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Allison Transmission Holdings, Inc. (ALSN)

Q3 2023 Earnings Call

CORPORATE PARTICIPANTS

Jacalyn C. Bolles
Executive Director, Treasury & Head-IR, Allison Transmission Holdings, Inc.

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

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

OTHER PARTICIPANTS

Lawrence T. De Maria
Analyst, William Blair & Co. LLC

Rob Wertheimer
Analyst, Melius Research LLC

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

Isaac Sellhausen
Analyst, Oppenheimer & Co., Inc.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. Thank you for standing by. Welcome to Allison Transmission's Third Quarter 2023 Earnings Conference Call. My name is Alicia, and I'll be your conference call operator today. At this time, participants are in a listen-only mode. After prepared remarks, Allison Transmission's 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 call over to Jackie Bolles, Executive Director of Treasury and Investor Relations. Please go ahead, Jackie.

Jacalyn C. Bolles

Executive Director, Treasury & Head-IR, Allison Transmission Holdings, Inc.

Thank you, Alicia. Good afternoon and thank you for joining us for our third 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 November 8.

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 third quarter 2023 earnings press release, our Annual Report on Form 10-K for the year ended December 31, 2022 and 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 third quarter 2023 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 third quarter 2023 results and provide an update on recent announcements across our product portfolio. Fred Bohley will then review our third quarter financial performance and the full-year 2023 guidance. Dave will close with the review of our wide-body mining dump and defense end market growth opportunity 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.

During the third quarter, net sales increased 4% year-over-year to $736 million. Sales gained momentum throughout the quarter after a slow start, driven by supply chain constraints and expanded OEM shutdowns in July, resulting in August and September sales volumes above monthly levels in the first half of the year. Net sales growth was outperformed by growth in net income up 14% and diluted EPS up 21% to $1.76.

Furthermore, our team's efforts towards price realization and cost mitigation drove gross margin expansion of 230 basis points year-over-year. Our capital investments continue to fund the ongoing expansion of our technology capabilities, as well as product development focused on value propositions that address the challenges of our evolving end markets. These next-generation initiatives, along with the various financial, operational and strategic milestones that we have achieved over the last several years, demonstrate the power of Allison to capitalize on market opportunities with new products to drive innovation and growth and create value for all of our stakeholders.

The next-generation initiatives also underscore our dedication to remain a leader in propulsion solutions across all of the end markets we serve and are instrumental to driving future growth. Allison is committed to offering a portfolio of conventional electric hybrid and fully electric propulsion solutions designed to meet the needs of customers.

Today, I would like to highlight recent announcements across our On-Highway product portfolio. Starting with alternative fuel sources for our conventional products, in the quarter, we announced our currently exclusive release with Mack Trucks for their compressed natural gas-powered Granite model truck. To meet the need of refuse collection customers, Allison's proven 4000 Series transmission was seamlessly paired with a CNG engine. This partnership is the latest example of Allison's ability to deliver optimized performance and capability in demanding locations indifferent to the fuel source for the powertrain.

Moving forward with Allison's transit hybrid offering, our eGen Flex system, adding to the many nationwide releases we have highlighted in recent quarters, we are pleased to announce earlier this month that the B-Metro, the public transit system in Brownsville, Texas, has chosen to equip their buses with the Allison eGen Flex system. Brownsville joins the growing list of transit properties in states such as Indiana, Wisconsin, Nevada and California that will utilize the eGen Flex electric-only capabilities, activated by geofencing technology to automatically switch to engine off mode in densely populated areas of the city. We are excited for this partnership and remain committed to collaborating with transit agencies nationwide to support them in their emissions reduction goals.

Wrapping up with our eGen Power of fully electric e-Axles, we were excited to launch the eGen Power 85S, the newest addition to the eGen Power family. Partnering with Anadolu Isuzu, the 85S was integrated into a fully electric 8-meter midi bus and released at Busworld Europe in early October. The eGen Power 85S was specifically developed to address the needs of midi bus and small truck applications and joins the larger 100S and 130S in the single motor eGen Power e-Axle family. The introduction of the 85S is the latest example of Allison's commitment to expanding our propulsion solution portfolio to meet the demands of the wide range of applications and market segments we serve.

In summary, Allison's third quarter results demonstrate strong operating performance with the business well positioned across our fuel sourcing different product portfolio. Our products have been developed to support our customers' needs as they adopt to different technology sources and driving future growth across 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 third quarter 2023 comments, I'll discuss the Q3 2023 performance summary and the Q3 2023 cash flow performance. I'll then reaffirm the full year 2023 guidance.

Please turn to slide 5 of the presentation for the Q3 2023 performance summary. Third quarter net sales increased 4% from the same period in 2022 to $736 million. The increase in year-over-year results was led by a $36 million increase in net sales in the North American On-Highway end market, principally driven by strengthened customer demand for Class 8 vocational and medium duty trucks and price increases on certain products, and a $14 million increase in the service parts support equipment and other end market, principally driven by strength in North American On-Highway service parts and support equipment and price increases on certain products.

Year-over-year results were also improved by an $8 million increase in the net sales in the defense end market, principally driven by increased demand for tracked and wheeled vehicle applications.

Gross profit for the quarter was $357 million, an increase of $29 million from $328 million for the same period in 2022. The increase was principally driven by price increases on certain products, partially offset by higher manufacturing expense. Net income for the quarter was a $158 million, compared to $139 million from the same period in 2022. The increase was principally driven by higher gross profit, partially offset by increased selling, general and administrative expense. Adjusted EBITDA for the quarter was $267 million compared to $245 million for the same period in 2022. The increase was principally driven by higher gross profit, partially offset by increased selling, general and administrative expenses.

Diluted earnings per share increased 21% from the same period in 2022. Third quarter diluted EPS of $1.76 was driven by higher net income and lower total shares outstanding. A detailed overview of our net sales by end market and Q3 2023 financial performance can be found on slide 6 and 7 of the presentation.

Please turn to slide 8 of the presentation for the Q3 2023 cash flow performance summary. Adjusted free cash flow for the quarter was $182 million flat from the same period in 2022, driven by increased net cash provided by operating activities offset by increased capital expenditures. During the third quarter, we returned capital to shareholders through a quarterly dividend of $0.23 per share. We also repurchased $20 million of our common stock, with nearly 4% of our shares outstanding repurchased in the first three quarters of 2023.

Since our IPO in 2012, we have repurchased over 60% of our outstanding shares. We ended the quarter with a net leverage ratio of 1.9 times, $501 million of cash and $645 million of available revolving credit facility commitment. In addition, we continue to maintain a flexible, long dated and covenant light debt structure with the earliest maturities due in 2026. Of our $2.5 billion of outstanding debt, $620 million is subject to variable interest rates, of which $500 million is hedged, resulting in 95% of our debt being fixed to the third quarter of 2025.

Please turn to slide 9 of the presentation to review our 2023 guidance. Given third quarter results and current end market conditions, we are reaffirming our full year 2023 guidance provided to the market on July 27, 2023. Allison expects net sales to be in the range of $2.96 billion to $3.04 billion. At the midpoint, this represents over 8% year-over-year growth based on the continued strength in demand in the majority of our end markets, price increases on certain products and the continued execution of our growth initiatives, leading to another anticipated record net sales year.

In addition to Allison's 2023 net sales guidance, we anticipate net income in the range of $575 million to $625 million, adjusted EBITDA in the range of $1.05 billion to $1.11 billion, net cash provided by operating activity in the range of $675 million to $725 million, and capital expenditures in the range of a $125 million to $135 million, and adjusted free cash flow in the range of $550 million to $590 million.

Thank you. And I'll now turn the call over to Dave for an update on our wide body mining dump and defense end market opportunities.

David S. Graziosi

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

Thank you, Fred. During the quarter, we announced that several Chinese mining equipment manufacturers have expanded their exports of wide body mining dump trucks equipped with Allison Transmissions to the Americas, Asia and the Middle East increasing export opportunities for wide body mining dump trucks was one factor that led to our resizing of the opportunity to a $100 million of annual incremental revenue during the first quarter. Our longstanding partnerships with major mining OEMs in China continue to lead to further global penetration in this vocation.

Allison is growing our international defense business through partnerships with global defense OEMs such as Hanwha Aerospace with utilization of Allison products not only in South Korea but in various tracked and wheeled applications for customers around the world. Last week, we announced that our Allison X1100 cross-drive transmission was selected as the propulsion solution for the Hanwha Redback armored vehicle. The Redback is Hanwha's newest tracked vehicle chosen to be Australia's infantry fighting vehicle of the future and selected for Australia's Land 400 Phase 3 program. The Redback strives to duplicate the success of Hanwha's K9 self-propelled howitzer family of vehicles, which has been chosen for numerous European, Asian and North African programs utilizing the Allison X1100.

During the quarter, Allison was awarded a $13 million second phase low rate initial production contract for the US Army's M10 Booker light tank program, formerly the MPF. We look forward to ramping into higher production volumes with the M10 Booker utilizing Allison's new 3040 MX medium weight cross-drive transmission. Development of new products such as the 3040 MX will drive international growth in the near future as the demand for medium weight armored combat vehicles increases with shifts in geopolitical dynamics.

Also during the quarter, Allison signed a memorandum of understanding with PGZ, a Polish defense holding group and one of the largest defense companies in Europe. The MOU includes cooperation on tracked vehicle programs, as well as partnership to provide service and repair in Poland adding to Allison's network of authorized dealers and distributors. Poland has contracted to purchase several hundred Abrams tanks, as well as hundreds of Hanwha's K9 howitzers using Allison products. The PGZ has also recently been awarded a contract for over 1,000 [indiscernible] (00:14:58) infantry fighting vehicles. This partnership will further Allison's relationships with global defense industry participants and advance the realization of our $100 million incremental annual revenue opportunity.

This concludes our prepared remarks. Alicia, 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] Our first question comes from the line of Larry De Maria with William Blair. Please proceed with your question.

Lawrence T. De Maria
Analyst, William Blair & Co. LLC

Q

Hi. Thanks. Good afternoon, everybody. And thanks for all the color on the mining stuff. A question, you had very strong operating performance in the quarter, especially the margins. The sales were a little bit below. But you noted you had a slow start on supply chain. So, to clarify that, did you catch up throughout the quarter? Were there some more wood to chop that goes into the fourth quarter?

And the second part is, can you describe the UAW situation both upstream, downstream and how that's implied in the guidance for the rest of the year, whether that becomes an issue or not? Thank you.

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

A

Larry, it's Dave. Good afternoon. And I appreciate the questions. On your first question, in terms of the activity that we saw in the third quarter. The slow start really referred to component constraints at the OEM level. So as we entered our expectation was more of a normal run rate, frankly, for July, that proves to be a bit disconnected from what the OEMs were experiencing.

I would refer you to the OEMs that have publicly reported already in terms of some of their commentary around the constraints that unfortunately they were dealing with, and we reacted accordingly. As we noted in the prepared remarks, certainly August and September run rate at a higher level or more consistent with what we saw in the second quarter. So in terms of carryover into the fourth quarter, obviously, as our midpoint implies, which is a lack of change in the midpoint, we see a number of activities happening in the fourth quarter. Some of that will be some level of carryover, at least expectation that constraints will be mitigated a bit. So and I think again, referring you back to the public comments of OEMs, I think that's consistent with some of the comments that they've made as well.

So in terms of your question on the UAW negotiations, Allison is certainly committed to providing competitive wages and benefits to all our employees, which includes those represented by the United Auto Workers. A team of Allison Management and UAW Local 933 leaders have begun discussions at an offsite location. The company is focused on negotiating agreement that creates flexibility, simplicity and efficiency. This focus allows us to continue to provide the highest quality product to all of our current and future customers.

In terms of the activities that are going on with the automakers, I would just offer that, and I'm sure you know, at Allison, our UAW-represented employees have a labor contract that is unique to our organization and negotiated separately from the contracts of the Big Three, so to speak. So, as such, the UAW strike affecting the Big Three does not have any direct impact on our local operations.

Lawrence T. De Maria
Analyst, William Blair & Co. LLC
Q

Thank you very much.

Operator: Thank you. Our next question comes from the line of Rob Wertheimer with Melius Research. I apologize.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Not that bad. Hi. Thank you. So I know it's not your biggest business, but the reasonably sharp decline in Off-Highway, both domestically and international, was a bit of a surprise. Your slides called out, I guess, energy, and I'm just curious what happened there. I don't quite know your mix within those segments if it's just energy or if there's anything construction, mining that [indiscernible] (00:20:07). And I don't know if that's a synchronous or a coincidental decline because I assume the international is more China gas fracking. Anyway, could you maybe just elucidate what happened there?

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

Rob, it's Dave. So a few things, just a little context. The Off-Highway business by definition is probably one of our more volatile end markets, and history has certainly proven that. As we entered this year, our expectation was certainly more of a stable setting in terms of players, especially within the North America energy market. I think, as you know, there's been a number of transactions that have been announced that was certainly not part of our plan coming into the year. That has naturally led to a reconsideration of those impacted players. And I would say the broader industry around fleet sizing, capital deployment as well as replenishment. So we're seeing some of that frankly play that way.

The market, North America, I think, as you well know, is largely an energy market for us. So the other thing that continues is the high level of capital discipline within that particular end market and the increased cost to cap has certainly proven that out as the players continue to focus on cash flow and return on their operations, and frankly, margins. So we would expect that situation to play out near to medium term. Our sense is the fleets are pretty well equipped at this point. They've done a number of refurb projects. Some of that has been led into some new unit sales. But our sense is that there's adequate amount of equipment when you look at supply demand balance. And I think service companies will naturally try to maintain that balance.

Outside North America, that portfolio is more evenly split between energy and mining construction, hauling, if you will. So that portfolio continues to evolve well, in our prepared remarks referring to the wide body mining dump, I would say to my comment in terms of one of our more volatile end markets, some of that activity is really tied to tenders that are being executed by the vehicle OEM. So to the extent that there are occurring on time or the buyers are actually executing the tenders, that really drives the – obviously the volume through our side, where our experience at least entering the fourth quarter and a portion of the third quarter was some of those tenders getting pushed a bit.

So we'll be revisiting all of that as you would expect as part of our 2024 guidance in the first quarter. But it's something we're obviously staying close to from a volume and timing expectation.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Perfect. And if I can just ask one that matters more, I guess, vocational and medium duty outlook, or customer orders or your impression of the current state of the market there? I don't suppose it's experiencing the kind of weakness you might see in the On-Highway freight-heavy haul side. But just to make sure that that still looks on track. I'll stop here.

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

We wouldn't disagree with your assessment there. I think it's – we're fortunate with the – our portfolio as you well know, being weighted in medium duty as well as vocational and municipal as well. But those markets continue to hold up. Well, again, the public comments by the OEMs, the references back to some continued gaps in what fleets are looking for from a replacement perspective. And I think the industry is still trying to catch up a bit. The average age of vehicles continues to increase. So, we're following that trend, but we – as you mentioned, continue to see a pretty firm market for medium duty as well as Class 8 vocational. And I think as again, public comments by the OEMs are consistent in that view.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Thank you.

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

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

Thanks. Good evening. The question, Dave, is – or Fred, is just on pricing. I think the expectation for the year was maybe just under 500 basis points of price capture for this year. Is that still the expectation? And then just to continue on your – on that last thread in terms of what the OEM seem to be signaling in terms of relative strength in the On-Highway markets, most important to you, especially in the vocational segment and I think some have communicated, at least their attempts, initial attempts for price increases in 2024. How do you think Allison fares in that kind of backdrop should that hold? Thank you.

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

A

Hey, Tim. This is Fred. From a pricing standpoint, it was another strong quarter from a pricing standpoint. As you know, we passed on pricing throughout 2022. So the comps become difficult as we progress through the year. But over $30 million in price plus the 470 basis points in the quarter, revenue really up about 400 basis points. So you're really looking at price driving the revenue performance. I said what's encouraging about that is on fairly constant volume. Our gross margins are up 230 basis points, EBITDA margin is up 180 basis points. So we're in a situation where we clearly have price outrunning cost and you're seeing those really drop through from a margin standpoint.

For the full year, we're still tracking to that, that total, 500 basis points, roughly a $150 million in price realization on a year-over-year basis, and relative to 2024 as we've talked about on numerous calls, as the vehicles continue to increase in price, our value prop is that we make those vehicles run more efficiently, less repair time, more vehicle uptime. Ultimately, you can get from point a to point b quicker, you can size fewer vehicles in your fleet. So as that the vehicles continue to advance, whether it's inflation cost pressures driving that or outside North America, moving up the emissions curve and adding safety features, it just significantly increases our value proposition. And we've been in a position to both take advantage of that from a price and the share standpoint.

So we're certainly going to continue to monitor what the OEM price actions will look like going into 2024, but we do anticipate another, I think, historically pre-pandemic, 50 basis points to 100 basis points of price. We do anticipate in 2024 pricing significantly above those historical pre-pandemic levels.

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

Q

Thank you, Fred.

Operator: Thank you. 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. Just a follow up on Off-Highway. Does the reaffirmed guidance assume we see Off-Highway recover in the fourth quarter? Or will On-Highway perhaps make up for some lower performance there given the dynamics you discussed in Off-Highway?

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

A

Yeah. . I think as Dave commented on Off-Highway, our expectation with outside North America is there's been an element of timing. And we do have an elevated expectation for Q4 and outside North America Off-Highway versus what we saw in Q3. Relative to North America, that's something we're going to continue to closely monitor North America On-Highway, I mean, Dave hit on it. I mean there's a significant amount of demand for medium duty and Class 8 straight and we feel very solid about where that order book is going into the fourth quarter.

Isaac Sellhausen
Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Thanks very much.

Operator: Thank you. 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. Thank you so much. So my question is on the impressive gross margin expansion 230 basis points. I think this is the highest we've seen this year. How should we think about it for the fourth quarter? And also, how should we think about gross margin in general as you start lapping these expansions next year?

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

A

Hi, Tami. This is Fred. Obviously, I think us providing full year guide, you can back into the midpoint guide for fourth quarter. We – historically, fourth quarter has been our lowest margin quarter. Obviously, a lot of that is dependent on top line revenue. But North America, you've got the holidays in November and December, which traditionally have a little bit more fixed cost, puts a little pressure on our margins in the quarter. As things play forward, there's a lot of moving pieces. We've seen commodity prices come off. That's been advantageous to us. But we continue to see labor pressure through our supply chain that's driving increases to our value add.

As we talked about, still the challenges in the supply chain and some inefficiencies that are out there for us to get after expedited freight, some manufacturing efficiencies within our facilities, carrying a little bit more inventory than you'd like. And then obviously, I commented earlier on where we are from a price expectation. So we continue to form our view on 2024 and all those puts and takes will be taken into consideration when we provide that initial guidance February.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

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. Fred, I'm wondering if you could just talk about capital deployment from here. Obviously, a strong track record of returning cash to shareholders. You ended the quarter. I think with your highest quarterly balance as a public company. So I'm just wondering how you folks are thinking about capital deployment from here and why we've been seeing more significant stock buyback in the quarter given the cash generation? Thanks.

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

A

Sure, Jerry. I mean, our capital allocation priorities have been consistent. I mean we're going to fund the business for organic revenue earnings growth, focus on new product technology development. And you really see that in the capital expenditures that we've had, the engineering and R&D, the fact that we kept our foot down on those investments throughout the pandemic, what's out there from strategic acquisitions, but we've returned a significant amount of capital to shareholders. I mean, we've repurchased over 60% of our shares we've raised the dividend over the last five years on a dividend payout per share by over 50%.

Obviously, a big driver for us is to always have to be managed in the balance sheet and have low-cost flexible prepayable debt structure, long-dated maturities. So as we sit here, the priorities, they haven't changed. We're – at this point, obviously, as you mentioned, carrying a little higher cash balance than we have historically. We're also earning quite a bit higher interest rate than we have historically. But we'll continue to ultimately return the cash to our shareholders in the most opportunistic way.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks.

Operator: Thank you. There are no further questions at this time. I would like to turn the floor back over to David Graziosi for closing comments.

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

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

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