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Allison Transmission Holdings, Inc. (ALSN)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. Thank you for standing by. Welcome to the Allison Transmission's Fourth Quarter 2022 Earnings Conference Call. My name is Camilla, and I will be your conference call operator today. At this time, all participants are in a listen-only mode. After prepared remarks, Allison Transmission executives will conduct a question-and-answer session. And conference call participants will be given instructions at that time. As a reminder, this conference call is being recorded.

I would now like to turn the conference call over to Jackie Bolles, Executive Director of Treasury and Investor Relations. Please go ahead, Jackie.

Jacalyn C. Bolles
Executive Director-Treasury and Investor Relations, Allison Transmission Holdings, Inc.

Thank you, Camilla. Good afternoon, and thank you for joining us for our fourth quarter 2022 earnings conference call. With me this afternoon are Dave Graziosi, our Chairman and Chief Executive Officer; and Fred Bohley, our Senior Vice President, Chief Financial Officer and Treasurer.

As a reminder, this conference call, webcast, and this afternoon's presentation are available on the Investor Relations section of allisontransmission.com. A replay of this call will be available through February 22.

As noted on Slide 2 of the presentation, many of our remarks today contain forward-looking statements based on current expectations. These forward-looking statements are subject to known and unknown risks, including those set forth in our fourth quarter 2022 earnings, our annual report on Form 10-K for the year ended December 31, 2021, and our quarterly report on Form 10-Q, for the quarter ended March 31, 2022, as well as other general economic factors. Should one or more of these risks or uncertainties materialize, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those that we express today.

In addition, as noted on slide 3 of the presentation, some of our remarks today contain non-GAAP financial measures, as defined by the SEC. You can find reconciliations of the non-GAAP financial measures to the most comparable GAAP measures attached as an appendix to the presentation and to our fourth quarter 2022 earnings press release.

Today's call is set to end at 5:45 PM Eastern Time. In order to maximize participation opportunities on the call, we'll take just one question from each analyst.

Please turn to slide 4 of the presentation for the call agenda. During today's call, Dave Graziosi will review highlights from our full year 2022 results and provide an operational update. Fred Bohley will then review our fourth quarter financial performance and introduce full year 2023 guidance prior to commencing the Q&A.

Now I'll turn the call over to Dave Graziosi.

David S. Graziosi

Chairman & Chief Executive Officer, Allison Transmission Holdings, Inc.

Thank you, Jackie. Good afternoon and thank you for joining us. I would like to start by taking a moment to thank the Allison team and our partners for their dedication and support this year in delivering the Allison Brand Promise. 2022 was a record year for our business, driven by strength in demand in our global On-highway and Off-highway end markets and the continued realization of our growth objectives. We achieved record fourth quarter net sales leading to record full year net sales of $2.8 billion, an increase of 15% from 2021.

As we have consistently demonstrated, our net sales performance was once again surpassed by even stronger growth in net income up 20% and diluted EPS up 34%. Our EPS growth is a testament to not only our operating performance but also our opportunistic capital allocation priorities. During 2022, we repurchased a total of $279 million of shares of our common stock, representing 8% of shares outstanding and ended the year with approximately $1 billion of authorized share repurchase capacity. We remain committed to our capital allocation priorities of generating cash to fund the business, investing for appropriate returns to grow our business, and returning the balance of cash to our shareholders.

In our North America On-highway end market, strong demand and share gains in Class 6, 7, Class 8 straight, and Class 8 day cab markets led to net sales of $1.4 billion, a 15% increase from 2021. We are excited about our recent announcement that the award-winning 3414 Regional Haul Series transmission is now available for order in Daimler Truck North America Class 8, Freightliner Cascadia day cab model paired with a 12-liter natural gas engine from Cummins. The 3414 RHS has become a compelling option for our customers in the Class 8 day cab market. The superior performance and fuel economy, as well as the lightweight durability, enables our customers to reduce their emissions and carbon footprint while maintaining industry-leading performance.

Focusing on our Outside North America On-highway end market, we have made several announcements of partnerships and awards in previous quarters as many of our initiatives in the regions come to fruition. The Outside North America On-highway team achieved record full year net sales of $463 million in 2022. This is an increase of nearly 22% year-over-year and shows impressive growth as the Allison Automatic provides a differentiated value proposition with a proven track record of durability and reliability, which has led OEMs and fleets to make the transition to our products.

I am very proud of the team's success in achieving growth across multiple locations and regions in this end market, specifically in our Europe, Middle East and Africa region, net sales for the year increased 28% from 2021.

This increase was driven by an accelerated market recovery, led by strong sales in vocational trucks and wheeled defense vehicles, which leverage variants of our On-highway products.

In addition, during 2022, we secured new releases with European OEMs for specialty vehicles, for use in fire, refuse, and construction applications, and European and Turkish defense OEMs for wheeled defense programs that we expect will continue to provide revenue growth opportunities over the coming years.

In China, despite their commercial truck and bus market contracting by more than 40% in 2022, Allison realized a 59% increase in net sales, led by strong wide-body mining dump and export bus sales. Our wide-body mining dump initiative in China, which leverages our existing 4000 Series fully automatic transmission, has already received multiple awards and is gaining traction quickly. We estimate that Allison has approximately a 10% share in this new market. Also driving top-line increases in our Outside North America On-highway end market, the South America region saw a 38% increase in net sales year-over-year, led by front engine bus and wheeled defense markets.

Last quarter, we touched on our growing presence in the agriculture sector since our entrance in 2015. As mentioned, leading OEMs in both Argentina and Brazil have selected the Allison 2000 Series and 3000 Series transmissions for use in their agricultural sprayers, due to the enhanced performance in soft soil, which is critical in this application.

Moving on to our Defense end market, last quarter, we announced a contract award of over $6 million from the US Army's Ground Vehicle Systems Center, which is being used to support the design, development, and testing of the newest addition to the eGen portfolio, the eGen Force. As a reminder, the new eGen Force electric hybrid system is designed for 50-ton tracked vehicles and will meet the US Army's optionally manned fighting vehicle requirements and has been selected as the propulsion solution for American Rheinmetall's Lynx vehicle. The eGen Force is scalable to 70-ton tracked vehicles, making it capable of meeting future main battle tank requirements as well.

Late last year, we announced that Allison was awarded a $51 million contract for our X1100-3B1 transmission to support Abrams tanks production for the US Army as well as US allies. The Abrams is the most prevalent main battle tank in the free world, and the recent announcement of defense sales expanding to Taiwan, Australia, and Poland increases its presence to eight US partner nations. The Abrams tank, introduced in the early 1980s, has been the subject of continuous capability improvements throughout its service life.

Similarly, Allison continues to develop innovative enhancements to meet customer demand while ensuring transmission longevity and performance. Allison is proud of its relationships with the US Army and the world's defense vehicle manufacturers. Our internal investments have led to new contracts in the last six months for not only the Abrams, but also the Mobile Protective Fire Power Vehicle, or MPF and the US Army's newest light tank, as well as the M88A3 Hercules Recovery Vehicle, which we expect to drive future revenue growth in the defense end market.

Internationally, we recently announced that Larsen & Toubro selected Allison's proven 3040 MX transmission, which is currently used in the US Army's MPF as the propulsion solution for India's Future Infantry Combat Vehicle or FICV. The FICV is a tracked armored vehicle designed to replace India's fleet of aging BMP infantry fighting vehicles with the Army's – the Indian Army's stated intention to procure approximately 750 (sic) [1,750] FICVs over the next two decades. The FICV is just one of several programs that will continue to support growth in Allison's international defense business.

With geopolitical uncertainties leading to increased defense spending and defense forces now utilizing equipment following a period of idleness due to COVID, as well as new defense production programs launching every year for the next several years, we believe the defense market is entering a period of sustained revenue growth. By delivering record sales and earnings per share in 2022 we also continue to invest in the development of new products and technologies across all of our end markets to drive future revenue growth. Our 2022 results demonstrate the Power of Allison as we continue to take action to realize our growth initiatives and develop the next generation of propulsion solutions that meet the challenges of tomorrow and ensure sustainable growth for our business.

Thank you. And I'll now turn the call over to Fred.

G. Frederick Bohley

Senior Vice President, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

Thank you, Dave. Following Dave's full year 2022 results comments, I'll discuss the Q4 2022 performance summary, key income statement, line items and cash flow. I'll then introduce full year 2023 guidance.

Please turn to slide 5 of the presentation for the Q4 2022 performance summary. Year-over-year net sales increased 11% from the same period in 2021 to a fourth quarter record of $718 million. The increase in year-over-year results was led by a 19% increase in the North American On-highway end market, driven by the continued strength in customer demand for last mile delivery, regional haul and vocational trucks.

Year-over-year results were also improved by a 24% increase in net sales in the Outside North America On-highway end market, leading to record quarterly and full year revenue driven by the continued execution of growth initiatives in Europe, Asia, and South America. Finally, a 9% increase in net sales in the service parts, support equipment, and other end market, principally driven by price increases on certain products, also contributed to the year-over-year increase in Allison's fourth quarter net sales.

Gross profit for the quarter was $338 million, an 11% increase from $305 million for the same period in 2021. The increase was principally driven by price increases on certain products and increased net sales, partially offset by higher direct material cost.

Net income for the quarter was $141 million, compared to $118 million for the same period in 2021. The increase was principally driven by higher gross profit and lower income tax expense, partially offset by higher selling, general and administrative expense.

Adjusted EBITDA for the quarter was $245 million, compared to $220 million for the same period in 2021. The increase was principally driven by higher gross profit. Diluted earnings per share increased 32% to $1.52 from the same period in 2021, driven by higher net income and lower total shares outstanding. A detailed overview of our net sales by end market can be found on slide 7 of the presentation. Please turn to slide – on slide 6 of the presentation.

Please turn to slide 7 of the presentation for the Q4 2022 financial performance summary. Selling, general and administrative expenses increased $18 million from the same period in 2021, principally driven by higher commercial activity spending and increased product and warranty expenses. Engineering, research and development expenses for the quarter were essentially flat from the same period in 2021.

Please turn to slide 8 of the presentation for the Q4 2022 cash flow performance summary. Adjusted free cash flow for the quarter was $132 million, compared to $105 million for the same period in 2021. The increase was driven by higher gross profit and lower operating working capital requirements, partially offset by higher capital expenditures.

During the fourth quarter, we paid a dividend of $0.21 per share and settled $54 million in share repurchases for a total repurchase amount of $279 million in 2022, representing 8% of shares outstanding. Since our IPO in 2012, we've repurchased nearly 60% of shares outstanding. We ended the quarter with a net leverage ratio of 2.4 times, $232 million of cash, and $644 million of available revolving credit facility commitments.

In addition, we continue to maintain a flexible, long-dated, and covenant-lite debt structure with the earliest maturity due in 2026. Of our $2.5 billion in outstanding debt, $625 million is subject to variable interest rates, of which $500 million are hedged, resulting in 95% of our debt being fixed through the third quarter of 2025.

Please turn to slide 9 of the presentation for the 2023 guidance. For 2023, Allison expects net sales to be in the range of $2.825 billion to $2.925 billion, reflecting continued strength in demand in all of our end markets, price increases on certain products, and the continued execution of growth initiatives leading to another record net sales year.

In addition to Allison's 2023 net sales guidance, we anticipate net income in the range of $500 million to $550 million, adjusted EBITDA in the range of $965 million to $1.025 billion, net cash provided by operating activities in the range of $605 million to $665 million, capital expenditures in the range of $125 million to $135 million, and adjusted free cash flow in the range of $480 million to $530 million.

This concludes our prepared remarks. Camilla, please open the call for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Thank you. And our first question is from Jamie Cook with Credit Suisse. Please proceed with your question.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Congrats on a nice quarter. I guess one, can you just talk about what you're seeing from OEs in terms of prioritizing production on medium duty versus heavy-duty because that would obviously be a positive for you on the medium-duty side. And then my second question just Fred, there's quite a lot of variability around your assumptions on incremental margins at the low end and at the high end. So what's sort of embedded in there preventing you from getting to the higher end of your normalized range? Thanks.

David S. Graziosi
Chairman & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Good evening, Jamie. It's Dave. Thank you for the questions. So on your question around the OEMs prioritization, I think as we may have mentioned on some of the calls last year, as you know, OEMs for a number of obvious reasons were favoring higher margin products, if you will. Last year, that also created gaps in terms of supply for medium duty. So the – our feeling is right now, what we're hearing is certainly medium duty we'll see a fair bit of demand this year. And again, I think that's subject to the OEMs having the availability of all the components that they need aligned with those timelines.

You also know there's some seasonality in terms of medium duty production, but certainly our expectation that will – that medium duty side will receive a fairly high level of attention this year. Having said that, certainly with the HD, the heavy duty side, from our perspective, as you know, with our markets heavily oriented towards vocational, we continue to see very strong market conditions in the vocational market as well. So for our purposes, I think it's the guide implies to the comments that were made in the prepared remarks that we're certainly expecting a relatively busy year with well supported from quite a bit of pent up demand in the market.

G. Frederick Bohley
Senior Vice President, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

Yeah, Jamie, and this is Fred. Relative to your question on margins in the guide and the range that we have out there, obviously the demand is there. The real question is, how many vehicles can the OEMs produce? As we've looked at the year, the vast majority of our revenue increase at that midpoint is driven by price. So from a volume standpoint, while there's some lift, the bigger drivers price to offset cost increases that we continue to see. The movement from 2022 to the midpoint 2023, from an EBITDA standpoint is almost exclusively driven by increased gross profit.

At this point, we, from a SG&A and an engineering R&D expense, relatively flat with just a small amount of inflation in those numbers. As to what could drive the variance to those guides. Clearly, the biggest thing is going to be net sales and the industry's ability to ramp-up and meet demand, which has been obviously a challenge all of 2022. I think commodities, we have things modeled relatively flat year-over-year. So definitely movement up or down there could influence the numbers as well.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Operator: Thank you. And our next question is from Tami Zakaria with JPMorgan. Please proceed with your question.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Hi. How are you? Thanks for taking my question. So how should we think about seasonality? This year, should it be similar to 2022 and [indiscernible] (21:21)?

David S. Graziosi
Chairman & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Tami, it's Dave, thank you for the question. The short answer is we don't expect different seasonality than we typically experience in our business. Having made that point, to Fred's comments, we are going to be largely dependent on what the OEMs are able to produce, right? So [indiscernible] (21:46) from – dating from 2020 that carried into 2021 and 2022. From a component availability perspective, we'll obviously react to that.

Our sense is there's a fair bit of scheduling that's going on to align with what's ultimately available to produce vehicles. Subject to that being aligned with plan, as I said, I do not expect a different answer from a seasonality perspective. I would offer, as we think about the year in totality, there are a number of things that can drive the market as well, to Fred's comment, around what can change.

We're certainly positioned to be able to supply if you weight the year overall, the seasonality typically aligns with Q2 and Q3. So we don't expect, again, a different answer there. And then I think a more similar outcome as you get into Q4 on a year-over-year basis.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Got it. That's very helpful. And if I could ask for a quick follow-up, circling back on the EBITDA guide, EBITDA margin guide, I think – and correct me if I'm wrong, it seems like at the midpoint, EBITDA margin is going to be flattish to slightly down this year. And what would really drive that, like should we think about GM rate up due to – gross margin rate up due to price plus tailwind, but more than offset by [ph] SG&A or R (23:16) headwind? What's driving that flattish to slightly down EBITDA margin at the midpoint?

G. Frederick Bohley
Senior Vice President, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

Sure, Tami. This is Fred. When you look at the results, it's really all within gross profit. You've got price and incremental revenue, and we continue to see cost increases from the supply chain and primarily driven by labor inflation. So, we're well ahead of cost. But when you make 45%, 50% gross margins, we're not that far ahead of cost.

So the point is that incremental revenue is slightly dilutive to the gross margins, and EBITDA margin is basically flat year-over-year. But absolute gross margins, gross profit, and EBITDA and cash generation is up, as we have price outrunning the cost increases.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you so much.

Operator: Thank you. And your next question is from Sherif El-Sabbahy with Bank of America. Please proceed with your question.

Sherif El-Sabbahy
Analyst, BofA Securities, Inc.

Q

Hi. Good afternoon. I just wanted to ask, we've seen OEMs and dealers see strong demand from off-highway markets, in particular energy and mining. What are you seeing in your markets that seems to indicate low-single-digit growth over the course of this year?

David S. Graziosi
Chairman & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Hi, Sherif. It's Dave. Thanks, appreciate that question. Really a number of things as we mentioned. If you look at our markets, North America is largely tied to hydraulic frac, as I'm sure you're aware. The stated intention of end users to be very disciplined around capital allocation, and I think that capital allocation being what I would term regulatory considerate, which is when you're being told what your outcome is, what others would like your outcome to be, you're generally going to constrain the capital intensity that you're putting out there.

So, what you're really expecting, what we're expecting and seeing is more sustainment of capacity versus any real additions. And even on a sustainment side, you're not necessarily seeing new rigs being built. What you are seeing is rigs having components replaced. So the net of all of that is, the guide for at least relative to North America frac is more of a holding serve, if you will, from a capacity perspective.

Outside North America is a bit different in terms of the dynamic there, where you had, I think, continue to have a bit of a challenge around meeting demand for equipment. So and that's a market that's still really catching up with itself. So we are expecting stronger demand for both energy and mining construction outside of North America for that Off-highway market.

So and again, I think consistent with the regional issues that you've seen, I think there's been more variability, I would say, in those regions for a number of reasons, really tied to reopenings and closing and reopening and such. So that's a market that's probably not as far down the path as North America in many ways.

Sherif El-Sabbahy
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: [Operator Instructions] There are no further questions at this time. I would like to turn the floor back over to Dave Graziosi, for closing comments.

David S. Graziosi
Chairman & Chief Executive Officer, Allison Transmission Holdings, Inc.

Thank you, Camilla. Well, we'd like to thank all the call participants for dialing in and participating. We certainly appreciate your continued interest in Allison and look forward to our next quarterly call. Enjoy your evening.

Operator: This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation.