Lens this quarter, which adds significant scale to our Kalypso digital services business.

Let's now turn to slide four, to review key highlights of our Q2 end-market performance. Consistent with my earlier comments on the gradually improving supply chain environment, all three industry segments grew strong double digits versus prior year.

Our Discrete sales were up about 20% in the quarter. Within Discrete, Automotive sales grew over 40% versus prior year. We saw a number of strategic wins in EV and Battery this quarter, both in the U.S. and China, where a combination of our core automation and strong partner ecosystem helped edge out our biggest competitors. While some customers are optimizing operating cost in the near term, they still continue to invest in building out new capacity to meet their production goals.

Semiconductor sales were up mid-teens year-over-year. I already mentioned one Semiconductor win. Another example of how Rockwell is expanding our existing semi footprint now with wafer transport applications is our multi-year project win with Analog Devices. Our Independent Cart Technology was chosen to automate ADI's material handling applications at several of their global fabs. By implementing our technology, ADI will improve operator productivity by at least 20% by moving away from manually delivering lots across the fab.

In eCommerce and Warehouse Automation, our Q2 sales were down mid-single digits versus prior year. While we continue to see a pause in greenfield announcements, eCommerce players, traditional retailers, and many Consumer Packaged Goods companies continue to invest in modernizing their warehouses.

Turning to our Hybrid industries. Sales in this segment increased 35% year-over-year, led by strong growth in Food and Beverage. Food and Beverage sales were up almost 40% versus prior year. We also saw a number of large orders this quarter, with customers in this vertical continuing to invest in making their brownfield facilities more efficient and resilient. Demand in our dairy and agriculture processing business remains especially strong.

Life Sciences sales grew 20% year-over-year. One of the important wins this quarter was with a leading European healthcare company, where our Kalypso digital services used our Emulate3D simulation software to model and test multiple plant layouts to eliminate potential bottlenecks and increase worker safety. Tire was up over 50% in the quarter.

Moving to Process. This segment was up over 25% versus prior year, once again led by growth in Oil & Gas and Metals. Within Process, we had an important sustainability win. Through Occidental Petroleum's 1PointFive subsidiary, Rockwell is providing control systems for Direct Air Capture units that help remove carbon dioxide from the atmosphere. We are proud to be a part of Oxy's low-carbon strategy to deliver large-scale carbon management solutions that accelerate a net-zero economy.

Turning now to slide five and our Q2 organic regional sales.

Similar to prior quarters, our growth by region reflects the electronic component availability and what's in our backlog, rather than the underlying customer demand. North America organic sales grew 23% year-over-year. Latin America increased 16%, EMEA sales grew 42%, and Asia Pacific was up 32%.

Let's now move to slide six, Fiscal 2023 Outlook.

We have previously said that fiscal year 2023 sales performance is primarily based on our ability to ship backlog. Given our performance in the first half, improving chip supply, and the benefits of our resiliency actions, we are increasing our sales and earnings outlook for fiscal 2023.

Our fiscal 2023 guidance projects total reported sales growth of 14.5%. We expect organic sales growth of 15% at the midpoint. We expect acquisitions to contribute over a point of growth, and currency to be a headwind of a point and a half. Nick will touch more on this later. Organic Annual Recurring Revenue is expected to grow 15%. Segment margin is expected to increase by over 150 basis points year-over-year. Adjusted EPS is expected to grow 25% versus prior year, and we continue to target 95% Free Cash Flow conversion.

Before I turn it over to Nick, let me share some of our thoughts on the setup for fiscal year 2024. With more than half of this fiscal year behind us and through our continued discussions with end customers, we believe we have better visibility into our full year orders and backlog levels. We expect our fiscal 2023 orders to be about $9 billion, which implies a slight moderation of orders in the second half of this year. This is consistent with our expectations of improving component availability and the subsequent reduction in customer lead times. With our current orders outlook we anticipate exiting the year with backlog levels of around $5 billion, positioning us well for fiscal year 2024. Also, as the largest pure-play, we have an impressive record of earnings growth, and we expect that to continue given our unique market, focus, and differentiation.

Let me turn it over to Nick to provide more detail on our Q2 performance and financial outlook for fiscal 2023. Nick?

Nicholas Gangestad

Senior Vice President & Chief Financial Officer, Rockwell Automation, Inc.

Thank you, Blake, and good morning, everyone. I'll start on slide eight, Second Quarter Key Financial Information.

Second quarter reported sales were up 25.8% over last year. Q2 organic sales were up 27.3% and acquisitions contributed 130 basis points to total growth. Currency translation decreased sales by 2.8%. About 6 points of our organic growth came from price.

Segment operating margin expanded to 21.3% and was higher than our expectations. The majority of this outperformance was driven by the higher revenue. The 560-basis point year-over-year increase in margin was driven by higher sales volume and positive price/cost, partially offset by higher incentive compensation and higher investment spend.

Corporate and Other expense was $29 million, in line with our expectations. Adjusted EPS of $3.01 was ahead of our expectations and grew 81% versus prior year. I'll cover a year-over-year Adjusted EPS bridge on a later slide. The Adjusted Effective Tax Rate for the second quarter was 17.4%.

Free Cash Flow of $156 million was $110 million higher compared to last year driven by higher pre-tax income, partially offset by higher working capital. The increase in working capital was primarily driven by higher accounts receivable given our Q2 sales outperformance. We improved our days on hand in inventory by seven days in Q2 and we expect reductions in inventory days to continue for the balance of the year.

One additional item not shown on the slide. We repurchased approximately 140,000 shares in the quarter at a cost of $38 million. On March 31st, $1.1 billion remained available under our repurchase authorization.

Slide nine provides the sales and margin performance overview of our three operating segments. Organic sales grew double digits year-over-year in each of our operating segments.

Turning to margins, Intelligent Devices margin increased by 560 basis points year-over-year due to positive price/cost and higher sales volume, partially offset by higher investment spend and incentive compensation. Segment margin for Software & Control increased 900 basis points compared to last year, on higher sales volume and positive price/cost, partially offset by higher investment spend and incentive compensation. Lifecycle Services margin decreased by 180 basis points year-over-year as the benefit of higher sales was more than offset by higher incentive compensation and one-time items to expand future profitability. We expect Lifecycle Services margin to expand sequentially and exceed 10% in Q4.

The next slide, 10, provides the Adjusted EPS walk from Q2 fiscal 2022 to Q2 fiscal 2023.

Core performance was up $1.95 on a 27.3% organic sales increase. The impact of currency was a $0.15 reduction in EPS. The year-over-year headwind reflects a stronger dollar versus Q2 of last year. Incentive compensation was a $0.40 headwind. This year-over-year increase reflects our lower bonus in Q2 of last year and our higher growth and earnings expectations for this fiscal year. Higher interest expense was a $0.05 impact. Our higher Adjusted Effective Tax Rate was a $0.05 headwind. Our reduction in outstanding shares added about $0.05.

Let’s move on to slide 11, Guidance for Fiscal 2023.

We are increasing our reported sales guidance to approximately $8.9 billion in fiscal 2023, or 14.5% growth at the midpoint. We expect organic sales growth to be in a range of 13% to 17%, or 15% at the midpoint. We expect volume to add 10 points of growth and price to add 5 points of growth. This guidance takes into account our performance through the first half of the fiscal year and is based on our current view of ongoing supply chain improvement.

In terms of the second half, we expect mid-teens organic growth in Q3 and high-single digit growth in Q4. This calendarization includes our view of chip availability in each of the next two quarters and our Q3 transition from one third-party logistics provider to another at one of our distribution centers. We now expect a full-year currency headwind of 150 basis points, which is 50 basis points better than our previous guidance. This updated outlook primarily reflects the strengthening of the euro against the US dollar.

We expect full-year segment operating margin to be about 21.5%, up from our prior guidance of about 21%, driven by higher volume and higher benefit from price/cost for the full year. We now expect an over 200 basis point improvement to margin year-over-year from positive price/cost. This represents a 100-basis point increase versus our prior guidance, split evenly between price and cost.

Our updated guidance now assumes full year core earnings conversion of close to 40%. We now expect the full year Adjusted Effective Tax Rate to be around 17.5%, down from our prior forecast of 18% due to discrete items that were realized in Q2. We are increasing our Adjusted EPS guidance to $11.50 - $12.20. At the midpoint of the range, this represents 25% Adjusted EPS growth, up from prior guidance of approximately 17% growth at the midpoint. We expect full-year fiscal 2023 Free Cash Flow conversion of about 95% of Adjusted Income.

A few additional comments on fiscal 2023 guidance. Corporate and Other expense is still expected to be around $120 million. Net interest expense for fiscal 2023 is still expected to be around $130 million. We’re assuming average diluted shares outstanding of 115.6 million shares.

Turning to slide 12. Versus our prior guidance, we are increasing the midpoint for EPS by $0.75. Our guidance reflects an increase in our core of $1.05, driven by higher organic sales and our improved outlook in price/cost. We also deployed additional investments in sales and new product development, as well as digital infrastructure that will generate future revenue growth and profitability. Currency is adding $0.05. Given the stronger outlook, our incentive compensation is increased by $0.40. And finally, our 50-basis point drop in our Adjusted Effective Tax Rate will add $0.05.

With that, I'll turn it back over to Blake for some closing remarks before we start Q&A. Blake?

Blake Moret

Chairman & Chief Executive Officer, Rockwell Automation, Inc.

Thanks, Nick.

We are still operating in a dynamic environment and are laser focused on execution through the rest of this fiscal year. With that said, we are continuing to accelerate new product development and investments in cloud-native technologies. Revenue from our new offerings, both organic and inorganic, is becoming a more meaningful contributor to growth and share gains.

We are the largest pure-play automation company with market-leading solutions across discrete, hybrid, and process industries. And we are adding scale to our differentiated offerings through strong partnerships and strategic acquisitions.

Our recent acquisition of Knowledge Lens is adding 600 resources with cutting-edge data science, AI, and cloud solutions to our existing digital services business. This expanded team is already working with our key customers on their next generation plans. I want to welcome all Knowledge Lens employees to Rockwell.

Our close relationships with end customers, our best-in-class ecosystem, and our talent give us confidence in the continued momentum for growth and profitability – this year and beyond.

Aijana will now begin the Q&A session.

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thanks, Blake. We would like to get to as many of you as possible, so please limit yourself to one question and a quick follow up. Thank you.

Q&A Session

Aijana Zellner

Head of Investor Relations & Market Strategy, Rockwell Automation, Inc.

Thank you, everyone, for joining us today. That concludes today's call.