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Allison Transmission Holdings, Inc. (ALSN)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and thank you for standing by. Welcome to the Allison Transmission's Fourth Quarter 2023 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. [Operator Instructions]

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

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

Thank you, Camilla. Good afternoon and thank you for joining us for our fourth quarter 2023 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 27. 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 2023 earnings press release and our annual report on Form 10-K for the year ended December 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 2023 earnings press release. Today's call is set to end at 05:45 PM Eastern. 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 2023 results. Fred Bohley will then review our fourth quarter 2023 financial performance and introduce full year 2024 guidance. Dave will then close with an update on recent announcements across our business 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. 2023 finished on a strong note with fourth quarter net sales accelerating 5% sequentially and 8% year-over-year. Fourth quarter increases boosted full year top-line performance to a record $3,035 million, an increase of 10% from 2022. Our top-line performance for the year was driven by robust demand in our North America On-Highway end market up 13% year-over-year, attributed to strength in the Class 8 vocational and medium duty trucks. We hold a favorable outlook for our largest end market into 2024 and beyond, as we believe the market has not fully satisfied pent-up demand, and upcoming emissions changes in 2027 will support our medium duty strength.

Also contributing to our full year performance, we realized an 18% increase year-over-year in our service parts, support equipment and other end market leading to record annual revenue of nearly $700 million. We expect continued strength in our aftermarket business driven by aging fleets and increased demand for Allison genuine service parts as warranties for units from high volume production years in 2018 and 2019 expire. Continuing with our full year 2023 performance, we are pleased with our team's commitment to controlling cost in an inflationary environment and expanding margin while increasing our earnings power. Adjusted EBITDA increased to $1,108 million for 2023, with adjusted EBITDA margin expanding 180 basis points from 2022.

Net income increased 27% year-over-year to $673 million. Finally, we achieved full year record diluted EPS of $7.40, up 34% from 2022. As we increase earnings while reducing share count through our capital allocation priorities, we expect to further improve our per share performance while funding the business for growth and returning capital to shareholders through our quarterly dividend and share repurchase program. In the fourth quarter of 2023, we repurchased over $100 million worth of our shares, bringing the total for 2023 to over $260 million and ending the year with almost $800 million of authorized share repurchase capacity remaining. Shares repurchased in 2023 represent nearly 6% of outstanding shares, with over 63% (sic) [62%] of our outstanding shares repurchased since our IPO in 2012.

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 2023 results comments, I'll discuss the Q4 2023 performance summary and the Q4 2023 cash flow performance. I will then introduce full year 2024 guidance. Please turn to slide 5 of the presentation for the Q4 2023 performance summary. Year-over-year net sales increased 8% from the same period in 2022 to a fourth quarter record of $775 million. The increase in year-over-year results was led by a 14% increase in the North American On-Highway end market due to continued strength in demand for Class

8 vocational and medium duty trucks, and a 34% increase in net sales in the Defense end market, principally driven by increased demand for Tracked and Wheeled vehicle applications.

Year-over-year results were also improved by 31% increase in net sales in the Outside North America Off-Highway end market, principally driven by higher demand in the mining sector. Gross profit for the quarter was $371 million, a 10% increase from $338 million for the same period in 2022. The increase was principally driven by increased net sales and price increases on certain products, partially offset by higher direct material cost. Net income for the quarter was $170 million, an increase of 21% from $141 million for the same period in 2022. The increase was principally driven by higher gross profit. Adjusted EBITDA for the quarter was $277 million, compared to $245 million for the same period in 2022. The increase was principally driven by higher gross profit.

Diluted earnings per share increased 26% to $1.91 from the same period in 2022, driven by higher net income and lower total shares outstanding. A detailed overview of our net sales by end market in Q4 2023 financial performance can be found on slides 6 and 7 of the presentation. I'll now turn to slide 8 of the presentation for the Q4 2023 cash flow performance summary. Adjusted free cash flow for the quarter was $186 million compared to $132 million for the same period in 2022. The increase was principally driven by lower capital expenditures, higher gross profit and lower operating working capital funding requirements. During the fourth quarter, we paid a dividend of $0.23 per share and repurchased $105 million of our common stock.

We ended the quarter with a net leverage ratio of 1.8 times, $555 million of cash and $645 million of available revolving credit facility commitments. In addition, we continued to maintain a flexible, long dated and covenant light debt structure. Of our $2.5 billion of outstanding debt, $618 million is subject to variable interest rates, of which $500 million is 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 2024 guidance. For 2024, Allison expects net sales to be in the range of $3,050 million to $3,150 million. We're guiding to another record net sales year.

In addition to Allison's 2024 net sales guidance, we anticipate net income in the range of $635 million to $685 million, adjusted EBITDA in the range of $1,070 million to $1,130 million, net cash provided by operating activities in the range of $700 million to $760 million, capital expenditures in the range of $125 million to $135 million, and adjusted free cash flow in the range of $575 million to $625 million.

Thank you. And I'll now turn the call back over to Dave for an update on recent announcements.

David S. Graziosi

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

Thank you, Fred. The 2024 outlook for our North America On-Highway end market remains robust as infrastructure spending is expected to continue to support Class 8 vocational demand. Last month we made two notable announcements related to this end market. First, we were pleased to announce that our $100 million incremental annual revenue opportunity in the Class 8 regional haul and day cab market continues to progress as one of the largest global logistics and delivery companies has specified Allison's 3414 Regional Haul Series as the propulsion solution of choice. The global logistics and delivery company is purchasing Freightliner Cascadia CNG tractors equipped with Allison's 3414 RHS for their fleet.

Last year, Daimler released our 3414 RHS paired with a CNG engine into their Freightliner Cascadia Day Cab tractor, highlighting the benefits of our new product and the fuel agnostic nature of Allison's conventional transmissions. Second, in our North America On-Highway end market, we were pleased to announce that Allison was selected as the exclusive electric axle supplier for Oshkosh Corporation's new fully integrated, electric refuse collection vehicle. Allison's eGen Power 100S has been integrated into Oshkosh's vocational truck, specifically designed for the waste management industry in order to minimize environmental impact and reduce noise. The electric refuse collection vehicle or eRCV will utilize two Allison eGen Power 100S e-Axles in tandem configuration, while delivering cleaner air and quieter operation where deployed.

Allison is already the established propulsion leader in the North America refuse market, and we look forward to maintaining our leadership position now and into the future. Our Outside North America On-Highway end market is expected to have another record year in 2024, with revenue guidance up 14% year-over-year at the mid-point. After a record year in 2023, we anticipate continued strength driven by the execution of our growth initiatives. Last month we announced a strategic partnership agreement with SANY, a global heavy equipment manufacturer for mining and construction markets. Through the partnership, Allison will supply its family of Off Road Series and Wide Body Dump Series transmissions for integration into mining vehicles, including the next generation SANY SKT105 wide body mining dump.

This partnership will support Allison's $100 million incremental annual revenue opportunity and strategically aligns with our efforts to grow share in the mining dump market in Africa, Asia and South America as part of our Outside North America On-Highway growth initiative. For our Defense end market, the fourth quarter was a decade high quarter with revenue of $63 million, full year revenue of $166 million, an increase of 14% from 2022 was a solid start toward achieving our $100 million growth initiative. We expect continued growth in this end market in 2024 as we capitalize on the Defense upcycle, both internationally through our increased defense investments globally amidst geopolitical uncertainties, and domestically through our opportunities with the United States modernization programs, as well as increased international sales through the US Department of Defense.

Allison remains committed to investing in and pursuing growth in our Defense end market, leveraging our asset light business and longstanding relationships with defense OEMs as a competitive advantage. We are realizing our investments and are poised for success with a well-rounded portfolio of products to satisfy the needs and demands of global defense customers. Today, I would like to highlight the recent announcement that Allison was awarded over $83 million to provide upgraded and new X1100 transmissions supporting Abrams Main Battle Tank variants used by the US Army, as well as Foreign Military Sales or FMS customers. Allison has long supported the US Army and its close partners, and is proud to be part of the world's premier main battle tank. We look forward to continuing our partnerships in support of these customers in the decades to come.

In addition to the announcements we have made in our Defense end market over the last few years, we are looking forward to a pipeline of programs in the near future, particularly in global Wheeled applications. These programs will drive further growth in our Defense end market, and we look forward to updating you as timelines advance. Moving on, in late January we announced the launch of Allison Ventures, our new venture capital arm. Allison Ventures will strategically invest in and partner with startup and growth stage companies to foster advancements in commercial duty, mobility and work solutions. The Allison Ventures team is focused on increasing our innovation pipeline in support of our industry technology advancement and expanding our global strategy in evolving the mobility market. We look forward to investing in technologies to grow our portfolio and further our mission to improve the way the world works.

In closing, 2023 was a solid year of top-line records and margin expansion, while returning capital to shareholders. We continue to invest in the development of new products and technologies across all of our end markets in order to drive growth. Our 2023 results and future outlook demonstrate the power of Allison as we continue to make strides forward 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.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Rob Wertheimer with Melius Research. Please proceed with your question.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Thank you. Good evening, everybody. So my question was going to be on North America On-Highway just to start with. We saw Cummins guide on medium duty sort of flat to down 5%. So in line with what you did. I don't think we have a great look in the Class 8 straight. And I'm just curious about how you're seeing those markets and whether the outlook is in line with current production, in line with first half builds, or whether it assumes an acceleration or deceleration from what you see in your current order book. Thank you.

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

A

Hey, Rob. It's Dave. So a couple of things there. So medium duty to start with, we certainly had a strong result in 2023. As we mentioned in the prepared remarks, it's a space that continues to be in what we refer to as catch-up mode, some fleets are in better shape than others, but I would say overall, it continues to be a market that has fairly healthy demand. We talk about the Class 8 straight truck or vocational, as we refer to, that's been relatively unsupplied, I think as you know, a number of constraints based on the public comments by the OEMs. I think that's relatively consistent with what you're hearing from them as well.

So I think, that was a focal point for many coming into the latter part of 2023, and certainly as 2024 starting, it's also typically a seasonally strong portion of the year for vocational anyway. So I think that emphasis is expected to carry through for a good portion of 2024. To your question on timing, again, I think that's largely going to be dependent on the availability for all the components to make the trucks. As we talked about, it takes all of them to deliver a complete vehicle. And I think that's one particular attribute, as you think about trying to understand how the year is going to play out, whether the supply base is really capable of performing and ultimately delivering. So everything we're hearing is certainly strong demand, as I said, for Class 8 vocational with the intentions of OEMs to supply that demand. So we stand ready to do that and certainly prepared to support the industry as best we can.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Okay. Thank you.

Operator: Our next question comes from the line of Ian Zaffino with Oppenheimer. Please proceed with your question.

Isaac Sellhausen
Analyst, Oppenheimer & Co., Inc.

Q

Hey, good afternoon. This is Isaac Sellhausen on for Ian. Congrats on a really strong quarter and year. Can you help us understand the expectations for volume and price mix maybe in North America On-Highway for the year? Where do we stand on pricing as we start this year and your expectations sort of implied in guidance? Thanks.

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

A

Hi. This is Fred. Relative to pricing, and I mean, to start really with 2023, we actually realized 540 basis points of price on a year-over-year basis and $155 million of price. That was really up from our initial guidance assumption which was $400 million (sic) [400 basis points]. So we continue to – as we progressed through 2023 to pursue price. Look, if you take that and you couple that with what we did in 2022, we've realized in 24 months $275 million of price or a 1,000 basis points of price. As we are looking at 2024, we're currently anticipating approximately 200 basis points of price. I think, as most of you're aware, over 90% of our North America On-Highway end market, our largest end market is covered by long-term agreements with defined pricing.

So as we progress through these really high inflationary times, we've certainly honored those agreements. But looking out to 2025, over 60% of the North America On-Highway end market will be available to price. So as we've mentioned in previous earnings calls, yes, OEM prices increase, our value proposition to the end user continues to increase, the vehicle prices continue to increase, whether that's inflationary cost pressure or outside North America moving up the emissions curve and adding safety features. We are really well-positioned to both take advantage of this from a pricing standpoint, but also from a market share standpoint.

Isaac Sellhausen
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. Thank you very much.

Operator: Our next question comes from the line of Tami Zakaria with JPMorgan. Please proceed with your question.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Hi. Good afternoon. How are you? So my question is around the off-highway market. I think the growth expectations in North America versus outside North America for the market is pretty, difference wise, one positive, one negative. So just wanted to understand what's driving those expectations for each of those end markets.

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

A

Tami, it's Dave. I appreciate the question there. So take the regions, North America first. As you know, North America's off-highway is largely a energy market. As we mentioned, I think certainly second half last year with the continued capital discipline, which is, we would view as very much regulatory and capital markets considerate by end users. And generally, I think the energy space, what you are seeing is a continued high level of capital discipline to maximize cash flow and returns. Commodity prices are obviously supportive. As we talked about, we view the market as relatively well equipped and capacitized, new rig builds we saw on the conventional side very limited at this point. So you're seeing some level of refurbs, some new components going into that particular market. But from our perspective, very well supplied. And again, as we talked about second half of last year, with that as a backdrop, not expecting much in terms of increased demand there until there's a higher level of equipment that's consumed, frankly, which is still in front of us. But in this medium term, really look at largely a refurb replacement type of market.

Outside North America for us is a combination of energy and mining, construction, hauling, et cetera. That continues to be a relatively busy market coming into the second half of last year and certainly fourth quarter.

There were some challenges out there in terms of executing against some tenders by the OEMs. So if you think about that in terms of what's actually happening in the underlying market, trying to catch up with some level of demand there. So that's an aspect of 2024 as we start the year. And again, I think, the general overall market, macro conditions for our Outside North America Off-Highway business can continue to be relatively strong. So we'll do our best again to supply, I think, some of that though it gets back to ultimately the broader industry's capability in terms of total component supply, meeting demand from a time perspective. So again, we'll do our best, but we still see that as a relatively strong market.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

Operator: Thank you. Our next question comes from the line of Angel Castillo with Morgan Stanley. Please proceed with your question.

Angel O. Castillo
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks for taking my question. Just wanted to get a little bit more color. You talked about the 200 basis points of price. If you could just kind of walk that through and maybe more sort of the price cost dynamic and what you kind of anticipate from a margin standpoint, then maybe continuing to follow that through the financial statements, you have growth in at the sales level, but ultimately net income comes down and free cash flow seems a little bit lower year-over-year. So could you just help us understand the puts and takes that are ultimately kind of impacting each of those pieces?

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

A

Sure. Angel, this is Fred. From a cost standpoint, our 2024 guide does reflect the increased cost associated with the new UAW collective bargaining agreement with the majority of those incremental costs associated with the new labor agreement being incurred in 2024. Also, from a material cost standpoint, we are anticipating higher material costs, principally driven by increased value-add in our supply chain, and that's really as a result of increased labor cost within our supply chain. So those are the two primary drivers from a cost standpoint. As you mentioned, price, we're modeling a couple of hundred basis points of price and have EBITDA basically flat on a year-over-year basis.

Operator: Our next question comes from the line of Tim Thein with Citi. Please proceed with your question.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Good afternoon. Fred, I just want to go back to a comment you made earlier about, I think you said 65% of the North American LTSAs will come up for renewal. From memory that's a much bigger percentage than what I recall it, they tend to be more staggered. But from a timing perspective, it's also interesting that it's coming on the front end or leading up to potentially one of the larger percentage increases in terms of what the vehicle costs are set to increase just given the emissions. So I guess, it's just how you're approaching that, your vehicles and what your transmissions hurt, being put into are set to increase pretty significantly. So how might that increase or kind of influence how you approach, I guess, those negotiations?

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

Yeah. Tim, this is Fred. So you did hear me correctly. So over 60% of the book of business for North America On-Highway end market, which is obviously our largest end market, over 50% of our revenue will be available for price. And there's a reason obviously called that out, well, they've been relatively consistent in the way they've been staggered. They're typically four to five years in nature. There are more that will be negotiated in the second half of 2024 for pricing in 2025. To your comments relative to where the market is, where the cost of vehicles are, is certainly something that we pay close attention to. Ultimately, we price our product for the value that it delivers in the market.

And as we, I think on three or four earnings calls in a row highlighted, that value that we deliver is up significantly because the price of the vehicles are up, and our transmissions, our products make those vehicles run more efficiently. You get more work done in a day to get from point A to B, you don't have the maintenance cost, so you save on maintenance cost, but you don't have the downtime, it's a lot easier to train drivers, retain drivers in a tough labor market, and ultimately, you can size fewer vehicles in your fleet. So we definitely believe that we're in a position where we have a significant amount of pricing power, and that will be taken into consideration as we negotiate new long-term agreements.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.
Q

All right. Thank you, Fred.

Operator: Thank you. Our next question comes from the line of Jerry Revich with Goldman Sachs. Please proceed with your question.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Yes, hi. Good afternoon, everyone. I'm wondering, Fred, if you could just say more about the margin outlook for 2024. Generally, at the mid-point of sales and EBITDA outlook, you're looking for, I mean, we're pretty close to flattish margins. You spoke about the price assumptions. Can you just flesh out the other moving pieces? And if you folks were to surprise the upside, what would those levers look like?

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

Sure. Jerry, this is Fred again. Really walking through from an engineering SG&A standpoint, flat to slightly up with just some inflationary pressures, I think to the upside, and I think this gets to Dave's comments earlier, the demand is really strong. We're still in this situation where, can the entire vehicle supply chain get the proper parts to the OEMs to build, clearly they're building less over the road tractors and are focused on building where they have strong demand which fortunately for us is right in the middle of our core addressable market, medium duty Class 8 straight truck. So I think the upside to margins will be stronger top-line revenue. And as you know, we have very, very attractive incremental margins. So that's what will drive the upside. That's unfortunately not entirely in our control. We'll control what we can and will be positioned to supply our products. But that that's the biggest upside in the guide that we put in front of you guys today.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC
Q

Thanks.

Operator: Our next question comes from the line of Tim Thein with Citi. Please proceed with your question.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

All right. [ph] Thanks (32:48), and again a two for one here. Maybe I'll just ask just Fred, and from the standpoint of product mix and with Defense seeing another outsized growth year, that that business can carry, the margin dynamics can be quite varied depending on whether to be selling to the DoD or international customers. So maybe just a word in terms of how that – is that historically, a lot of that, I guess, more so on the Wheeled or on the Tracked side would be a headwind to margins. But just how are we thinking about the impact from this big growth in Defense and the implications just in terms of the overall impact to mix? Thank you.

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

A

Yeah. Tim, thanks. This is Fred. As you mentioned, we do have Defense guided up at a mid-point 34%. And historically, our Defense business, especially our Tracked defense to the US government has been our lowest margin business, cost plus fixed fee. But as we've continued to expand the business, over half of that Tracked business is being driven by outside North American sales, where it's really a commercial negotiation. So as we look at that increased 34%, certainly don't expect it to be a negative drag on EBITDA margins.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thank you, Fred.

Operator: Thank you. There are no further questions at this time. And I'd like to turn the floor back over to Chairman and CEO, Dave Graziosi for closing comments.

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

Thank you, Camilla. Thank you for your continued interest in Allison and for participating on today's call. Enjoy your evening.

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