SPAR - Q3 2017 Spartan Motors Earnings Conference Call
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Company Representatives:
Juris Pagrabs; Group Treasurer and Director of Investor Relations
Daryl Adams; President and CEO
Rick Sohm; CFO

Analysts:
Steve Dyer; Craig-Hallum Capital Group LLC
Matt Koranda; Roth Capital Partners
Rhem Wood; Seaport Global Securities

Presentation

Operator: Hello. And welcome to Spartan Motors, Inc. third quarter 2017 earnings results conference call. [Operator Instructions]. Please note, this event is being recorded.

I now would like to turn the conference over to Juris Pagrabs, Director of IR and Treasurer. Please go ahead, sir.

Juris Pagrabs: Thank you, Keith, and good morning, everyone. Welcome to the Spartan Motors 2017 third quarter earnings call. I'm Juris Pagrabs. And joining me on the call today is Daryl Adams, our President and Chief Executive Officer; and Rick Solm, our Chief Financial Officer.

For today's call, we've included a presentation deck, which will be filed with the SEC and is also available on our website at spartanmotors.com. You may download the deck from our Investor Relations section of the website to follow along with our presentation during the call.

Before we start today's call, please turn to Page 2 of the presentation for our safe harbor statement. You should be aware that certain statements made during today's call, which may include management's current outlook, viewpoint, predictions and projects regarding Spartan Motors and its operations, may be considered forward-looking statements under the Private Securities Litigation Reform Act of 1995.

I caution you that, as with any prediction or projection, there are a number of factors that could cause Spartan's actual results to differ materially from projections. All known risks that management believes could materially affect the results are identified in our Forms 10K and 10-Q filed with the SEC. However, there may be other risks that we cannot anticipate.

For today's call, Daryl will provide an overview of the third quarter and a brief business update, and Rick will review the third quarter results and our 2017 guidance. We plan to then return to Daryl for closing remarks before proceeding to the question-and-answer portion of the call.

At this time, I am pleased to turn the call over to our CEO, Daryl Adams, for his opening remarks, which begin on Slide 3.

Daryl Adams: Thank you, Juris. Good morning, everyone, and thank you for joining us this morning for our third quarter update. I'd also like to thank everyone who attended or watched our recent Analyst and Investor Day event in New York City, where we shared long-term business goals and financial targets.

For this quarter, I'm pleased to report another solid quarter of sales and profitable growth for Spartan Motors. Revenues for the third quarter rose 27.3%, to $189.2 million from $148.7 million a year ago. The increase in sales was driven by strong performances from our ER and SCV segments.

For the third quarter of 2017, adjusted net income more than doubled to $7.4 million or $0.21 per share from $3.4 million or $0.10 per share last year. Our strong financial performance across all business segments is evidence that our unrelenting focus in profitable sales growth and operational performance is paying off, as shown by our 6.8% consolidated adjusted EBITDA margins for the quarter, which is 180 basis points improvement over the prior year. Even more exciting is that our ER segment was profitable on both a GAAP and an adjusted basis for the quarter.

Now turning to Slide 4, we'll provide an update on the new USPS contract. On September 29, we were awarded a $214 million multiyear cargo body order with the USPS. This represents our largest single order in the history of Spartan Motors. The award is for more than 2,000 vehicles configured in Cab Over and Cab Behind chassis and in 18- and 24-foot bodies. This award demonstrates industry confidence in our ability to design, custom engineer and build commercial trucks across Classes 1 through 6, in addition to providing [custom] location-specific upfits that uniquely position us to serve the growing demand for the last-mile vehicles our fleet operates.

The USPS contract provides a means for us to expand our truck body manufacturing footprint to the East Coast. One potential location would be to leverage our Ephrata, Pennsylvania location. This will provide access to the entire East Coast on the largest truck body markets and, combined with the Midwest market, would give us access to over 60% of the truck body market in the United States. Production is expected to begin sometime in the second quarter of 2018 and will ramp up to full production during the second half 2018.

Now turning to Slide 5, I'll provide an update on a few business highlights and developments. AmeriPride -- last week, we announced the receipt of a 20-unit electric vehicle walk-in van order from AmeriPride services, one of the largest linen and uniform service companies in North America. This innovative walk-in van integrates Utilimaster body design with the Motiv Power Systems EV propulsion solutions, as more fleet operators look for solutions to reduce the carbon footprint and address environmental sustainability.

Strategic alliances with alternative propulsion providers has allowed Utilimaster to produce nearly 800 EV vehicles over the past 8 years. Couple these strategic alliances with our 45-year history as a leading fleet provider, Utilimaster and Spartan Motors are in the optimal position to serve the growing alternative fuel market for large fleet customers.

Isuzu F-series ramps up -- as indicated last quarter, suddenly the new Isuzu F-series Class 6 medium-duty truck is ramping up. And today, we are at full production. The F-series truck is designed to optimize fuel efficiency and maximize cargo space in order to serve the growing urban and last-mile delivery segments.

Class A Motorhomes -- our motorhome chassis segment demonstrated a strong performance during the quarter as we continued to gain market share within the Class A greater-than-400-horsepower segment, as evidenced by our $31.2 million backlog at the end of the third quarter. That's up 63% from a year ago. Motorhome sales for the quarter were up 65.7% to $37 million and is a tribute to our superior products and services, which encompass first-to-market innovations for superior ride and handling as well as safety.

S-180 Pumper continues to capture awareness and market acceptance. We've sold 40 units including nine units in October. Six of these units are slated for hurricane-affected areas, which demonstrates an unexpected benefit of our quick delivery.

The Smeal acquisition -- our integration efforts continue to run ahead of schedule, as we've discovered more synergies than originally anticipated, which helped facilitate the strong third quarter performance in Emergency Response as we return to profitability.

Please turn to Slide 6. Two weeks ago at our Analyst Day and Investor Day in New York, we informed you that the ER segment will be profitable on a GAAP basis for both Q3 and Q4 and on an adjusted basis for the full year. I would like to congratulate the entire Spartan team for their hard work, dedication and execution of our ER business plan. We expect ER to show year-over-year improvement of approximately 400 basis points in gross margin, approximately 300 basis points in SG&A improvement, approximately $10 million in adjusted EBITDA, as well as a significant reduction in warranty expenses.

I will now turn the call over to Rick to discuss Spartan's financial results for the third quarter and outlook for the remainder of the year.

Rick Solm: Thanks, Daryl. I'll start on Slide 8.

Revenue for the quarter increased $40.5 million, to $189.2 million from $148.7 million, driven by almost $24 million from ER, and SCV contributing more than $18 million to our top line growth. Smeal contributed more than $17 million to the ER result and excludes approximately $9 million of intercompany chassis sales. For the full year, we expect Smeal to generate approximately $105 million of revenue, which excludes $20 million of Spartan intercompany chassis sales.

Third quarter adjusted EBITDA was $5.5 million, or almost 75%; to $12.9 million from $7.4 million. And our adjusted EBITDA margin improved 180 basis points, to 6.8% from 5% of sales a year ago. Third quarter adjusted EBITDA excludes the impact of $600,000 of restructuring and acquisition-related expenses, which compares to $300,000 in restructuring expenses and a product recall of $1.7 million in the prior year. Our backlog at September 30 reflects the new $214 million USPS order, which puts us at $537.7 million, up 97.6% compared to $272.1 million a year ago.

Now let's take a look at results by operating segment, starting with FVS on Slide 9. FVS reported revenues of $78.6 million compared to $78 million last year, an increase of $600,000; despite the fact that we experienced difficult top line comparisons due to the large upfit order last year that has not yet reoccurred. Adjusted EBITDA declined $1.3 million, to $8.8 million from $10.1 million a year ago, largely due to product mix, driven by lower sales in our upfit business. Adjusted EBITDA margin declined 180 basis points to 11.2% of sales from 13% a year ago, driven again by unfavorable product mix. But this was partially offset by improved labor and manufacturing productivity. Backlog increased 186.2%, to $292.5 million compared to $102.2 million a year ago, reflecting the new USPS order.

As Daryl mentioned, production of the order for USPS is expected to begin sometime in Q2 of 2018. And with that time line, we anticipate approximately 35% to 40% of our contract revenue to be achieved in 2018.

We do expect to incur certain launch costs and spend additional capital as we begin to ramp production early next year. Despite this, we expect operating margins during the first year of production to be accretive to overall corporate margins, despite the startup costs and the inefficiencies we expect with the early production runs.

Turning to Slide 10 and the SEV segment -- third quarter revenue increased $18.2 million or 59%, to $49 million compared to $30.8 million last year, and reflects a $14.7 million increase or 65.7% increase in motorhome sales as we continue to gain market share in the Class A diesel segment across our product portfolio. The remaining increase is due to contribution from Reach and the F-series production, which Daryl mentioned achieved full run rates late in the quarter.

Adjusted EBITDA for the quarter grew more than 34% or $3.8 million, to $5.1 million or 10.5% of sales from $1.3 million or 4.3% of sales last year. This was driven primarily due to the higher sales volume and improved operational performance. Our backlog experienced strong growth, up more than 58%, to $31.9 million compared to $20.1 million a year ago, and reflects a continued strength in Class A motorhome orders. In fact, year-over-year motorhome backlog is up 63% to $31.2 million as we continue to gain share.

Moving to Slide 11 and the ER segment -- revenue for the quarter was up 56%, to $65.9 million from $42.1 million in the prior quarter. Adjusted EBITDA improved $3.7 million to $2.5 million from an adjusted EBITDA loss of $1.2 million a year ago. Adjusted EBITDA a year ago included a $1.7 million charge for a legacy product recall. And our adjusted EBITDA margin improved 660 basis points to 3.8% of sales for the quarter. The improvement reflects more profitable sales, driven by lower warranty and product quality cost, improved vehicle mix and increased labor, material and manufacturing productivity. We also believe this validates the focus, hard work and execution of the entire Spartan team over the last several years.

Backlog increased more than 42% to $213.3 million compared to a year ago. And our Smeal backlog at the end of the quarter was more than $83 million.

Turning to our balance sheet on Slide 12 -- our earnings growth, combined with the progress we have made in converting working capital to cash, is driving increased liquidity. Total liquidity at September 30 totaled $67.4 million, which reflects $21.9 million of cash on hand and more than $45 million of capacity on our revolver. Sequentially, total liquidity improved approximately $11 million, which continues to increase our overall capacity to pursue future acquisition opportunities.

Please turn to Slide 13, and we'll discuss our outlook for the remainder of 2017. Looking ahead to the fourth quarter, which typically has lower sales lines than the third quarter, we expect to see continued year-over-year sales growth and improved operational performance, which will result in our eighth profitable quarter in a row. We expect to see year-over-year revenue growth, primarily driven by last-mile delivery orders, Class A motorhomes and the production of the new Isuzu S-series.

At this time, I'd like to take a few minutes to discuss the release of our valuation allowance against our deferred tax assets that occurred during the quarter and its impact on the remainder of 2017 and 2018. As background, in the third quarter of 2015, we recorded a valuation allowance against our deferred tax assets, as we determined that it was more likely than not that we would not be able to realize their future tax benefit due to cumulative losses that occurred in prior years.

Since that time, we have performed quarterly reviews to determine whether the valuation allowance continued to be warranted. During the third quarter, we concluded that the valuation allowance was no longer required as a result of our trend in profitability over the last seven quarters, our expectation of significantly higher earnings next year and the acceleration of earnings growth long term. Accordingly, we reversed $6.3 million of the valuation allowance as of September 30.

As a result, our effective tax rate going forward will be more closely aligned with the statutory rate, which will have an impact on our fourth quarter and full year 2018 tax expense. Please note that this change only affects tax expense and adjusted EPS. Our current revenue and adjusted EBITDA guidance remains unchanged, reflecting our strong year-to-date operational performance.

For the remainder of '17, we expect revenue to be in the range of $790 million to [$710] million, adjusted EBITDA to be in the range of $29.3 million to $30.3 million, and a tax benefit recorded in the third quarter, and an expected tax rate of approximately 35% in the fourth quarter; adjusted earnings per share to be in the range of $0.40 to $0.42, which includes the $6.3 million or $0.18 per share valuation allowance adjustment reported in the quarter and includes the impact of the expected fourth quarter income tax expense.

At this point, I'll turn the call back over to Daryl for his closing remarks.

Daryl Adams: Thanks, Rick.

Before I conclude, I'd like to thank the entire Spartan team for their execution and effort in achieving our terrific third quarter results. As we mentioned 3 weeks ago at our Analyst Day and Investor Day in New York, the Emergency Response business turnaround is behind us. We're now focused on sales growth and operational improvements as all three business segments demonstrated this past quarter. This disciplined concentration on sales growth and operational improvement is the underlying foundation to our financial performance as we move forward to accomplish our stated goals of achieving $1 billion in sales and approximately 10% adjusted EBITDA margins by 2020.

Since 2015, we have worked hard to consistently improve and deliver on our commitments. I'm proud to say we've re-earned the confidence of our customers, our employees, our board of directors and our shareholders. Today, I tell you with confidence that we are determined to keep the course and deliver real measurable shareholder returns by accelerated organic growth, making sure it's sustainable for the long term, and aggressively pursuing strategic market expansion and acquisition targets as they present themselves.

Thank you. Operator, we are ready to take questions.

Questions and Answers

Operator: [Operator Instructions]. And the first question comes from Steve Dyer with Craig-Hallum.

Steve Dyer: Thanks. Good morning, guys. First if we could spend a little bit of time on FVS. Rick, you sort of touched on a little bit the cadence of current revenue for the new USPS contract. Could you talk a little bit, I guess as specific as you feel comfortable, about sort of what that means for next year's costs? You talked about some launch costs -- I don't know what's capitalized versus expensed -- and kind of how that all sort of plays into EBITDA next year. Obviously going from, call it, 30 to 100 in 3 years is a steep ramp. But I just want to make sure everybody's expectations are where they should be?

Rick Solm: Yes. So I think what you'll see, Steve, next year is revenue from the contract of somewhere near $80 million. What that means is that 2019 we probably pick up somewhere around $130 million. I think some of the expenses I talked about, there will be some capital. But in terms of expense, there's probably some training costs -- we have cost in bringing on some new employees -- and then maybe some of the efficiencies, and ramping that production. Daryl alluded to the fact that we're looking at where we're going to produce these vehicles. There's a number of options. But we have production facilities located in Ephrata, Pennsylvania, which puts us in a nice location and a good proximity to the East Coast markets and, I think, allows us longer term to invest and make better use of our manufacturing footprint.

Steve Dyer: Got it, okay.

Outside of this contract, your FVS backlog was down a little bit year-over-year. And I know that's a really lumpy business with some nonrecurring stuff. Just wondering if there's anything else to that. Are you being more selective or turning away anything? Is there a capacity issue, or is that just kind of timing of these lumpy orders?

Rick Solm: Yes, unfortunately, Steve, I think it is timing of some of these orders. We have a significant upfit order, which -- over time, we expect some of these customers to come back, it just hasn't happened yet. And that's what I'd attribute to the year-over-year comparison. Walk-in van and truck bodies have a good backlog. But the one order's been difficult to replace.

Steve Dyer: Yes.

And then, just moving to the ER segment -- obviously, really impressive operational turnaround there. Was there anything sort of one-time in the quarter that -- you addressed the profitability a little bit, but are these margins you can build off of in that segment? Or was there sort of anything that tilted it to the better for this quarter?

Rick Solm: Other than -- obviously, these results we're all happy with, they were a little stronger than we expected. I think we got some higher volumes in the third quarter. And as I head into the fourth quarter, I would think volumes may be down sequentially, but nothing out of the ordinary, Steve.

Steve Dyer: All right. I'll hop back in line, thanks.

Operator: And the next question comes from Matt Koranda with Roth Capital.

Matt Koranda: Good morning, guys. Just wanted to start off with the guidance question. The midpoint of your adjusted EBITDA guidance looks unchanged, I think, despite what looks like a pretty strong Emergency Response EBITDA contribution that'll continue to be pretty strong into Q4. And then I think SCV looks like it's firing all cylinders. Does that imply sort of a bit of segment weakness in FVS in Q4 that led you to maintain EBITDA guidance rather than raise it for the year?

Rick Solm: No, I don't know that it implies any weakness there, Matt. Our Reach production run will be completed early in the fourth quarter here, probably over the next few weeks. So, yes, that explains, I think, some of the sequential quarter-over-quarter decline. Sales will probably be off in total about $15 million. But no, we're happy with what we're seeing down in Bristol from operational perspective. And like I just answered with Steve, unfortunately, the orders for the upfit business haven't come back to this point.

Matt Koranda: Got it. Any sense for what's driving that softness in upfit near term?

Rick Solm: Just, like I said, the one order that was significant last year. It's a customer that has been a customer of ours, continues to be a customer, Matt. And I don't think it's a question of if but when we'll see additional orders for that product.

Matt Koranda: Okay. Got it.

Wanted to see if I could attack that USPS contract ramp-up in maybe a little bit of a different way. So the ramp-up, you guys mentioned an impact to margin next year. Just looking historically at sort of where you guys have been in that segment on EBITDA margins in the same timeframe, so in Q2 over the past 3 years, you guys have ranged kind of from 8% to 11.5% EBITDA margins. Would you expect during the initial stages of the ramp-up, maybe Q2, Q3, to kind of be at the low end of that EBITDA range? Is that a fair assumption? Just a little bit of help on sort of the ramp-up would be great.

Rick Solm: Yes, I think Q2 and Q3 of next year will be a little lower. I think our truck body business, if it's in a new location, we expect to benefit from that, as it'll be -- if it's outside of Bristol will be a dedicated facility. But obviously, as we go from, call it, $80 million next year to $130-plus million in '19, we would expect to see a significant improvement in margins year-over-year.

Matt Koranda: Got it.

In ER, I mean, really phenomenal ER margins this quarter, already more than halfway toward the low end of your 6% to 8% EBITDA margin target for the 3 years forward here. Is there any sense for where we improve off of this base for next year? Could you give us a sense for kind of the expected margin improvement in the near term, so that we don't get too far ahead of ourselves in '18?

Rick Solm: Yes, I think third quarter is definitely a high-water mark. We expect the fourth quarter to be profitable as well, as I think we talked about in New York a few weeks ago. The full year of 2018, we would certainly expect to be profitable on a GAAP basis and an adjusted basis. So while third quarter may be a high-water mark, if I look at the full year year-over-year, I would expect 100, 150 basis points at a minimum improvement.

Matt Koranda: Okay, that's helpful.

And then, just last one for me -- I think in the prepared remarks and in the slides, at least, you guys mentioned Smeal coming through with more synergies than anticipated. Any way to quantify that for us? And then, what buckets would those synergies fit into in particular? Is it productivity, is it sourcing? Just a little bit more color on that?

Rick Solm: Yes, I don't know that we've called out the absolute levels of the synergies. But I think a good example, Matt, is what we're seeing -- as we have throttled down our Spartan aerial product, what we're seeing is a lot of acceptance for the Smeal aerial product. So call it a mix, where we've had some of our top dealers having a lot of success selling the Smeal aerial. So I think we should see that continue forward.

And there's also an important part of productivity that we've seen. And we talk about focused factory concept going forward. And I think that helps drive margins longer term.

Matt Koranda: All right, thanks, guys, I'll jump back in queue.

Operator: And the next question comes from Rhem Wood with Seaport Global.

Rhem Wood: So first question, still in the tax rates, we're all on the same page. I think you talked about 35% for the fourth quarter. I'm using 38.5% for 2018. Can you kind of ballpark that, or where you think that might go?

Rick Solm: Yes, Rhem, I mean, there's a statutory federal rate, and then you'll probably look at some state taxes as well. So fully loaded, it's probably somewhere between that 35% and 38%.

Rhem Wood: Okay. All right.

And then, this opportunity in Pennsylvania, can you talk -- I mean, seems like that there's an opportunity to kind of expand your manufacturing facility to get closer to these customers. Can you talk a little bit more about that? And then, what is the likelihood of maybe winning some additional business like that UPS, United States Postal Service business you just won? Do you have the manufacturing capacity now to win additional business, or do you need to expand some? Just can you talk about what your thoughts are there?

Daryl Adams: Sure, Rhem, I'll take that. This is Daryl.

Good question. And I think if you go back to the comment that Rick made, I think, a couple minutes ago about us winding down our Spartan aerial products and moving to the Smeal aerial products, we've talked about that as part of the synergies and the want when we purchased Smeal. What that does is it frees up our Ephrata campus for this truck body build. So that's part of the reason why we're looking at it. It's still under evaluation.

But I think from a capacity standpoint, we're growing sales, we're going to be able to move the truck body out into this location. And it actually turns out to be a really nice location, within 200 miles of the coast. Gives us a lot of East Coast presence that we haven't had from the FVS business segment, which will allow us to potentially build some other products onto that campus as we continue to grow.

So yes, it's a positive in a number of ways, not just after this USPS 2-year run. We're going to have some salespeople out in that area, continuing to try to grow the truck body business. So we see it as a win-win.

Rick Solm: Yes. And the only thing maybe I would add is, if you go back to our Analyst Day presentation, I think Daryl and [Anton Minneman] talked about our truck body business now. We're looking at kind of a 4% market share run. And we've talked about expanding our production footprint over time both to the East Coast and the West Coast, where transportation costs just eat us up.

So I think the investment, if we make it out on the East Coast, it's kind of the first step to being able to grow that truck body market share.

Rhem Wood: Okay, yes, that's good color. And it seems like a big opportunity there for you guys, with maybe a little bit more cost in the first part of '18?

Rick Solm: That's our thinking currently. To convert from an ER plant to a truck body plant, we're going to have to spend some money and invest some capital. But we think there are big opportunities longer term.

Rhem Wood: Okay.

And then, you've got a lot of things going on right now and good internal initiatives in progress. What are your thoughts on M&A right now, and what does your deal pipeline there look like? I mean, what would you be interested in potentially?

Daryl Adams: Yes, Rhem, I'll take it as well. We haven't talked about the number of deals we're looking at. We continue to look at them, evaluate them; very disciplined approach. I think we've talked about this at some of the conferences we've been at. They do need to be accretive. Right? And I think we also said that the ER business would not be of interest.

But any other opportunity, if we're talking fleet vehicles, like we just talked about truck body; van upfit is of interest, something to get us, as Rick mentioned, different footprint that we would have. EV is probably down the road a little bit, but we're looking at EV, and then, if there's something that we could use on the SCV segment. So the two that we're looking at would be fleet vehicle in service and SCV. We're going to let ER continue to digest and work their plant to be more profitable.

I hope that gives you enough color on it. And again, we're not going to list the number of deals we're looking at, because we all know that you get a lot of them, you get one good one.

Rhem Wood: Right, yes, that helps.

Thanks for the time, guys.

Daryl Adams: Thank you.

Rick Solm: [Thank you, Rhem].

Operator: Thank you.

As that was the last question, I do return the call over to management for any closing comments.

Daryl Adams: Thanks, everyone. Thanks for joining us today on our conference call.

We have a couple investor conferences coming up over the next couple weeks, so I'm sure we'll see some of you. And if not, if you're interested, please sign up for one-on-one meetings.

And additionally, have a great holiday. And I think the next time we touch base will be for our fourth quarter earnings, which are scheduled for the end of February, first week of March. So have a good day, and thanks.

Operator: Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.