

# **PHINIA Inc. (PHIN) Q2 2024 Earnings Call Transcript**

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**Body**

PHINIA Inc. (PHIN)

Q2 2024 Earnings Conference Call

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Company Participants

Kellen Ferris - Vice President of Investor Relations

Gordon Muir - Vice President and Treasurer

Brady Ericson - Chief Executive Officer

Chris Gropp - Chief Financial Officer

Conference Call Participants

Jake Scholl - BNP Paribas Exane

Adam Jonas - Morgan Stanley

Daniel S - Barclays

Drew Estes - Banyan Capital Management Inc

Presentation

Operator

My name is Ian, and I will be your conference operator today. At this time, I would like to welcome everyone to the Phinia Q2 2024 Earnings Call [Operator Instructions]

I will now hand the call over to Kellen Ferris, Vice President of Investor Relations. Kellen, you may begin your conference.

Kellen Ferris

Thank you. Good morning, everyone. We appreciate you joining us. Our conference call materials were issued this morning and are available on Phinia's Investor Relations website, including a slide deck we'll be referencing in our remarks. We are also broadcasting this call via webcast. Joining us today are Brady Ericson, CEO; and Chris Gropp, CFO.

During this call, we will make forward-looking statements, which are based on management's current expectations and are subject to risks and uncertainties. Actual results may differ materially from these statements due to a variety of factors, including those described in our SEC filings.

And with that, it's my pleasure to turn the call over to Brady.

Brady Ericson

Thank you, Kellen, and thank you to everyone for joining us this morning. I will start with some overall comments on what we've accomplished during our first year as a stand-alone entity, and then discuss our second quarter performance and outlook. Chris will provide additional detail in our financial review before we will open up the call for questions. This month, we celebrated our first anniversary as a stand-alone publicly traded entity.

Throughout the past year, we rigorously applied financial discipline in everything we did from day-to-day operations to business development to capital allocation. In turn, we successfully executed our financial, operational and capital allocation strategies, many of these ahead of plan.

Some highlights include consistent operational performance, strong cash flow generation, successful refinancing of high-cost debt and returning over $180 million to shareholders via dividends and share repurchases, coupled with a long list of new business wins and pipeline of new product launches, you can understand why we are confident in our long-term future. We have also been active on the corporate governance front, having appointed a new independent member of the Board of Directors adding investor perspective, financial expertise, and diversity.

Additionally, we're wrapping up our first sustainability report with an expected release date in August. From an overall market perspective, we see both the commercial and light vehicle markets globally coming in softer than our expectations. This is partially offset by the slowing growth rate of EVs as they are clearly not for every application, market or region. The softer OE markets are mitigated by a complementary OES and independent aftermarket business. There's still a large market for internal combustion engines or ICE, as it appears that they will play a key role in our road to carbon neutrality.

First, by driving efficiency improvements for today, and then moving to carbon neutral and carbon-free fuels of tomorrow. Solutions such as ethanol, bio-fuels, e-fuels and hydrogen will become important growth drivers for us over time. We are prudently investing in a wide range of alternative fuel products, including hydrogen by leveraging our core technologies and resources. Our performance this past year clearly validates our long-term strategic plan, and demonstrates the progress we continue to make in executing the plan.

Additionally, the accomplishments from the past year are being recognized as evidenced by Phinia's recent addition to the Russell 2000 Index. I want to congratulate and say a special thank you to all of our colleagues across the business, many of whom listen into this call. It's their passion and dedication, along with our strong brands, that contributed to and will continue to contribute to our long-term success.

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Now moving on to our second quarter results, starting on Slide 4, one I would note before we dive in is this will be the last time we are comparing stand-alone quarterly financials with pre-spin carve-out quarterly financials. The performance highlights our leadership team's commitment to the execution of our long-term strategic plan with the operational and financial discipline we expect.

Our top line reflects the resilience and consistent performance of our aftermarket business, particularly in Europe, our Fuel Systems segment adapted to weaker-than-expected CV sales in Europe and lower light vehicle sales in China. Adjusted sales in the quarter were $863 million, down slightly from the same period of the prior year. We reported adjusted EBITDA of $117 million and an adjusted EBITDA margin of 13.6%, decreases of $13 million and 110 basis points due to an increase in stand-alone company costs, transactional currency losses and lower sales.

Margins were strong in our two business segments, Aftermarket and Fuel Systems at 15.1% and 10.1%, respectively. Total segment adjusted operating margins of 12.2%. This was 30 basis points lower than the previous year as the Q2 2023 Fuel Systems margins benefited from some retroactive customer recoveries. We continue to make good progress on the transition from our former parent and have exited all transition service agreements, or TSAs, and all material contract manufacturing agreements or CMAs.

We're now operating completely independent of our former parent, including all IT systems. Furthermore, our balance sheet remains strong with $339 million of cash on hand that was supported by adjusted free cash flow of $108 million in the quarter, and we've returned $101 million to shareholders during this quarter as well.

Now let's move on to Slide 5. On the product and market share front, we continue our efforts to identify both near-term and long-term organic growth opportunities that leverage our engineering expertise and reputation for high-quality products. This is once again evidenced by our recent wins across product lines and geographies.

First, a contract extension for gasoline fuel deliver modules for a 2-wheeler with a leading global OEM, supporting the customer mostly in the Indian market. A conquest business wins to supply field delivery modules to a leading luxury global OEM for three of its light vehicle platforms in the Asian, North American and European markets. In an ECU conquest win augments a previously awarded GDi fuel system a major win, as this is the first full system package utilizing Phinia's complete hardware, software and calibration. This is a great example of the increasing content per vehicle opportunities that we have moving forward. This is for a leading domestic Chinese OEM in the light vehicle segment, supporting both the Chinese and export markets.

We look to differentiate ourselves where we can through value, quality of service, efficiency and innovation. These recent business wins, particularly the conquest wins are further proof that we are successfully diversifying and growing by leveraging our product leadership global footprint and proven capabilities.

Now let's move to Slide 6. Strengthening our financial position post spin has been a priority. As previously disclosed, in early April, we paid off our term loan B and then drawn balance on a revolving line of credit with the issuance of new senior secured notes. This transaction significantly reduced our run rate interest expense, rebalanced the majority of our long-term debt to fixed rate and improve our overall liquidity position by restoring undrawn capacity on our revolver.

We also amended our credit agreement to modify numerous restrictive covenants, which provides more flexibility to execute on our strategic priorities. Given the stability and lower rates, we feel it's prudent to increase our target net leverage from 1x to 1.5x. If we increase our leverage to 1.5x, we expect our interest and debt service costs to be similar to what they were prior to the refinancing. Obviously, we will only add new debt if the cash is utilized to enhance shareholder value.

During the quarter, we opportunistically repurchased over $90 million of our outstanding shares, and have nearly completed the $150 million authorized by the Board. With only $13 million remaining, we plan to review next steps for the Board in the coming days. This most recent share repurchase further demonstrates the company's commitment to returning value to shareholders and our confidence in our long-term growth potential.

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Our healthy cash generation, coupled with our solid balance sheet provides us with the flexibility to support our growth initiatives, both organic and inorganic as well as continue to return capital to shareholders via dividends and opportunistic share buybacks. In summary, we remain confident in our strategies and the long-term growth of our business despite the current market conditions. We are well positioned today and for the future as we have many opportunities to leverage our globally recognized brands, our capabilities and our scale.

With that, I'd like to hand it over to Chris, who will walk us through our Q2 results, and discuss our outlook for the year. Chris?

Chris Gropp

Thanks, Brady, and thank you all for joining this morning. As a reminder, as we discuss our results and outlook, please keep in mind there were TSAs and CMAs with our former parent in Q2, which are coming to material and/or full completion at the end of this period. In addition, reconciliations of all non-GAAP financial measures that I will discuss can be found in today's press release.

Moving to Page 8 in the deck. In Q2, we generated $863 million in adjusted total sales, down slightly versus a year ago. Our aftermarket business benefited from higher pricing and volume for an increase of 4.1%, whereas Fuel System was impacted by lower commercial vehicle or CV revenue in Europe and light vehicle or LV sales in China, and reduced inflationary price pass-through as Q2 2023 benefited from some out-of-period customer recovery.

Our adjusted diluted earnings per share were $0.88 per share and impacted by ongoing structural tax issues. We earned $84 million in adjusted operating income and $117 million of adjusted EBITDA, resulting in an adjusted operating margin of 9.7%, which represents a year-over-year decrease of 90 basis points.

While the adjusted EBITDA margin of 13.6% represented a year-over-year decrease of 110 basis points. Year-over-year conversions were affected by stand-alone corporate costs, which we will break down shortly. Of net, net income was partially impacted by higher interest expense, which includes the onetime noncash impact from the loss on the extinguishment of debt.

From a core business performance standpoint, our segments reported strong overall margins. Q2 segment adjusted operating margins were healthy at 12.2% as our Aftermarket segment ended at 15.1% on the back of inflationary price pass-through and positive product sales mix.

Q2 Fuel Systems margins were strong at 10.1%, down 120 basis points, mainly due to some retroactive customer recoveries, equalized for this fuel systems downside conversion on sales would be less than 15%. Corporate costs were $21 million in the quarter compared with $17 million in the same period of the prior year. The largest driver this year was to build up our stand-alone corporate function as we separated from our former parent.

Now let me bridge our revenue and EBITDA, which you can find on Pages 9 and 10 in the presentation. Our adjusted sales performance in the quarter was affected by softness in volume and mix, which was a headwind of $18 million due to lower CV sales in Europe, LV's softness in China partially offset by ongoing strength in aftermarket sales in Europe. By contrast, we saw offsetting inflationary increases and aftermarket sales against the noted onetime lump-sum prior period non-commodity inflationary recovery for Fuel Systems in Q2 2023.

Negotiation of customer recovery to piece price was finalized in Q2 2023 versus lump sum, and results in program and segment profitability, moving in line with expectation on a more consistent basis after this period. Finally, weakening of the euro and Chinese yuan reduced sales by another $6 million for the quarter.

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Turning to Page 10. The quarter saw negative volume and mix on sales of $4 million or a 22% contribution margin. Strong supplier savings and recoveries of $13 million were a tailwind for the quarter, offset by increases in employee and other manufacturing costs of $4 million. Employee costs increased by $11 million, including $4 million in corporate costs as expected. R&D costs were up $2 million, mainly due to increased spending.

Transactional FX was a negative impact of $5 million quarter-over-quarter as the basket of currencies used in our operations was a headwind. Net cash from operations in Q2 was $109 million. During the quarter, we generated adjusted free cash flow of $108 million as we continue to be disciplined in management of our working capital, and drive optimization of resources and processes on a daily basis. Capital spend was less than 2% of sales in the quarter and 3% year-to-date, but still projected to come in for full year at guidance of approximately 4% of revenue.

Now moving to Slide 11. With respect to 2024 guidance, as Brady and I both mentioned, our second quarter results are trending in line with our full year guidance, but expect softness in the second half of the year, with full year revenue trending closer to the lower end of the range. We have also refined our full year effective tax rate assumptions and expect it to be between 33% to 37%. The expected changes to our legacy legal entity and tax structure that are required to reduce the company's effective tax rate are proven to be more time and resource consuming than anticipated.

These efforts are complicated by the adoption of OECD Pillar two global minimum tax rules in some jurisdictions that we do business, resulting in much of our team's efforts early this year being focused on mitigating further rate increases that could have had an immediate negative effect as rules have been introduced, where efforts and analysis required that we are committed to an effective tax rate more in line with our peers.

Overall, we expect solid earnings and cash generation in 2024 as we continue to drive operational efficiencies and grow our aftermarket segment. In closing, we remain financially disciplined and focused on generating strong shareholder returns.

And with that, we'll now move to the Q&A portion of our call.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Jake Scholl with BNP Paribas.

Jake Scholl

Congrats on the great quarter. So first question for me. So your entire sales are planning towards the low end, but it looks like your EBITDA and cash flow ranges are pretty much intact and tracking a little bit towards the midpoint. So can you just talk about the cadence in the second half, especially on the Fuel Systems segment?

Brady Ericson

Yes. Thanks for the question. What we're seeing, obviously, is we see the CV side and the light vehicle side coming in softer in the second half. I think all the forecasts we see on CV are going to be softer. And so we do see continued pressure on that side. Light vehicle side is also a little bit softer in Asia. We're seeing some customers here this summer going to take longer shutdowns in Europe and make some inventory adjustments.

And so it's a little bit noisy. It always kind of gets noisy around the summer months of how long they're going to take off and where they come back as far as run rates. And so we do see our Fuel Systems segment softer in the second half, and we're taking adjustments, I think, with our downside conversions, and we're making sure those stay with them within reason.

But then as we kind of highlighted in this call, we also -- with that, we also see upside potential in the aftermarket as customers keep their vehicles longer, and that's why we like the aftermarket so much as it kind of counterbalances when the OE side is a little bit softer. So we're going to continue to keep a monitor on that. And as I said, we think the second half is going to be a little bit softer in the first half.

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Chris Gropp

And from the cash point of view, even with the hit on the tax rate, we continue to hold. Our cash is coming in well. The units are doing a really good job. We've been working on working capital, which was a bit of a problem at the end of last year, that's improved and we continue to see improvement. So that's going to more than make up for any hits on the tax rate and any softness in any of the top line sales.

Jake Scholl

And then I think we're all impressed by the $90 million of buyback in the quarter. So what opportunity do you see for future buybacks going forward and maybe some other uses of cash?

Brady Ericson

Yes. I mean, as you see, our cash balance remains really strong even with the $100 million return to shareholders, our net cash balance went up. And so that just kind of reaffirms the cash-generating potential of the business. And again, from our capital allocation strategies is we're looking to maximize shareholder value. And right now, the opportunities in our shares, and that's what we're doing.

I do think we still have a little bit of excess cash that we need, and so we'll continue to kind of allocate both our cash flow that we generate each quarter as well as kind of bring our cash balances maybe down a little bit over time, and we're going to continue to apply that to where we think it's going to generate the most value. We do continue to look at M&A opportunities. But again, those need to add more value than buying back our own shares or paying down debt or increasing our dividend.

So we're going to continue to review that with the Board on kind of next steps, and we'll hopefully have some more news after that discussion here in the next week or so.

Operator

Your next question comes from the line of Adam Jonas with Morgan Stanley.

Unidentied Analyst

This is William Saket on for Adam Jonas. I was curious, with the new emission standards for heavy-duty vehicles that came out, I think, back in March and went into effect in June. Obviously, that increases the need for more advanced injection systems. I guess with the final role now out, are you seeing any indications of increased demand for GDi or diesel direct injection systems from your OEM customers?

Brady Ericson

Yes. I mean both -- I guess you mentioned kind of CV and then the GDi is more for the light vehicle. But on CV, as you know, with the emissions regulations, there's the model year '27 are kind of now defined, and that's going to be another significant upgrade in the performance of those injection systems in order to meet the requirements.

And so -- we're launching -- it seems like on the CV side about every three years with customers kind of a significant upgrade in our fuel systems. So our model year '21, we've got another one '24 and now in '27 with the new EPA regulations. And those are going to be relatively significant increases in performance requirements for our injection systems. So I guess the answer is yes. We are seeing significant increase in demand.

And we've announced a number of those new business wins for those applications over the last year from a GDi perspective as we kind of announced today as well for the Chinese OEM, not only was that on the GDi system, but now it includes our ECU, our software and our calibration services that we're providing. So we are seeing an uptick in GDi kind of request some demand as people see GDi being a key technology to help them towards their carbon neutrality and just overall efficiency improvement goals.

And so we're seeing a lot of increased demand or opportunities that we've been announcing as well as programs that were originally planned to kind of phase out being extended as well. So we do see some positives there on the GDi side as well.

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Chris Gropp

And last quarter, we announced 500bar, which is also going to end up...

Brady Ericson

From a technology perspective, yes.

Unidentied Analyst

Got it. That's all really helpful. Maybe just kind of going off of that, I guess, how is competition evolving in the GDi space? I mean, with the rapid shift to hybrids, have any competitors move to take advantage of the increase in demand? Or is this a space where you feel confident you can retain share and have some pricing power in the coming years?

Brady Ericson

Yes. I mean I think the folks that have been exiting a lot of combustion products are still exiting. There's still a number of key competitors still in the marketplace, some significant players. And so they're still supporting customer demands. I think over time, as they've cut back on some of their R&D spend and investments, that's going to come into play. And that's where our 500bar technology is giving us some competitive advantages and has allowed us to get some conquest wins.

I think when we also take a look at -- there's a number of competitors that have already exited and those that have reduced their R&D spend, they're not doing an about face and saying they're going to now reinvest in combustion. I think that's -- that path has already been set. And so from our perspective, we think it's a good positive to where we're still going to have a few competitors, say, 2030 and beyond, but it's a better situation than having or 6 or 8 competitors in the space.

And so we're just trying to be a reliable partner for a lot of our customers. And that's why I think we've been gaining a lot of share on the GDi side, it's allowed us to kind of keep our light vehicle revenues flat despite declining engine production volumes.

Operator

Your next question comes from the line of Federico Morandi with Bank of America.

Unidentied Analyst

Just a quick question on the outlook beyond 2024. So a lot of -- the other suppliers mentioned that EV demand is -- EV production volumes are slower to ramp, and it seems that is going to stay around for longer, also given the hybrid popularity. So what I'm wondering is what's your growth expectation for 2025 plus? And if you could also touch upon the growth opportunities from consolidation in the fuel system industry?

Brady Ericson

Sure. We haven't given a specific guide for 2025, but we have given what our expectation is through the decade of averaging that 2% to 4%. And that's what we expect to continue going forward. We're in kind of a down cycle right now, which is why we're seeing kind of flat, but we see that rebounding in '25 and '26 as light vehicle and GDi penetration rates and hybrids increase in the outer years as well as with the CV segment kind of rebounding in '25 and '26 with some of the new emissions regulations coming out in '27.

So the EV slowing, does that give us an opportunity on the light vehicle side longer term, that may help. But again, our main focus is on maintaining our light vehicle revenues in GDi throughout the decade. And we've been doing that by picking up additional market share. Even with the slowing EV penetration rates, EV penetration rates are still going up. And so that means engine production is still going to be going down. So rather than going down maybe 3% or 4% a year, it may be only going down 1% or 2% or 3% a year throughout the decade.

And so our goal is to ensure that we offset that nice decline with some market share gains and content improvements. I think our original outlook for 2030 for EV penetrations on light vehicle was, I think, close to about 40% EV penetration rates. And so that obviously is only 30% penetration out there that does give us an opportunity. And with the declining competitive environment, that's allowing us to continue to gain share, and that may give us some opportunity in 2030 and beyond. But I think it's a little bit too early to kind of bake that in at this point.

Operator

[Operator Instructions] Our next question comes from the line of Dan Levy with Barclays.

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Daniel S

This is Daniel on for Dan. First, I wanted to double click on your prior comments on inorganic growth opportunities. Would you be able to share any specific products or areas that you're evaluating currently? And just more broadly, how has the M&A landscape shifted over time?

Brady Ericson

Yes. I mean as we've kind of mentioned in the past, our focus on the inorganic are going to be items that are going to enhance our commercial vehicle, industrial highway OE business as well as our aftermarket. Those are going to be kind of the key areas. We like product lines that are going to also have a significant exposure in the aftermarket.

We like that balance of having both the OE and a growing aftermarket. There may be some opportunities for us to continue to consolidate in our current product portfolio as well as adding additional product lines that are synergistic with our core.

But again, they're going to be heavily weighted towards commercial vehicle, industrial and aftermarket are the ones that we're kind of targeting. But we are going to be financially prudent in those acquisitions. And so from our perspective, we think we have a good business right now, and we're not desperate to go out and make acquisitions if they're not going to enhance shareholder value, and they're not better than maybe reinvesting in share repurchases or in our and ourselves from an organic standpoint.

So we're going to continue to be financially disciplined when we look at those, but obviously, our focus is growing our CV industrial and aftermarket businesses for the long term.

Daniel S

Got it. That's helpful. And as a follow-up, could you provide an update on how your new product launches have been progressing through the year through 2Q? And from a timing perspective, when should we expect these benefits to begin flowing through your financials?

Brady Ericson

I mean they're happening all the time. I think the nice thing about our business is we're pretty diversified regionally by platform, by customer. So there's not like 1 program that's going to add $200 million and be a big tick. There's always a constant stream of new product launches that are happening. I think we've already launched a couple of dozen yet this year. We've got more in the pipeline, and it's more of a consistent cadence of launches.

And so we do see a number of additional GDi hybrid applications in China that we'll be launching towards the end of this year, beginning part of next year. But again, I think we just have a number of programs that are consistently coming on or being replaced that should continue to have an average growth rate of 2% to 4% over the decade. So there's nothing that's going to be some step function than I would expect.

Operator

Your next question comes from the line of Drew Estes with Banyan Capital Markets.

Drew Estes

Brady and Chris, this is Drew. Congrats on getting through the first year as an independent company. That's a big accomplishment. So my question is with regard to the ECU business, I know you all talked quite a bit about it and are very optimistic about its prospects. Could you elaborate on the margin and capital returns on this business as well as how it helps you win more fuel systems business, if at all?

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Brady Ericson

Sure. Yes. We don't disclose, I guess, margins or arguably see for any particular product line but it is an example that it will always have to meet our minimum guidelines for all businesses, which is our hurdle rate that we use is 15%. And so we do see it as a nice business that's going to meet or exceed our internal hurdle rates.

From an overall market perspective, we see more and more customers that are moving from just buying components to wanting to buy the complete system. And we're one of only a couple that can provide the complete system. And I think if you go back and take a look at our Investor Day deck from June of 2023, you'll see kind of a chart there of where we see customers going from the left to right from buying individual components where we have a lot of competition. There's a lot of different players out there that can do 1 component that we're competing against. But once you go to the complete system, there's only maybe two or three that we see as significant competitors.

And so as we kind of highlighted in today's, I guess, announcements is we have the GDi system in. Now we're getting added the ECUs that's giving us additional content. And that's also going to make it a lot more difficult and make it stickier with that customer because now they're relying on us for all those components, so it gives us a content addition and it makes us more integrated into our customers' engineering and development side of things.

And so that's where we see it's going to not only add another product line for us. It's going to add a content, add content for us, but it also allows us to win additional business and keep customers longer.

Chris Gropp

Also of note on the ECUs, we were already doing the software. So we already have the investment in the R&D and the know-how and the knowledge of that. And to me, the brands that the ECU is the more difficult part that's already embedded in the business. So we're not adding for that. It is really just the hardware side of it that comes into play.

And also from that investment, we're still using our former parent to supply some of those ECUs, but this is an ECU that was designed by us, and we'll have some more flexibility on where to source the PCBA or some of the components as well.

Operator

There are no further questions at this time. I will hand things back over to Brady Ericson for some closing remarks.

Brady Ericson

Great. Thanks, everybody, for your questions. We really look forward to building on the achievements of the past quarter, end of the last year. And we really think we have a clear line of sight on our long-term goals. Really want to again say thank you to our entire team around the world on delivering a great year. I think we've accomplished a lot in this first year, and really couldn't be more proud of our team. And so I just want to say thank you again to them.

Thanks for everybody for joining us on this busy morning, and have a nice day.

Operator

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

**Load-Date:** July 30, 2024

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