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RS - Q2 2019 Reliance Steel & Aluminum Co Earnings Call

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OVERVIEW:

Co. reported 2Q19 sales of $2.88b, non-GAAP net income attributable to Co. of $184m and non-GAAP diluted EPS of $2.71. Expects 3Q19 non-GAAP diluted EPS to be $1.90-2.00.

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PRESENTATION

Operator

Greetings and welcome to Reliance Steel & Aluminum Co. Second Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Brenda Miyamoto. Thank you. You may begin.

Brenda S. Miyamoto - *Reliance Steel & Aluminum Co. - VP of Corporate Initiatives*

Thank you, operator. Good morning, and thanks to all of you for joining our conference call to discuss our second quarter 2019 financial results. I'm joined by Jim Hoffman, our President and CEO; and Karla Lewis, our Senior Executive Vice President and CFO. Bill Sales, our Executive Vice President of Operations, will also be available during the question-and-answer portion of this call. A recording of this call will be posted on the Investors section of our website at investor.rsac.com.

The press release and the information on this call may contain certain forward-looking statements, which are based on a number of assumptions that are subject to change and involve known and unknown risks, uncertainties or other factors, which may not be under the company's control, which may cause the actual results, performance or achievement of the company to be materially different from the results, performance or other expectations implied by these forward-looking statements. These factors include, but are not limited to, those factors disclosed in the company's annual report on Form 10-K for the year ended December 31, 2018, under the caption Risk Factors and other reports filed with the Securities and Exchange Commission. The press release and the information on this call speak only as of today's date, and the company disclaims any duty to update the information provided therein and herein.

I will now turn the call over to Jim Hoffman, President and CEO of Reliance.

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Thanks, Brenda. Good morning, everyone, and thank you for joining us. I'm very pleased to discuss our 2019 second quarter results with you today. We had a solid second quarter characterized by relatively steady demand conditions in most of the key markets we serve.

We generated quarterly sales of $2.88 billion and a strong gross profit margin of 29.6%, which produced second quarter gross profit dollars of $853.6 million, the third highest in Reliance's history. Our non-GAAP net income and non-GAAP quarterly earnings per share were also the third highest in our history, trailing only the record second quarter of 2018 and the first quarter of 2019.

We also continue to make progress in improving our safety performance, which remains a top priority. I'd like to thank the 15,000-plus employees for their ongoing commitment to maintaining a safe working environment each and every day.

Underlying demand trends remain relatively healthy in the second quarter across the key end markets we serve. However, metal pricing was slightly weaker than we anticipated. While there were multiple metal price decreases on many of the carbon steel products we sell, our broad diversification of products, customers and end markets help mitigate the impact on our business.

During periods of declining metal prices, customers often changes their buying pattern, delaying purchases and reducing order sizes. However, our customers' buying patterns are generally more consistent as they focus more on need versus price. We service the majority of our customers on a just-in-time basis, which typically involve smaller order sizes that require next-day delivery. We believe this contribute to our shipment volume declining less than the industry average.

Our same-store tons sold declined 5.5% in the first half of 2019 compared to the first half of 2018, which compares favorably to the industry decline of 6.9% reported by the MSCI for the comparable period.

Our managers in the field continue to maintain our disciplined strategy of focusing on high-quality, high-margin business, including increasing levels of value-added processing. As such, we believe our expenses and diverse customer base, smaller order sizes, just-in-time delivery and significant value-added processing capabilities meaningfully differentiate us from our peers. These business models, characteristics also support our ability to maintain industry-leading gross profit margins throughout industry cycles. This is especially evident in the second quarter of 2019 as we maintained a FIFO gross profit margin of 28.8% compared to a 28.9% in the first quarter of 2019, despite declining prices.

Turning to market conditions in our key end markets. Demand for processing services we provide to automotive market, which we serve as mainly through our toll processing operations in the U.S. and Mexico remains strong. Our outlook for toll processing remains positive as demand for aluminum content in vehicles continues to grow. We have been proactively investing in facilities and value-added processing equipment to meet this increasing demand.

During the quarter, we completed a 150,000 square-foot building expansion and the installation of additional aluminum's slitting line in Kentucky and production is ramping up nicely. We're also in the process of expanding 3 of our toll processing operations in Mexico to support increased automotive activity in that region.

Aerospace demand remains strong with the growing order backlog. Our sales into the aerospace market consist of heat-treated aluminum products primarily plate and -- as well as specialty stainless steel and titanium products. Given strong demand environment, the recently announced 5% price increase on heat-treated aluminum plate effective in August has been fully supported by the market.

Demand for common alloy aluminum sheet also remains steady, although availability has increased from the tight levels previously experienced, which could pressure pricing going forward.

Demand for our stainless steel flat products remains steady.

Demand in heavy industry and non-residential construction remained relatively steady in the second quarter. However, volumes in some areas were impacted by customer-buying patterns due to declining prices for certain of our carbon steel products. We believe carbon steel prices have generally bottomed and, therefore, expect customers to resume more normal buying patterns in the near term. We are optimistic in regards to potential tailwinds in non-residential construction in the second half of 2019, as we believe large projects were delayed due to difficult weather conditions in the first half of the year. In addition, the active fabricated structural steel trade case could shift more activities to the U.S.

Demand for energy, which is mainly oil and natural gas, has been slowing with declining rig counts and muted overall activity. We anticipate continued steady slowdown in activity in this market in the near term.

Turning to capital allocation. Our 2019 capital expenditure budget of $245 million include strategic investments to support our customers' needs and drive organic growth. Our investments primarily focus on facility upgrades and expansions, new innovative equipment and advanced technology. Importantly, we continue to identify opportunities to expand our value-added processing capabilities and high-performing operations that significantly contribute to our gross profit margins and earnings.

In regard to acquisition, we are pleased with a broad area of opportunity we're seeing in the market. We will remain selective in our M&A activities, executing on opportunities to meet our strict criteria of high-quality businesses with experienced management teams and excellent customer service and that are complementary to our diverse product and service offerings and immediately accretive to our earnings.

Return on capital to our shareholders remains a key focus to Reliance. During the second quarter, we repurchased $50 million of our stock, reflecting the confidence our Board and the management team have in our long-term strategy and outlook. We will continue to be opportunistic in our approach to stock repurchases activities. We've continued to pay our regularly quarterly dividends as we have now done for 60 consecutive years. We most recently increased our regular quarterly dividend by 10% in the first quarter of 2019, marking the 26th increase since our 1994 IPO.

In closing, we are pleased with our second quarter results, which were once again largely attributed to the strong execution of our managers in the field. We achieved the third highest gross profit dollars, non-GAAP net income and non-GAAP earnings per share in our history, despite steeper pricing declines than we anticipated, which is a testament to our unique business model and pricing discipline as well as our strategy of concentrating on higher-margin business. Looking ahead, we will continue to focus on providing industry-leading service to our customers, while at the same time maximizing our earnings power and increasing value to our stockholders. Thank you for your attention today.

I will now turn the call over to Karla to review our second quarter financial results and third quarter 2019 outlook in more detail. Karla?

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

Thanks, Jim, and good morning, everyone. We are very proud of our second quarter results. Our net sales in the second quarter of 2019 decreased 2.5% from the first quarter of 2019, mainly due to downward pricing pressure on many carbon steel products. Our tons sold increased 0.4% compared to the first quarter of 2019, in line with our expectations of down 1% to up 2% with one more shipping day in the second quarter of 2019 than the first quarter of 2019. Compared to the second quarter of 2018, our tons sold declined 4.9%. However, we do not believe the decline in shipments is reflective of end demand as there was unusual buying activity in the second quarter of 2018 due to the enactment of Section 232 tariffs at that time.

Our average selling price per ton sold was down 2.8% compared to the first quarter of 2019, outside of our expected range of flat to down 1% due to multiple metal price decreases on many of the carbon steel products we sell. Our average selling price per ton sold increased for our aluminum, stainless and alloy products. Our continued pricing discipline and focus on higher-margin orders by our managers in the field as well as our continued investments in value-added processing equipment resulted in a strong gross profit margin of 29.6% in the second quarter of 2019, slightly above our estimated sustainable range of 27% to 29%.

Because metal prices decreased more than we expected in the second quarter, we have increased our estimated full year LIFO income to $70 million from our previous estimate of $50 million. As a result, we recorded LIFO income of $22.5 million or $0.25 of earnings per diluted share in the second quarter of 2019 compared to LIFO income of $12.5 million or $0.14 of earnings per share in the first quarter of 2019. Given our current estimate at annual LIFO income of $70 million in 2019, we expect to record $17.5 million of LIFO income in the third quarter of 2019.

Our second quarter SG&A expenses of $531.4 million declined slightly from the first quarter of 2019 on relatively steady demand given our continued focus on expense control.

Our effective income tax rate for the second quarter was 25.0%, up from 24.0% in the second quarter of 2018. And we expect our effective tax rate for the full year of 2019 to be approximately 25%, up from our full year 2018 tax rate of 24.5% primarily due to increased state income taxes.

Non-GAAP net income attributable to Reliance for the second quarter of 2019 was $184 million, resulting in non-GAAP earnings per diluted share of $2.71, both the third highest in Reliance's history.

Turning to our balance sheet and cash flow. We generated very strong cash from operations of $346 million during the second quarter of 2019. We invested $70.9 million in capital expenditures in the second quarter and paid regular cash dividend of $36.9 million to our stockholders. We also repurchased approximately 592,000 shares of our common stock at an average cost of $84.33 per share for a total of $50 million. At June 30, 2019, our total debt outstanding was $2.02 billion, resulting in a net debt-to-total capital ratio of 27.4%. And we had $699 million available on our $1.5 billion revolving credit facility, providing us with ample liquidity to continue executing on all areas of our capital allocation strategy.

Turning to our outlook. We remain optimistic with regard to business conditions in the third quarter of 2019. We expect that end demand will remain relatively steady with shipment levels impacted by normal seasonal patterns, which include a decline in shipping volume due to customer shutdowns and vacation schedules. As a result, we estimate our tons sold will be down 4% to 6% in the third quarter of 2019 compared to the second quarter of 2019.

Additionally, we anticipate that overall metals pricing will generally remain consistent with current levels. However, because metal prices, especially from any carbon steel products, declined throughout the second quarter of 2019, we expect that our average selling price in the third quarter of 2019 will be down 1.5% to 2.5% compared to the second quarter of 2019 to adjust to current pricing levels. Also given that carbon steel prices appeared to have bottomed with potential for metal price increases in certain products, we expect our FIFO gross profit margin to remain consistent with levels achieved so far in 2019. As a result, we currently expect non-GAAP earnings per diluted share to be in the range of $1.90 to $2 for the third quarter of 2019.

In closing, we were very pleased with our financial and operational performance in the second quarter, despite a softer pricing environment for certain of our products. Excellent execution by our employees coupled with our disciplined strategy resulted in yet another quarter of strong earnings and excellent cash flow, enabling us to continue executing on our capital allocation priorities of investing in the growth of our business and returning value to our stockholders. That concludes our prepared remarks. Thank you for your attention.

And at this time, we would like to open the call up to questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Martin Englert with Jefferies.

Martin John Englert - *Jefferies LLC, Research Division - Equity Analyst*

So based on the sequential volume guide of down 4% to 6% continues to indicate that mid-single digit year-on-year declines that we've seen so far year-to-date and you did touch on this earlier, but can you discuss end-user destocking that's distorting the volumes? Where you think true underlying demand may be trending?

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Yes. This is Jim. The term destocking, I've never really understood it. We really don't change our model. Our model is, we listen to our customers, they tell us what they're going to buy. We make sure we have the product for them, and we service the way they need us to service. So we react to what they do, we react to the intelligence we get from our suppliers, that's just the way we see things. I don't think there is -- I understand why people use that terminology, but we don't. And as far as the markets, it sounds like we said, there is just some seasonality in our business. It's been that way for a long time, and it really hasn't changed that much one way or the other. I think that's reflected on our comments. And the markets themselves are okay, other than the ones we -- though we have wanted out. Energy seems to be slowing a little bit, but that's -- a lot of geopolitical issues involved with that. Semiconductor has been slow and perhaps there may be an uptick in the future, we hope for that. And the other markets we sell into are relatively steady.

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

And I think, Martin, just to expand on that, we wanted to be clear that we think that, as Jim said, end demand will continue -- it's continued at reasonable rates for us. So there is no change in our outlook for that other than the comments Jim made on the specific end markets. It's really the downward guide. It's our normal seasonality. In 2018, our third quarter tons sold were down 5% -- 5.1% from the second quarter. 2017, we actually were up slightly. 2016, we were down 4.9%. So we're just at this point guiding to reflect the typical seasonality that we see due to a lot of our customers doing extended shutdowns with our small customers. Vacation schedules can impact order activity also.

Martin John Englert - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And if I could, one other quick one. Within aerospace, there has been increased caution within the supply chain due to the MAX grounding. Can you provide an update on overall demand? And I know you touched on this earlier, but also any other changes within the supply chain inventories and maybe more specifically touch on product demand for aero aluminum heat-treated plates?

William K. Sales - *Reliance Steel & Aluminum Co. - EVP of Operations*

Yes, Martin. This is Bill Sales. We still see a good strong steady demand on the aluminum aerospace plate market. We also continue to monitor and evaluate the 737 MAX situation. We've got action plans ready to implement as things become more clear on that situation. To date, the impact on our business is negligible and we believe that the plane is recertified. If that happens this year, the impact to our businesses will be minimal. So I think you're hearing most of the metals are still really bullish and have a positive outlook for 2020. And based on our demand and what we see, we would agree with that.

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

And remember total aerospace sales are only about 10% of our overall sales dollars, and we're selling to several different customers on several different programs. So the exposure is pretty limited for us, if anything would happen.

Martin John Englert - *Jefferies LLC, Research Division - Equity Analyst*

Understood. And then just from a gross margin perspective, I would imagine those gross margin dollars are higher than group average for the aerospace, right?

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

Generally, on those types of orders, we do have some contractual business on some of the aerospace products that we sell. There are higher prices based on the product mix, I mean, especially the heat-treated aluminum plate is one of our more valuable products that we're selling. The margins are generally kind of in line.

Operator

Our next question comes from Matthew Korn with Goldman Sachs.

Hunter Davis Alley - *Goldman Sachs Group Inc., Research Division - Associate*

This is Hunter Alley on for Matthew Korn. How should we think about the removal of Section 232 tariffs on Canada, Mexico impacting Reliance? Do you all see it as a tailwind or headwind? Any color you can provide there?

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Yes. When all that started, when that's announced, obviously nobody really knows what's going to happen with that. So we're like everybody else. We just operate our business day-to-day, week-to-week, month-to-month. The one thing it did do and we knew that would do, it did hit -- the prices went up and that's good. We appreciate higher pricing. I'd say, our domestic partners deserve that money. They filed the suits based on facts and what seems like that their results have basically just on that, gave them opportunity to raise the prices somewhat. But if you go back and compare the prices where they are today to when that hit, they are actually below that level. So I'm not sure where it's going to go from here, but suffice it to say that we'll react accordingly.

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

Yes, and I think the actual -- the resolution of Canada and Mexico and the removal of the tariffs for them, generally it's not that big of an impact to us because we're typically serving local customers generally within a 200-mile radius of our locations. We do have operations in Mexico, but primarily servicing those markets, same thing in Canada. So if anything we think there is a little more certainty now that, that part is behind us and we support free trade throughout North America so to the extent our customers are busier, that's positive for us, but overall not a material impact anticipated for Reliance.

Hunter Davis Alley - *Goldman Sachs Group Inc., Research Division - Associate*

Great. That's very helpful. And one more, if I may. Just trying to pricing, steel prices have moved materially lower from the start of the year, albeit, they've seen an uptick more recently. How should we think about this impacting Reliance? Can you maybe just walk us through the lags we should see on pricing and cost?

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Yes. I'm assuming you're referring to the price increases this week actually on flat roll. They have -- we've seen 3 increases this week alone. I hope they stick, but that is not a big part of our business. That just happens to be the focused product, if you will. I think it's less than 7% of our business. It certainly is important to us, but that's just one piece of that. If you go through all of the rest of the products and material we sell, some prices are up, some prices are down and that's all based on demand. And like we said, the demand we see right now is steady to good depending on the market we're selling into. And as far as the lag is concerned, as soon as the prices are announced, we do our best to get those prices out. And when they're going down, we'd like to see what's going to happen. So I can't give you definitive answer on what exactly happens with pricing other than the fact that when they go up, we support them.

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

And there is, from the timing standpoint, as Jim said, we expect to get that sell price benefit right away when prices go up. But on the kind of receiving side from an inventory cost and cash flow standpoint, lead times vary, but we're usually out at least 2 months for us to receive in the lower cost metal and have our average cost decline. So we would anticipate going into third quarter still receiving in some lower cost metal, which would be positive for us from a working capital release and cash flow standpoint. So we would expect to see a little continued benefit of that in the third quarter.

Operator

(Operator Instructions) Our next question comes from Phil Gibbs with KeyBanc Capital Markets.

Philip Ross Gibbs - *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

Jim, can you educate us a little bit just here on this fabricated trade case? And how you all play in that arena? And how you would be positively impacted by the resolution here? I think given that it's a reasonably new issue and it's starting to be talked about a little bit more, I think just trying to get a better feel for what this all means.

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Sure. First of all, it's a very complex issue with what happened was the -- basically the domestic suppliers have been getting cheated. There's countries that they are just starting all the laws, they have government-subsidized producing metals, which we don't hear. And the countries like China have been shipping subsidized material into Canada and Mexico, having some fabrications done to it and shipped right back into The United States and that's not the way the rules are supposed to be followed. So they filed the suit.

So what's happened recently, they -- over a period of time -- short period of time, they did rule that there has been subsidies to certain countries, China and Mexico were the 2 that got hit with that. Canada was found to be doing some of it, but to a very, very small degree. So they -- it didn't hit the register where they're actually going to have something -- some negative impact. So that's what's happened right now. There is more to come. They've identified there has been subsidy, there has been a damage. The next phase of that will be how much of the damage is and what the tariff called as fines will be for the countries that continue to do that. And that's scheduled, I believe, for November. So we'll know more in November how it actually reacts.

I can tell you this, there is enough information around it for fabricators in the U.S. to just determine it's not worth it. So we have seen some business that wouldn't be earmarked for that kind of behavior that has come back into The United States. I think the domestic metals are doing the right thing. There is good as it gets when it comes to making material -- making the material we make worldwide. They just can't fight a battle with one arm behind your back. So I think they did -- they've done what they needed to do. I think in long term, if everything plays out the way it could, there will be stronger -- I think the fabricators will be stronger.

I think some of the domestic manufacturing business will return onshore, which is a good thing for the U.S. economy and certainly good thing for Reliance. But right now, Phil, it's all very positive and we hope that our business strategy, we -- looks like it's going to be a good thing for Reliance and we'll continue to service those customers who grow in that space.

Karla R. Lewis - *Reliance Steel & Aluminum Co. - Senior EVP & CFO*

Yes, I think, Phil, specific to Reliance is, as I think you're aware non-residential construction is our largest end market exposure, structural is a big part of that. It's usually about 9% to 10% of our revenue dollars that we sell in structurals. So as Jim said to the extent that, there is more activity sourced within the U.S., we would hope to sell more metal to our customers to support that and also we've talked in the past about the fact that we have made a lot of investments in our non-residential construction businesses in the form of additional value-added processing equipment.

So if there is more fabricating done in the U.S., we could pick some of that up or certainly support our customers so we would like to see them to be stronger and we will support them with everything they need from us. So we look at that as a positive. We did make a comment in the script about potential tailwinds on non-res construction in the second half due to difficult weather. In the first half, we're hearing that from others in the industry. We have not factored any of that into our guidance on volume for the third quarter. So just want to be clear that there is none of that factored in. So that could be a positive for us, if we see more activity from both the trade case and stronger activity in the second half.

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Phil, just one another comment along these trade cases of 232, it certainly hasn't instilled some positive forward-looking issues with their other domestic suppliers. The capacity and, more importantly, the capabilities that our partners are investing in, they're very encouraging. You're talking about, I believe, it's over $13 billion worth of future investment in The United States, in our economy and that's really good to see.

So I'm happy that there are partners who are able to feel they are good about what's been going on as far as material coming into The United States, being dumped in The United States that seems to be something that they're not going to have to fight with as much going forward. So that's very positive and looks good for Reliance too.

Philip Ross Gibbs - *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

So if I'm hearing you right on the fabricated piece of the equation, I can consider you to some degree a fabricator and then certainly your customers. Is that the right way to look at it?

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

I would consider us a value-adder of material. I would consider our customers fabricators. We don't compete with our customers or our suppliers.

Philip Ross Gibbs - *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

Okay. Understood. And then second question I have is just on the energy market, clearly drilling is down, completion activity though is strong, internationally things look strong. So kind of a mixed bag when you look at the world, that's certainly slowing down here. How do you see the inventories right now generally positioned at the distributor level and then also at the end user level because I know you were heavy coming into the year?

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Yes, we were. We were heavy coming into the year. I can just speak for Reliance. We've done a lot of work to get our inventories in line. I think we're close. As far as what's in the pipeline at the end users, my guess is not a lot. They don't -- they have a tendency to use Reliance versus putting their own inventory, which we were good with that. It's just an interesting market, I mean, a real change. I mean the whole technology of drilling and completions and what have you, so to speak for, I don't think we're ever going to see the days where we have upwards of 2,000 active words in The United States, which -- they just don't need that anymore with the sophisticated way that they can bring oil and natural gas out of the ground, we're tracking and what have you. There is no need for that many wells, but there certainly is a need for a lot of metal that goes into the completion and there's a plenty of that to come and we're very active in that with a lot of our customers.

And then the takeaway, the tanks and the pipelines and what have -- and the LNG plans and all these infrastructure when it comes to natural gas and oil, that all consumes metal. And we're heavily involved in that. It's just a matter of what happened yesterday as far as geopolitical, whether it's Iran or many different things. So we're -- it's a good market for us, it's a value-added market for us and it's a big consumer of metal. So we like the space. It's not a huge part of our business. It's smaller than it used to be based on all the things I just said, which we still like it, and our companies that are in that space are involved with the drilling and completion. So we've got -- we like our space.

Operator

Ladies and gentlemen, we've reached the end of the question-and-answer session. At this time, I'd like to turn the call back to Jim Hoffman for closing comments.

James D. Hoffman - *Reliance Steel & Aluminum Co. - President & CEO*

Yes. Thank you, everyone, for sitting on the call today and your continued support and commitment to Reliance. Have a great rest of your day.

Operator

This concludes today's conference. You may disconnect your lines at this time, and we thank you for your participation.