

***Transcript of  
Materion Corp  
Second Quarter 2020 Earnings Conference Call  
July 23, 2020***

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## **Participants**

Steve Shamrock – Interim Chief Financial Officer  
Jugal Vijayvargiya - President and Chief Executive Officer

## **Analysts**

Phil Gibbs - KeyBanc  
Marco Rodriguez - Stonegate Capital

## **Presentation**

### **Operator**

Greetings and welcome to the Materion Corporation Second Quarter 2020 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator instructions]. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Steve Shamrock, Interim Chief Financial Officer. Thank you. You may begin.

### **Steve Shamrock – Interim Chief Financial Officer**

Good morning. This is Steve Shamrock, Interim Chief Financial Officer. With me today is Jugal Vijayvargiya, President and Chief Executive Officer.

Our format for today's conference call is as follows. Jugal Vijayvargiya will provide an update on COVID-19 and key strategic initiatives. Following Jugal, I will review detailed financial results for the quarter, and then we will open up the call for questions.

Before we begin, let me remind investors that any forward-looking statements made in this announcement, including those in the outlook section and during the question-and-answer portion, are based on current expectations. The Company's actual future performance may materially differ from that contemplated by the forward-looking statements as a result of a variety of factors. Those factors are listed in the earnings press release we issued this morning.

Additionally, comments with regard to earnings before interest and taxes, net income and earnings per share reflect the adjusted GAAP numbers shown in attachment number five in this morning's press release. The adjustments are made in the prior year period for comparative purposes and remove special items, non-cash charges and certain income tax adjustments.

And now, I'll turn it over to Jugal for his comments.

**Jugal Vijayvargiya - President and Chief Executive Officer**

Thanks, Steve, and welcome, everyone. I hope all of you and your loved ones remain healthy and safe as we continue to manage through these challenging times. Today I'll provide a COVID-19 status followed by an update on our key strategic initiatives.

The health and safety of our people continues to remain our overriding priority. Throughout this very difficult time, we've taken input from all available sources and implemented protective measures for our people. To date, 11 of our employees have tested positive for the virus, and I'm happy to report that they're all doing well at this time. Nine people have returned to work, while two are quarantined at their home. A majority of our office employees continue to work from home, while all of our factories continue to operate.

As you would expect, we felt the full impact of COVID-19 in a number of our key end markets in the second quarter, including Consumer Electronics, Energy, Industrial, Automotive, and Aerospace. Despite these very challenging market conditions, we delivered sequential value-added sales and earnings growth. Defense end market sales rebounded in the second quarter, and we continue to see strong demand going forward. Sales in the medical market, particularly healthcare equipment used in the fight against COVID-19, contributed to sequential growth. We expect this to continue into the third quarter.

In response to reduced demand, we actively managed our costs, which you can see in our financial results. Sequentially, our sales increased 2% while earnings increased 14%.

Let me now transition to providing an update on our One Materion multi-pillar profitable growth initiatives. Once again, I have some exciting news to share. You will recall we held a special call announcing the signing of Optics Balzers acquisition. Our teams have worked diligently to close the acquisition in just six weeks. This week I'm excited to officially welcome Optics Balzers to the Materion family. The combination of our two companies creates the world's leading thin film optical coatings provider, with a highly complementary geographic, product, and end market portfolio. With this acquisition, Materion significantly expands the geographic reach extending beyond its core of North America to include Europe and Asia.

Optics Balzers maintains a very strong European presence, with two R&D and manufacturing locations in Liechtenstein and Germany. In addition, Optics Balzers recently launched a state-of-the-art manufacturing facility in Malaysia, which has been a key enabler for growth in Asia. Complementary technologies across the electromagnetic spectrum boost the capabilities of the combined thin film optical coatings portfolio and position Materion to capitalize on key megatrends in the areas of life science, consumer, and industrial. We're excited to get started on the value creation opportunities.

Our engineered clad strip project, which I announced on the last call, remains on schedule. As a reminder, we entered into a business arrangement with a new customer to expand our manufacturing capacity for a highly engineered clad strip product which will be used in the next generation model of an existing product. The total investment of the project is expected to be approximately \$85 million.

You'll recall, we had received \$12 million of the approximately \$70 million the customer will fund. Now, I can report to you that the customer has paid us \$31 million, with additional payments scheduled to be made over the next year. In support of this customer program, we are actively working to establish a new leading-edge manufacturing facility for future product supply. We're making progress on negotiating a long-term supply agreement and still expect to finalize later this year.

Lastly, a quick update on PAC facility consolidation project to improve our cost structure. We completed the closure of the Detroit, Michigan service center in the second quarter, and remain on schedule to exit the Fremont, California location by the end of this year.

In closing, we remain committed to take all necessary precautions to protect our people. I'm extremely proud of the dedication to our company during these difficult times. Despite all of the macroeconomic challenges we're facing, we are continuing the course to follow our One Materion multi-pillar profitable growth strategy.

Now, I'll turn the call over to Steve to cover the financials.

**Steve Shamrock – Interim Chief Financial Officer**

Thank you, Jugal, and good morning to everyone joining us on the call today. During my comments, I will cover second quarter 2020 financial highlights, review profitability by segment, provide brief comments on the balance sheet, cash flow, and modeling assumptions, and finally, cover the earnings outlook for third quarter 2020. Following my remarks, we will open up the line for questions.

In the midst of a global pandemic, I am pleased to report second quarter results which exceeded the first quarter. Second quarter value-added sales, which exclude the impact of pass-through precious metal costs, were \$161.6 million, up 2% compared to first quarter value-added sales of a \$158.7 million and down 17% versus second quarter of 2019.

Compared to the first quarter, defense, telecom and data center, and medical end-market sales improved, which offset reduced demand in markets impacted by the COVID-19 pandemic, including automotive, consumer electronics, aerospace, and industrial. We also had higher raw material hydroxide sales on a sequential basis of approximately \$4 million. On a year-over-year basis, all major end-markets except semiconductor were down due to the impact of the pandemic, with the consumer electronics, industrial, energy, and aerospace end-markets the most severely impacted.

Gross margin was \$48.1 million in the second quarter compared to \$69.6 million in the prior year second quarter. Excluding special items related to COVID-19, adjusted gross margin was \$50.8 million or 31% of value-added sales, an improvement compared to the first quarter adjusted gross margin of 30%. Versus the 2019 second quarter, gross margin was down due to lower sales volumes and resulting manufacturing inefficiencies.

Selling, general and administrative expense totaled \$32.9 million, a decrease of \$7 million versus the prior year of \$39.9 million. Excluding special items related to the acquisition of Optics Balzers, adjusted SG&A expense totaled \$31.5 million. As a percentage of value-added sales, adjusted SG&A expense was 19% in the quarter, down 100 basis points from 20% in the prior year period. We continue to aggressively manage our core SG&A expenses in response to current demand trends.

Research and development expense of \$4.5 million increased 11% versus 2019, as we continue to make investments to develop new products and applications to drive long-term profitable growth.

In the second quarter, we recorded restructuring expense of \$2.4 million related to the previously announced closure of our Detroit and Fremont facilities, primarily for relocation costs and severance. We also reported a \$2.2 million foreign exchange gain related to a special item regarding our purchase of Optics Balzers. The purchase price was denominated in Swiss francs, so we entered into a foreign currency hedge when we signed the agreement to limit our exposure.

We reported second quarter EBIT of \$9.6 million compared to the prior year second quarter EBIT of \$19.6 million. Excluding special items related to COVID-19, restructuring charges, and the acquisition of Optics Balzers, adjusted EBIT was \$13.9 million, or 9% of value-added sales.

Looking at income taxes, we recorded income tax expense of \$1.6 million in the second quarter of 2020, an effective rate of approximately 19.5%, in line with our previous guidance.

Finally, net income in the second quarter totaled \$6.7 million. On an adjusted basis, we reported net income of \$10 million or \$0.49 per diluted share, compared to \$0.43 per share in the first quarter.

The increase compared to the first quarter was due primarily to commercial performance improvements driving higher gross margins. Compared to the prior year, the decrease was driven by lower value-added sales, partially offset by spending cost controls.

Now, let me review 2020 second quarter performance by business segment. Looking now at our Performance Alloys and Composites business, value-added sales were \$89.8 million, an increase of \$6.1 million or 7% compared to the first quarter, but down versus \$115.3 million in 2019. The sequential increase is due to stronger demand in defense. Compared to the prior year, the decrease in sales can be attributed to lower demand across all major markets, primarily as a result of COVID-19.

EBIT, excluding special items, was \$12.3 million or 14% of value-added sales, compared to EBIT of \$8.2 million in the first quarter and \$19.1 million in 2019. The sequential improvement in EBIT is due to commercial initiatives to drive higher sales and improve mix. The decrease in EBIT versus 2019 is due to lower sales and reduced manufacturing efficiency related to lower production volumes. Despite the global pandemic, PAC managed to deliver the 10th consecutive quarter of double-digit profit margins and sequentially improved EBIT margins by approximately 400 basis points compared to the first quarter.

Moving to Advanced Materials, value-added sales in the second quarter of 2020 were \$54.7 million versus \$58.3 million in the prior year. Semiconductor end market sales were up 4% versus the prior year, the third consecutive quarter with a year-over-year increase. However, the impact of the pandemic on the energy, industrial, and automotive end markets more than offset this increase.

EBIT excluding special items was \$5 million in the quarter, compared to \$6.1 million in 2019. The decrease in profitability was due primarily to the decrease in sales volumes and unfavorable manufacturing performance. Compared to the first quarter, EBIT margins improved from 8% to 9% due to favorable product mix and aggressive cost management, despite the sequential decline in value-added sales. Looking ahead we continue to focus on improving manufacturing performance in this business.

Turning finally now to the Precision Coatings segment, second quarter value-added sales were \$17.8 million, down compared to \$23.1 million in the second quarter of 2019, primarily due to lower sales of the large area coatings product for the blood glucose test strip market. As you may recall, we announced our intention to sell this business on our first quarter earnings call. We continue to expect to complete the sales process later this year. Excluding the LAC business, second quarter 2020 value-added sales were \$15.1 million, down 2% year-over-year due to lower market demand in industrial and consumer electronics related to COVID-19.

EBIT excluding special items was \$2.4 million or 13% of value-added sales, compared to \$1.2 million in the first quarter and \$3.9 million in the second quarter of 2019. Compared to the first quarter, EBIT excluding special items improved by \$1.2 million due to higher optical filter sales and manufacturing performance improvements. The decline in profits versus the prior year was entirely driven by the decrease in sales within the LAC business, partially offset by cost reduction actions.

Moving now to the balance sheet and cash flow, the Company ended the second quarter of 2020 with a net cash position of \$113.3 million and \$179.1 million available on the Company's credit facility. We continue to have more than adequate liquidity to manage in this challenging environment. Despite everything that has happened this year, I want to point out that we have improved our net cash position by over \$41 million compared to the second quarter of 2019. Even with the Optics Balzers acquisition, our pro forma leverage ratio at the end of the second quarter is only 0.4, well below our targeted level of 1.5.

Our capital spending increased in the first six months to \$32 million. The increase versus the prior year is related to the customer funded engineered strip growth opportunity Jugal covered. We also increased our dividend in the second quarter for the eighth consecutive year. For financial modeling purposes in 2020, capital spending should run approximately \$30 million net of the customer prepayments related to the new engineered strip project. Mine development investments should be approximately \$14 million. Annual depreciation and amortization should run approximately \$40 million, and assume an 18% to 20% effective tax rate, excluding special items.

And finally, now the earnings outlook for 2020. The impact of the COVID-19 pandemic continues to create unprecedented levels of uncertainty, making it very difficult to predict the extent to which our business, results of operations, financial condition, or cash flows will ultimately be impacted. Therefore, we are only providing a near-term outlook. At this time, order entry levels remain approximately the same as the second quarter. We continue to expect demand headwinds in several key end markets, including consumer electronics, industrial, automotive, energy, and aerospace, while demand for defense and medical should remain strong. We will continue to aggressively manage our cost structure in the current environment. Assuming current conditions continue, we expect third quarter adjusted earnings to be comparable or slightly better than the second quarter.

This concludes our prepared remarks. We will now open the line for questions.

**Operator**

Thank you. We will now be conducting a question-and-answer session. [Operator instructions]. Thank you. Our first question comes from the line of Phil Gibbs with KeyBanc. Please proceed with your question.

**Q:** The question that I had was around Optics and the acquisition that obviously closed here very recently. In your guidance commentary for the third quarter, are you anticipating this deal to be accretive? Is there any purchase price accounting that we need to be aware of? Any help on that would be good. And then are you still of the opinion that this is a \$20 million EBITDA business in the next two years to three years?

**Jugal Vijayvargiya - President and Chief Executive Officer**

Yes. Phil, first of all, I can tell you that, as I indicated, our team has done just a wonderful job of getting this thing done in such a short period of time, six weeks, even though we're in the middle of a pandemic. So the team has to be congratulated, and we're extremely pleased to have Optics Balzers and the people on board, very excited about what I think the future holds, as we've indicated in our call that we had, and the few comments that I made already earlier here.

With regard to how we move forward here, obviously they're going to be in our Q3 for about a couple of months, so we'll have that in there. I don't expect really any meaningful impact here in Q3 as we just kind of bring them on board. But I think we're committed, as we've indicated I think in our earlier call, that we would expect this business to be accretive in the first year of ownership. That's our plan. We're continuing down that plan. As we've also indicated, this is really a growth play for us. We really want to have our two teams work together and drive the maximum possible growth that they can, so we're going to be quite focused on that. But in general, I expect this business to be, as I said, not really a meaningful impact here in Q3 because it's just a couple months, but then really starting to hit the ground running here in Q4.

**Steve Shamrock – Interim Chief Financial Officer**

And what I would add too, Phil, to your comments on purchase accounting, obviously, we've only owned the Company for less than a week, so that's something that we're really focused on here in Q3 and obviously can give you a better update on that on the next call relative to the impact of purchase accounting.

**Q:** I appreciate the existing clad investment is intact, I think your timeline there was late 2021, early 2022, but you do have existing assets that are primed to perhaps ship greater material into this opportunity later this year and

early 2021. Maybe give us an update on what you're seeing there. Should we anticipate any contribution later this year or early next year and could it be meaningful?

**Jugal Vijayvargiya - President and Chief Executive Officer**

Yes. So, I can tell you, what we referred to is one of the short-term project to be able to fulfill some near-term demand for our customer, we are taking existing capacity. We are having to update that capacity, as we mentioned last time, so we're spending some money to get that capacity to be able to produce this product. We expect that we'll be doing that here later this year, and if there was an issue, and really what that means is if it's more pandemic-related or anything, then it would be early next year. But we really hope that we're going to be able to later this year have some sales.

And then really it just comes down to the sooner we can get started, the sooner we can have an impact. There will be a ramp, as you can imagine, so if we can get started today, then we might be able to have a reasonable impact here in Q4. But if it's much later in the year, then it may not be able to have a meaningful impact in Q4. And that's one of the reasons we really just provided more of a near-term overall company guidance.

So, the project is on track. And just to answer, maybe anticipating a potential question, for the longer-term project, it's on track. As I indicated already, we've received \$31 million from the customer versus the \$12 million that we reported last time, so very, very good progress. And despite again, everything that's going on around us, the team is just making really, really good progress to be able to hit that at the end of next year, perhaps in early 2022.

**Q:** The last question is just housekeeping. Steve, you mentioned, I believe that the mind spending this year was going to be \$14 million. What is your capex before that that number?

**Steve Shamrock – Interim Chief Financial Officer**

Phil, we split that out even in terms of providing guidance, so I'll say our normal capex, we're still forecasting about a \$30 million run rate, if you exclude the project that Jugal referenced earlier for engineered clad strip. So, if you segregate that, you know we were at \$10 million before on mine development and now we're forecasting \$14 million. And that's really just based on the fact that we finalized our pit opening approach strategy, and actually that's to minimize the overall cost, but actually it's accelerated some of the timing into this year versus next year. And as you know, mine development expenditures can fluctuate a lot from year-to-year, unlike, I would say, our more steady-state normal capex.

**Q:** So, it's \$30 million of capex, \$14 million of development, plus the project, less the prepayments?

**Steve Shamrock – Interim Chief Financial Officer**

Correct.

**Q:** Thanks.

**Operator**

[Operator instructions]. Our next question comes from the line of Marco Rodriguez with Stonegate Capital. Please proceed with your question.

**Q:** I was going to follow-up on the prior question in regards to the client with the expansion. It was a pretty nice benefit to your cash flow from operations, receiving the prepayments, and then obviously you had capex of roughly \$32 million year-to-date. Just kind of wondering if you can kind of walk through the impacts you're going to see on your cash flow statements and the prepayments, and then how that kind of dovetails into the additional capex you'd need for that arrangement.



**Steve Shamrock – Interim Chief Financial Officer**

Marco, what I would say is what you're going to continue to see, even going forward is in our operating section of the cash flow we'll continue to get additional prepayments from the customer, so that number will continue to grow. And then as you've seen already from our capex line in the cash flow statement, it's up significantly versus just last year due to this project, so you're basically going to see a gross-up of both lines there as we kind of progress throughout the year. So hopefully that's helpful from that perspective.

**Q:** And I apologize if I missed this, but did you segment the \$32 million that you spent year-to-date between what is Materion normal run rate versus the prepayment?

**Steve Shamrock – Interim Chief Financial Officer**

No, we're not breaking that out separately, but obviously that's a significant driver of the increase year-over-year.

**Q:** Got it, okay. And then kind of sticking along with the PAC segment, I'm just kind of wondering, looking at the end market breakout that you provided in your press release, automotive, while obviously down year-over-year, doesn't seem to be as significant as some of the other areas. Just given the fact that most of the automotive manufacturers, at least in the US and then obviously at times in Europe, were shut down completely, I'm just kind of wondering, I would have expected a much larger decline year-over-year. Can you maybe talk a little bit about that segment and what you're seeing there?

**Jugal Vijayvargiya - President and Chief Executive Officer**

Yes, I think what you're looking at, perhaps you're doing the year-over-year comparisons there, so part of that I think is just the baseline comparisons, Marco, that you're seeing, and part of it is which OEs that we deal with and which customers. So, it's really just also depending on that. As we've talked before, our automotive business is mainly outside the US, so some of the shutdowns that occurred in the US didn't have as much of an impact on us as perhaps the outside, for example, Asia was starting to come back, and so some of our businesses in Asia and then of course in the Europe. So, I think those factors contribute to us maybe perhaps from your view maybe not having added as dramatic of an impact on automotive.

**Q:** Got it. That's helpful. And then switching over to the AM segment, last quarter you guys talked a little bit about the negative impacts you saw in Q1 due to new product launches kind of weighing on manufacturing efficiencies. Just maybe if you could talk about or update us there whether or not those new product launches have sort of worked their way up the ramp and there's less of an impact on your margins there, or anything you can kind of provide in terms of color would be appreciated.

**Jugal Vijayvargiya - President and Chief Executive Officer**

Yes. So, I would say that in general we're continuing to make progress. As you can imagine, the progress is not as much as we would like because of I think some of the challenges that we're facing of course on the pandemic side. One of the things that we're having to do in our manufacturing facilities is implement many, many safety procedures and protocols to protect our people, so social distancing, shift structure changes, and other things, so there's a lot of, I'll call it negative impact that has happened across the board, not just in our Advanced Materials business.

Now of course, we're offsetting that and continue to drive performance improvement on Advanced Materials. So, just to give you an idea, sequentially our sales were down 8% on Advanced Materials. However, our earnings were up 2%. So, despite the 8% down in sales, we actually were able to improve our earnings, and that is clearly due to the improvement that our teams are making. Of course, as I said, those improvements are being masked by some of the other issues that we're dealing with as well as the sales drop of roughly 8% that I mentioned. So, progress sequentially, and we'll continue to make progress into Q3, Q4 et cetera from that perspective.

**Q:** Got it. And then on the Optics Balzers acquisition, if you can kind of paint a picture here, a blueprint, if you will, in terms of the integration efforts that you'll start to undergo here, and then how you're kind of thinking about the synergies. I know that we talked before that the expectation is to have those synergies in a few years such that it's a \$20 million EBITDA type business, but maybe if you can talk a little bit more now that the company is under your umbrella now?

**Jugal Vijayvargiya - President and Chief Executive Officer**

Yes. So, as we have just brought the company, as you said, sort of using those words, under our umbrella this week, our teams have started to work very actively together. We have an integration team that we formed, with an integration director we recently hired just within the last week or so, an executive that has come onboard that will lead the integration efforts, dedicated to this very, very important initiative.

In that integration team, we have work stream owners from various functions and from various regions that we've defined what the level of integration is that we're going to do as well as what the level of synergies that we will accomplish. As you can imagine, integration involves synergy-related items and I'll call them non-synergy-related items, so just making sure that our teams, for example, can work together effectively, we're starting to drive maybe some common processes and common tools, and at the same time driving more top-line improvements and perhaps some cost level improvements. And those are more quantifiable synergy items. So, we have an integration team that has been established. They've started to meet. They're developing their 30-day, 60-day, 90-day, 6-month, 12-month type of plans, and then it is our intent to drive that in a very, very disciplined basis.

With regard to the synergies in general that we've talked about in the past as well, it's our objective that we really want to focus all of our attention on growth and being able to profitably grow the combination of Optics Balzers and our business, and I can tell you that that's one of the key work streams that we have in integration process. We're starting to look at what kind of objectives we can set for ourselves for next year and the year beyond, so that the teams can put energy around those objectives.

So, it's very, very exciting, but of course very preliminary right now, just us having it here in the first week. And we look forward to be able to provide you and others updates in future calls.

**Q:** Got it. And last question, just a housekeeping item. The balance sheet inventory levels have been picking up here sequentially for the last few quarters. Can you just talk a little bit about the drivers there?

**Steve Shamrock – Interim Chief Financial Officer**

Yes. Sure, Marco. I would say from my side, if you think about it, especially with COVID-19 and some of the shutdowns that we had in the second quarter, I think basically there were a lot of customer orders that were canceled. So, from that perspective it left us in a little higher inventory position.

I can tell you, looking forward, looking ahead, we are clearly focused on managing our working capital, and actually I'd point out, if you look at our cash flow statement, we actually had less use of working capital this year versus last year. So, again it's something we're very focused on, and expect to try to work down those inventory levels in the second half of the year or so.

**Q:** Got it. Thanks a lot, guys. I appreciate your time.

**Steve Shamrock – Interim Chief Financial Officer**

Thanks, Marco.



**Operator**

We have no further questions at this time. Mr. Shamrock, I would now like to turn the floor back over to you for closing comments.

**Steve Shamrock – Interim Chief Financial Officer**

Thank you. This is Steve Shamrock and this concludes our second quarter 2020 earnings call. A recorded playback of this call will be available on the Company's website, materion.com. We would like to thank all of you for participating on the call this morning and your interest in Materion. I will be available to answer any follow-up questions. My direct number is 216-383-4010. Thank you very much.

**Operator**

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.