Teledyne Technologies, Inc. (NYSE:TDY) Q4 2018 Earnings Conference Call January 23, 2019 11:00 AM ET

Company Participants

Jason VanWees - Executive Vice President

Robert Mehrabian - Executive Chairman

Al Pichelli - President and Chief Executive Officer

Sue Main - Senior Vice President and Chief Financial Officer

Conference Call Participants

Greg Konrad - Jefferies

Jim Ricchiuti - Needham & Company

Ladies and gentlemen, thank you for standing by and welcome to the Teledyne Fourth Quarter Earnings Call. At this time, phone lines are in a listen-only mode and we will have an opportunity for a question-and-answer session. As a reminder, today's conference call is being recorded. [Operator Instructions]

At this time, I'll turn the conference over to our host Jason VanWees. Please go ahead.

Jason VanWees

Thank you, Nick, good morning, everyone. This is Jason VanWees, Executive Vice President at Teledyne. And I'd like to welcome everyone to Teledyne's fourth quarter and full year 2018 earnings release conference call.

We released our earnings earlier this morning before the market opened. Joining me today are Teledyne's Executive Chairman, Robert Mehrabian; President and CEO, Al Pichelli; Senior Vice President and CFO, Sue Main; and Senior Vice President and General Counsel, Chief Compliance Officer and Secretary, Melanie Cibik. After remarks by Robert and Sue, we will ask for your questions.

Of course before we get started, our attorneys have reminded me to tell you that all forward-looking statements made this morning are subject to various assumptions, risks, and caveats as noted in the earnings release and our periodic SEC filings and actual results may differ materially. In order to avoid potential selective disclosures, this call is simultaneously being webcast and a replay, both via webcast and dial-in will be available for approximately one month.

And here is Robert.

Robert Mehrabian

Thank you, Jason, and good morning everyone and thank you for joining our earnings call.

I am exceptionally pleased with Teledyne's results, fourth quarter and full year sales and GAAP earnings per share were all time records. In the fourth quarter, sales increased 6.2% all of which was organic. In addition, each business segment experienced growth in sales and operating profit with the vast majority of our commercial and defense businesses growing nicely.

Earnings per share of $2.45 increased 33.2% compared to last year. GAAP operating margin was 14.9% and increased 143 basis points from last year. Finally, annual free cash flow of $360.1 million was also a record and allows us to end 2018 with the lowest leverage ratio in over four years.

Before turning the call to Al Pichelli, please allow me to digress for one moment. Today the story of Teledyne is about consistent and continuous improvement in financial performance; continuous improvement in operations and prudent capital allocation. It is a story about building a portfolio of related companies and related products with common underlying technologies, but serving different customers and markets, markets that are complementary subject to different business cycles and demand drivers. In other words, balanced; balanced in a way to reduce volatility. For example, within digital imaging strong sales of X-ray detectors and generators for healthcare applications more than offset some softness of standard products related to industrial machine vision.

Within instrumentation, sales of environmental and electronic test and measurement instruments increased year-over-year with electronics test and measurement particularly strong. This again more than offset a decline in sales of marine instrumentation. However, operating margin in each of those product lines improved.

Finally, organic sales growth of defense electronics was 11.9% which more than offset some expected declines and very tough comparisons in our commercial aerospace markets.

I will now pass the call to Al Pichelli and he will comment on the performance of our four business segments.

Al Pichelli

Thank you, Robert. Good morning.

In our Instrumentation Segment, overall, fourth quarter sales increased 3.4% from last year. Sales of electronic test and measurement systems increased 24% organically. Sales are strong across the range of our product lines, but were led by sales of protocol analyzers. For reference, protocol analyzers are designed to generate, capture and analyze high speed data communications across a range of protocols or standards such as universal serial bus or USB, other less familiar protocols were used in data storage and data movement applications. And we continue to benefit from growth in solid-state disk drives and cloud network storage.

In the environmental domain, sales increased 3.7% largely as a result of greater sales of selected laboratory and life science instruments as well as continued growth in particular monitoring instrumentation.

Sales of marine instruments declined 7.5% in the quarter, but fourth quarter orders increased 50% year-over-year and full year orders increased 10%. Overall, Instrumentation Segment operating profit increased 40% and margin increased 428 basis points, as a result of greater sales of higher gross margin environmental and electronic test and measurement instruments and significant prior cost reductions in the Marine domain.

Turning to Digital Imaging Segment, fourth quarter sales increased 9.3%, which was entirely organic. Sales of our proprietary medical and dental x-ray detectors increased significantly year-over-year. In addition, we also achieved robust year-over-year growth in x-ray generators for cancer radiotherapy. Finally, sales of micro-electromechanical systems or MEMS also grew due in part to increased shipments of consumables for life sciences and extreme UV lithography.

GAAP segment operating profit increased but margin declined 94 basis points from last year due largely to non-operating items such as stock-based compensation and $1.1 million purchase accounting gain in the prior fourth quarter.

In the Aerospace and Defense Segment, fourth quarter sales increased 2.8% primarily due to strong growth across the majority of our defense electronic businesses, but in particular sales of microwave devices for space applications as well as especially high reliability semiconductors.

Segment operating margins increased 81 basis points to 20.5% primarily due to greater sales, but also a favorable product mix.

In the Engineered Systems Segment, fourth quarter revenue increased 16.3% with strong sales related to missile defense and nuclear aviation and marine manufacturing programs partially offset by lower sales of cruise missile engines. Segment operating profit increased, but margin declined 105 basis points solely as a result of lower sales of fixed priced turbine engines.

To conclude, I want to briefly follow up on Robert's earlier comments. We appreciate that our business portfolio is balanced, but we also address issues quickly and decisively when market weakness appears. For example, over the last three years, we have made variable as well as permanent cost reductions in our marine instrumentation businesses. These actions included a 30% decrease in the total workforce and the closure of 20 sites including 4 manufacturing sites in 2018.

Finally, throughout this period, none of our earnings are adjusted for such cost actions which totaled nearly $30 million.

I will now turn the call over to Sue.

Sue Main

Thank you, Al. Good morning, everyone.

I will first discuss some additional financials for the quarter not covered by Robert and Al, and then, I’ll discuss our first quarter and full year 2019 outlook. In the fourth quarter, cash flow from operating activities was $125.5 million compared with cash flow of $126.4 million for the same period of 2017. The cash provided by operating activities in the fourth quarter of 2018 reflected the impact of higher operating income offset by higher income tax payment.

Free cash flow that is cash from operating activities less capital expenditures was $106.8 million in the fourth quarter of 2018 compared with $108.4 million in 2017. Capital expenditures were $18.7 million in the fourth quarter compared to $18 million for the same period of 2017.

Depreciation and amortization expense was $29.3 million in the fourth quarter compared to $25.6 million for the same period of 2017. We ended the quarter with $608.1 million of net debt that is $750.6 million of debt and capital leases plus cash of $142.5 million for net debt to capital ratio of 21.4%.

Stock option compensation expense was $4.9 million in the fourth quarter of 2018 compared with $3.2 million in the fourth quarter of 2017.

As noted in the earnings release, the fourth quarter of 2018 included $2.5 million of pre-tax severance and facility consolidation costs compared with last year's $0.7 million of similar charges offset by $1.1 million purchase accounting gain related to the e2v transaction. The fourth quarter of 2017 also included provisional charges of $4.7 million as a result of the Tax Cuts and Job Act of 2017 or the Tax Act.

In the fourth quarter of 2018, the company finalized its assessment of the Tax Act resulting in a decrease of $0.8 million to the provisional charge.

Turning to our outlook, management currently believes that GAAP earnings per share in the first quarter of 2019 will be in the range of $1.87 to $1.92 per share. And for the full year 2019, our GAAP earnings per share outlook is $9.25 to $9.35. The 2019 full year estimated tax rate is expected to be 22.3% before discrete items a 100 basis point increase compared to 2018.

In addition, we currently expect significantly less discrete tax items in 2019 compared with 2018.

I will now pass the call back to Robert.

Robert Mehrabian

Thank you, Sue.

Nick, we'd like now to take questions from the audience. If you're ready to proceed with the question-and-answer period, please go ahead.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] We will go to our first question, it's from Greg Konrad with Jefferies. Please go ahead.

Greg Konrad

Good morning. I was hoping maybe if you could just give a little bit of color around your organic growth expectations for 2019 and maybe just on a segment basis what the expectations are?

Robert Mehrabian

Thank you very much and good morning to you. This is Robert. First, let me start with the overall organic growth for 2019. It's a little lower than what I said in October. In October, I said we'd be in -- three months ago, I said it'd be about 5%. We're now projecting between 3.5% and 4%. So put that as a bucket for the overall anticipated growth and part of the slight decrease is because of China tariffs, governments shut down, currency headwinds, et cetera.

Let me now go to the segments. We think in the Instruments segment, so we will have some thing of the order of 3.5%, 3.6% in organic growth. Marine a little lower. We'll have a little pickup in marine, but it'll be just below 3%. In other instruments, environmental we expect to pick up about 4%. And in test and measurement about 4.5%. Digital imaging while we are enjoying very strong revenues and growth in our medical and dental products. We have some headwinds in the vision system, machine vision system. So overall, we think revenue growth would be of the order of 4%. Aerospace and Defense, we’ll continue to have a little headwind in aerospace, we expect defense to more than make up for it. And the two combined in that segment should be above 4%.

And then engineered systems, I think we'll see some moderation of the growth from this year to next probably about 2% to 2.5%. If you add all of those up it comes to about 3.7%. So I said the range between 2.5% and 4%.

Greg Konrad

Thank you. That's helpful. And then, now not to harp too much on guidance, I mean just your thoughts around margins in '19. I mean I just looking at how you exited the year there was a nice pickup in instrumentation, digital imaging and a little bit more volatile throughout the year. I mean maybe just your thoughts around margins in 2019?

Robert Mehrabian

I think, overall, if I go to GAAP margin, moderate some because we picked up some really nice margins this year as we mentioned. I think it'd be between 50 and 55. We anticipate at this point between 50 and 55 basis points improvement in GAAP operating margin. But going forward, we do have some other headwinds some in taxes below the margin line, some in taxes primarily because we're not going to have as much foreign tax benefit and we're going to have less R&D benefit. And Sue's guidance also is based on the fact that we will have about 400 basis points we expect right now, 400 basis points lower in discrete tax items.

To conclude, I think from a segment perspective, our margins in instruments will improve a little bit. Digital imaging will be flat, aerospace and defense will be slightly up and engineered system slightly down, balance all of that we expect the operating margin overall to go up by about 50 to 55 basis points.

Greg Konrad

Thank you. That's helpful. And then, just last one for me, I mean you mentioned the government shutdown. Is that, I mean I know Defense Department remains open, I mean is there other exposure, I know in the past, you’ve maybe had EPA, or just any impact you're seeing from the shutdown?

Robert Mehrabian

Right now. I don't see an impact to Q1, but having said that, if this goes on for a long time some of our programs would be affected. We would not get renewals and we're being a little cautious obviously between that and what's happening with the trade disputes that we have. So we're being a little cautious at this point.

Greg Konrad

Thank you.

Robert Mehrabian

Thank you.

Operator

[Operator Instructions] We will now go to the line of Jim Ricchiuti with Needham & Company.

Jim Ricchiuti

Hi. Good morning. Just given the full year guidance for revenue growth, do you anticipate stronger growth as the year progresses starting off a little slower just given some of the headwinds you alluded to?

Robert Mehrabian

Yes. I think Jim both in revenue and in earnings, if you go back I just went back and looked at earnings first, going back to 2011 and I noticed that every quarter's our earnings in the first quarter have been lower than the second. Most of the time, we've had a continuous improvement in earnings and part of that is because we've had continuous improvement in revenue. So at this point sitting where we are, I think that 3.5% to 4% is a good number for earnings. But if things turn up if the trade disputes begin to diminish, I think our revenues would go up and our earnings should go up as it is we anticipate earnings growth quarter-over-quarter anyway. That's how, if you add up the 9.25 to 9.35 and the guidance for Q1 you can conclude that we are anticipating earnings to grow anyways.

Jim Ricchiuti

Got it. And then, with respect to marine instrumentation, fairly significant increase in bookings in the quarter. So should we assume that things have finally begun to turn in that part of the business. And certainly the comparisons get easier this year. Is that fair to say?

Robert Mehrabian

Yes. It is. I will let Al expand that.

Al Pichelli

Good morning, Jim. You're absolutely right. And in terms of the bookings situation no matter, if we look at the book to bill ratio for marine for the entire year, it was 1.06, but if you look at just Q4, our book to bill order is 1.27 and we're all -- we look at that space in a couple of different ways. First of all, the seismic exploration space, our equipment has been there for quite a while. We think there is a need for replacement, but that's probably another year or so away. So we think that that part is going to be relatively flat in '19.

And then, in the offshore production side, there seems to be some good activity generating now, but these are large projects that have to be engineered and so in terms of actually seeing the sales come from that. Likewise, we think that probably late '19 and probably next year.

On a positive side, there are a couple of other areas, when we think about the defense and security as you know we provide quite a bit of equipment and on areas like the Virginia class submarine and those are orders we have in-house. The content is growing each year and so that gives us a pretty healthy growth on that side that could be as much as 8% to 10% just done on that submarine program.

And then, we're looking at other areas an area using autonomous underwater vehicles for science, for our infrastructure, for military application. And we have a broad suite of vehicles in that space and all of those seem to be doing pretty well and that's where we see the upside coming.

So that sort of historical deep water oil and gas and flattish, the remaining parts of the Marine though we do see some improvements and hence you see a little bit of an upside that Robert talked about.

Jim Ricchiuti

Al, you alluded to the book to bill in this part of the business, I wonder if you can give us any color on just broadly speaking book to bill for up for the quarter. Sure. And maybe some of the segments. Thank you.

Al Pichelli

Sure. Sure, I can do that Jim. Our orders input were pretty strong for the year as a company. We had a book to bill of 1.11, and if you go through the math that means we added about $320 million to the backlog and of that segment by some, I mentioned the Marine for the quarter about 1.27. So there you go to our [EMEA] [ph] which was an environmental and our test and measurement businesses. And as you know that's a short cycle book and burn business and it's about one I think that the environment was just a hair under one our test and measurement centered around [indiscernible] one. So that doesn't change too much from period to period.

In the digital imaging, we have a book to bill a little bit below 1.97. And again, I'm talking about Q4 now. As a point 97 in Q4 and sort of 1.05 for the year, aerospace and defense is where the majority of our orders come. Keeping in mind that a number of these programs in the space are multi-year programs. In fact, I'd probably say half of the extra orders are programs that will go out for the next three to four years. But in aerospace and defense electronics, we had a book to bill in Q4 of 1.37, that's fairly healthy and 1.29 for the year.

And then, when you move down to Engineered Systems keeping your mind Engineered Systems has very large programs as so the orders from one month or one quarter are a little bit lumpy but the orders in Q4 were 0.81, but for the year the orders are 1.08. And I think an engineered remorse on one else, I think you have to look at the total orders for the year. So if you add all that up as far as book to bill in Q4, we have a 1.09 and for the year 1.11. Hope that helps.

Jim Ricchiuti

It does help. Thank you. And just last question for me. You alluded to potentially some impact from the shutdown and I'm just wondering with respect to the pending acquisition, does that things get potentially delayed there.

Robert Mehrabian

Yes, I'll take that one Jim. Two things there first that the government programs isn't affected, nevertheless, we're going through the process, we've submitted our HSR filing. We did that right at the beginning of the year. We have an examiner that's looking at it and asking questions. But, at this point it's unpredictable. We expect to be able to close the transactions in Q1. But that's one part that could get affected even though so far our examiners seems to be very engaged with us. So we're very pleased with that.

Jim Ricchiuti

Okay. Robert, how is the pipeline for other acquisitions looking out over the balance of the year?

Robert Mehrabian

It's not bad. I'll charge you that. Let me go back and say because I want to mention because of our net debt to EBITDA, net debt getting down to about $600 million. Now our combined EBITDA this year is going to get up to 500 to 550. So close to our net debt, we don't do anything, we're going to get rid of that net debt by the year end or we have it maybe a 100 million or 200 million. So we have a lot of financial muscle this year more than I've seen in a long time.

I think we have something of the order of -- we will have in '19 something of the order of $1.3 billion to $1.5 billion capability. So let me put that as being an opportunity for us. We are looking at both small and large acquisitions, medium size, for others who are less large.

Having said all of that, we are going of continue to be fairly disciplined in that process. We have to keep looking at the balance -- keeping the balance of our businesses does not get out of whack. So that if one market goes down, it takes the company's revenue and earnings in one direction too much.

Having put all of that together, I think we're going to probably be a little more aggressive than in the past.

Jim Ricchiuti

Very good. Thank you. Appreciate it.

Robert Mehrabian

Thank you.

Operator

Thank you. At this time, there are no further questions in the queue.

Robert Mehrabian

Thank you very much operator. I will now ask Jason VanWees to conclude the call.

Jason VanWees

Thanks Robert, and again, thanks everyone for joining us this morning. If you do have follow up questions, my numbers are in the earnings release, please feel free to call. Nick if you could conclude the conference call and provide a replay details to the audience. I would appreciate it and again thank you everyone.

Operator

Certainly. Today's conference call is being recorded and it will be available for replay beginning at 10:00 a.m. Pacific Time today and running through February 23rd may call into the AT&T replay system by dialing 1-800-475-6701 and enter the access code of 457983, if you are calling from outside of the U.S. who may dial 320-365-3844. Again those dialing numbers are 1-800-475-6701 or 320-365-3844 with a common access code of 457983. That does conclude our conference for today. We thank you for your participation and for using AT&T Teleconference. You may now disconnect.