Steelcase Inc. Third Quarter FY 2017 Earnings Call, December 21, 2016 at 8:30am

Scripted remarks of David Sylvester, Senior Vice President and CFO

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Thank you, Jim.

I will cover our financial results first (noting where results differed from our expectations and highlighting year-over-year and sequential quarter comparisons) . . . and then I will talk about our balance sheet and cash flow before getting into our order patterns and outlook.

Overall, we continue to feel pretty good about the business and the progress we have made on several fronts over the past 12 to 18 months. Third quarter revenue <u>did fall</u> just below the low-end of the estimated range we provided in September and I will cover that in a moment, but first I want to share a few broader highlights, some of which Jim just referenced.

- First, EMEA was profitable in the quarter . . . and the $15 million improvement in adjusted operating income compared to the prior year was driven by a significant improvement in our gross margin.
- Second, our pipeline in the Americas for project business expected to be ordered and shipped during the next four quarters continues to reflect strength compared to the prior year . . . and while growth in day-to-day business was lower than we anticipated, we do take note of recent improvements in sentiment, whether it be from CEO's of the Business Roundtable or small companies as reported by The National Federation of Independent Business.
- Third, Asia Pacific posted a record level of quarterly orders . . . and we are achieving it by securing more and more business with leading organizations headquartered in China and India. We had anticipated we might also post a record level of revenue in the region during the third quarter; however, timing of completion related to a few projects pushed some revenue into the fourth quarter.
- Fourth, Designtex posted strong order growth and sales growth in the quarter . . . evidence that our product marketing strategies are paying off . . . and PolyVision made additional progress in the last 90 days to resolve the majority of the anti-dumping duty exposure we have been discussing for the last several quarters.

As it relates to <u>revenue</u> in the third quarter, the organic growth was lower than our estimated range of 1 to 4 percent growth. The shortfall was primarily due to lower than expected growth in day-to-day business in the Americas and a significant amount of customer deliveries shifting from the third quarter to the fourth quarter, in both the Americas and Asia Pacific. To give you some additional insight into the Americas revenue shortfall, and to provide some context for the lower than expected gross margins which I will discuss in a few minutes, I will share a few additional comments about our order patterns in the Americas during the quarter.

- Across the months, order patterns in total were largely consistent with our expectations . . .
    - o growing significantly in September, in advance of our October 3rd price adjustment, followed by

  - declining significantly in October, likely due to the pull-forward effect of the price increase on orders, and then
  - growing nicely by a mid-single-digit percentage in November (compared to a relatively weak prior year).
- However, the mix of business reflected stronger than expected growth in project orders and lower than expected growth in day-to-day business (which represents the aggregation of business from continuing agreements and marketing programs). In addition, business generated by our owned dealers and services business was greater than we expected. These mix shifts are important, as day-to-day business tends to ship faster than project business, and average gross margins tend to be higher . . . and gross margins on dealer and services business are much lower than our overall average.
- Related to the requested customer deliveries which shifted to the fourth quarter, the amount was higher than normal and the orders spanned across project and day-to-day business which is also somewhat unusual . . . and
- A significant amount of orders in the quarter were received with requests for delivery beyond the end of the fourth quarter. We see some of this every quarter, but the magnitude in the third quarter was unusual and we have no reason to believe it was linked to our October price adjustment.
- Finally, the third quarter included a higher than expected mix of business from some of our largest customers who earn deeper than average discounts (through volume related rebates) . . . an additional contributor to our lower than expected gross margins.

From an earnings perspective, the 34¢ in the quarter compares to our adjusted earnings estimate of 33¢ to 37¢, and includes 3¢ related to the tax benefit mentioned in the earnings release (which was not in our guidance). Operating income was significantly lower than our expectations in the Americas . . . and operating profit in EMEA compares to an anticipated loss in the quarter.

- For the Americas, lower revenue and the unfavorable shifts in business mix I previously mentioned were the largest drivers of lower than expected gross margin and operating income. We also had a few operational issues in the quarter that negatively affected gross margin . . . but their financial impact was offset by lower than expected operating expenses, and some of the issues are already resolved.
- For EMEA, the better than expected results were driven by our local teams continuing to improve operational performance, as well as beginning to realize benefits from various gross margin improvement initiatives. We also recorded ”true-up” adjustments to accrued liabilities, which improved our results by approximately $2 million.

Switching to year-over-year comparisons . . . I will add a few additional comments for each segment.

- For EMEA, the $15 million improvement in adjusted operating income was driven by a 1,050 basis point improvement in cost of sales . . . the result of hard work by our colleagues in Europe to rebuild the EMEA business model. We eliminated the costs associated with our footprint changes and other issues experienced in the prior year, and we have begun to realize benefits from cost reduction efforts and other gross margin improvement initiatives.
- For the Americas, the year-over-year decline in operating results was driven by the unfavorable shifts in business mix I mentioned earlier and higher operating expenses,

including variable compensation expense associated with the tax benefit recorded in the quarter and our improved results in EMEA.

- In the Other category, we posted lower operating income in Asia Pacific compared to a very strong prior year, as well as lower operating income in PolyVision in part due to costs associated with the steel tariff issue.
- Lastly, corporate costs were higher compared to last year, primarily due to lower COLI income.

Sequentially . . . third quarter adjusted operating income was lower compared to the second quarter, as benefits from seasonally higher revenue and improved operational performance in EMEA were more than offset by the impact from the unfavorable shifts in business mix (including some of the items mentioned previously, plus a seasonal shift in revenue mix across vertical markets in the Americas).

Moving to the balance sheet and cash flow . . . cash provided by operating activities approximated $83 million in the current quarter and was similar to the prior year. Capital expenditures totaled $14 million in the third quarter and $40 million on a year-to-date basis. We estimate capital expenditures for the full year will approximate $60 to $70 million, which is somewhat lower than our previous estimates as various capital projects are pushing into next fiscal year.

We returned approximately $29 million to shareholders in the third quarter - through the payment of a cash dividend of 12¢ per share and through repurchasing approximately 1.1 million shares under our share repurchase authorizations. Over the last twelve months, we have repurchased approximately 6 million shares under these authorizations and have $126.5 million remaining under the authorization approved by our Board of Directors in the fourth quarter of fiscal 2016.

Turning to order patterns, I will start with the Americas segment . . . where our orders in the third quarter grew by approximately 3.5% compared to the prior year, and included initial orders from a very large project that was won in the first quarter. In addition, orders in the Americas continued to reflect a significant decline in the Energy vertical market, which negatively impacted overall order growth in the segment by approximately 300 basis points year over year. Customer order backlog at the end of the quarter was 4% higher compared to the prior year, and the growth was almost entirely driven by orders with requested delivery dates which fall beyond the fourth quarter.

Turning to vertical markets in the Americas . . . we experienced growth in seven of the ten vertical markets we track (including four with double-digit percentage growth rates), as well as growth across our “untracked sector” (which includes retail customers and other vertical markets not large enough to track separately). This growth was dampened by declines in the Energy, Federal Government and Technical Professional sectors. We believe the significant impacts from the Energy sector on our year-over-year order comparisons are now behind us; however, we expect the year-over-year revenue comparison to be significantly impacted for one more quarter, as we finish fiscal 2017.

Across quote types, project orders grew by 6%, while day-to-day business grew modestly, reflecting growth from continuing agreements and a decline in our marketing programs (aimed at smaller day-to-day business). Year-over-year order growth was strongest from customers whose orders aggregated more than $3 million in the quarter, and grew at a strong single-digit rate outside of the initial orders from a very large project I mentioned earlier. Orders from customers whose orders aggregated less than $1 million declined compared to strength from this group of customers in the prior year.

Since June, we have talked about the year-over-year strength we were seeing in our pipeline of project activity in the Americas, and we also talked about the possibility that on-going uncertainty could negatively impact day-to-day business from continuing agreements and marketing programs. Our project pipeline of estimated project revenue over the next four quarters continues to reflect meaningful growth compared to this time last year. This pipeline calculation includes project business that we have already been awarded or that we believe we have a significant probability of winning, from customers we expect will generate more than $3 million of revenue over the next four quarters. It's only one piece of data, and these aren't binding commitments, and it's possible that day-to-day business could remain subdued, but we continue to feel good about this data point, as well as the improvement in CEO and small business sentiment I mentioned earlier.

For EMEA . . . the order decline of approximately 3% in the current quarter compares to significant growth in the third quarter of fiscal 2016. The order decline reflected declines in many markets that posted strong growth during the third quarter of the prior year, offset in part by growth in a couple of other markets which benefited from large project activity in the current quarter. Customer order backlog for EMEA ended the quarter down 11% compared to the prior year.

Within the Other category, orders in total grew 14% compared to the prior year, driven by the record amount of quarterly orders in Asia Pacific and solid order growth from Designtex.

To summarize . . .

- Order growth in the Americas was driven by the strength of our project pipeline, and was achieved despite continued weakness in the Energy sector and lower than expected growth in day-to-day business. We are hopeful that improved CEO and small business sentiment will help bolster demand in our day-to-day business.
- For EMEA, the environment remains mixed, but it's worth noting again that the modest decline in orders during the current quarter compared to a very strong prior year.
- Asia Pacific posted a record level of quarterly orders during the third quarter . . . and Designtex also posted notable order growth.

Before I turn to our outlook, I want to provide an update on PolyVision and the anti-dumping proceedings we have discussed on previous calls. During the third quarter, we secured the support of the domestic steel producers to file a request with the Department of Commerce to (i) revoke the duties related to the primary gauge of steel we have to import from Japan and (ii) to allow for the recovery of the related duties paid to date. We expect the Department to publish notice of this exclusion by the end of the month, solicit any comments and resolve the matter by the end of our fourth quarter. Accordingly, our current quarter earnings and our estimate for the fourth quarter do not include any duties associated with these purchases. The balance of porcelain-enameling steel we import remains subject to anti-dumping duties for now, and we estimate that our earnings could be reduced by a few hundred thousand dollars per quarter for these remaining duties and our on-going efforts to mitigate. We will provide periodic updates, as any new (material) information becomes available.

Turning to the fourth quarter of fiscal 2017 . . . we expect to report revenue in the range of $735 to $760 million, which reflects an expected range of an organic revenue decline of 1 percent to organic revenue growth of 2 percent.

Related to EMEA, we expect to report an operating loss in the fourth quarter, primarily due to our expectation of lower revenue and higher operating expenses, both on a sequential basis (compared to the third quarter) and on a year-over-year basis (compared to the fourth quarter of the prior year). We anticipate year-over-year improvement in our EMEA gross margin again in the fourth quarter, but we expect the resulting gross margin in the fourth quarter to be lower than the third quarter of this year, due to our expectation of lower revenue, as well as the non-recurring nature of the accounting benefits we recorded in the third quarter.

As a result of these factors, we expect to report fourth quarter earnings within a range of 22¢ to 26¢ per share.

As I said in the earnings release, there are two potential items which are not reflected in our earnings estimate for the fourth quarter that we estimate could reduce our fourth quarter results by up to $0.08 per share. One item is related to a potential reduction in the French statutory tax rate, which the French government is currently considering and if enacted in the fourth quarter could require us to record a non-cash charge to reduce the value of our deferred tax assets. In addition, we are working toward annuitizing some of our smaller defined benefit plans, which if completed in the fourth quarter would result in a modest use of cash and an accounting charge related to accumulated other comprehensive losses recorded in connection with these plans. We have not included these items in our earnings estimate as there are a number of factors in each case which are outside of our control.

From there, we will turn it over for questions.

[end of scripted remarks]

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Forward-looking statements

From time to time, in written and oral statements, the company discusses its expectations regarding future events and its plans and objectives for future operations. These forward-looking statements generally are accompanied by words such as "anticipate," "believe," "could," "estimate," "expect," "forecast," "intend," "may," "possible," "potential," "predict," "project," or other similar words, phrases or expressions. Forward-looking statements involve a number of risks and uncertainties that could cause actual results to vary from the company’s expectations because of factors such as, but not limited to, competitive and general economic conditions domestically and internationally; acts of terrorism, war, governmental action, natural disasters and other Force Majeure events; changes in the legal and regulatory environment; restructuring activities; changes in raw materials and commodity costs; currency fluctuations; changes in customer demands; and the other risks and contingencies detailed in the company's most recent Annual Report on Form 10-K and its other filings with the Securities and Exchange Commission. Steelcase undertakes no obligation to update, amend or clarify forward-looking statements, whether as a result of new information, future events or otherwise. Updating of information This presentation is provided as a supplement to our earnings release conference call and webcast on the date stated on the cover and is intended to be read in connection with the information provided therein and the related earnings press release. The information contained in this presentation is provided as of the date stated on the cover and may be superseded by information disclosed in our subsequent Form 10-Q, Form 10-K or other filings with the Securities and Exchange Commission. We undertake no obligation to update, amend or clarify this presentation, or any forward-looking statements included herein, whether as a result of new information, future events or otherwise.

Updating of information

This document is provided as a supplement to our earnings release conference call on the date stated on the cover and is intended to be read in connection with the information provided therein and the related earnings press release. The information contained in this document is provided as of the date stated on the cover and may be superseded by information disclosed in our subsequent Form 10-Q, Form 10-K or other filings with the Securities and Exchange Commission. We undertake no obligation to update, amend or clarify this document, or any forward-looking statements included herein, whether as a result of new information, future events or otherwise.