Company Name: Allison Transmission (ALSN)
Event: Raymond James 2023 Institutional Investors Conference
Date: March 07, 2023

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

So for those that don't know me, my name is Felix Boeschen, senior machinery and trucking analyst here at Raymond James. Today very happy to have Allison Transmission with us. The company's Chief Financial Officer, Fred Bohley, as well as Jackie Bolles, who heads up the Investor Relations efforts at the company. Fred, Jackie, I was hoping you could give just a brief intro on Allison, who you are, key end markets you play in, and we'll kind of go into a true fireside chat after that.

<<Jacalyn Bolles, Executive Director of Treasury and Investor Relations>>

Sounds good. Thanks everyone for joining today. I know it's the end of the day. So hopefully you've all had really productive meetings. Wanted to start just real quick, give you a brief outline of Allison Transmission, who we are, the end markets we serve, our financial profile, and some of our strategic priorities. So for those of you who don't know we are a leading designer and manufacturer of propulsion solutions for commercial and defense vehicles. Since introducing the world's first fully automatic transmission for commercial duty vehicles over 75 years ago, we've become the world's largest manufacturer of medium and heavy duty, fully automatic transmissions. And for the last two decades, we've been a leader in commercial duty electrified propulsion solutions. We serve our six end markets with the portfolio of products used in a wide variety of applications including on-highway trucks and buses.

And really here just to level set, we're talking about Class 4 to Class 8, except that we really don't have any exposure to the over the road Class 8 line haul market. We also are in the off-highway markets globally, and this is really vehicles and equipment that are primarily used in energy, mining, and construction applications. And then we're also in tactical wheeled and tracked defense vehicles. Over our 100-year history, we have built a reputation for providing innovative, efficient propulsion solutions that deliver a differentiated value proposition for our end users. And we're really known for our high quality, reliability and durability that not only improve the productivity and fuel efficiency of a vehicle, but reduce downtime and maintenance costs, which then result in overall lower total cost of ownership for our end user customers.

All of that being said, our reputation, the superior performance of our product really results in the end users often asking for us specifically by name who are OEM customers which has led to a few things for us. One, we have significant market share, particularly in our outside North America on-highway core addressable markets. We have what we consider elite EBITDA margins and strong cash flow generation. Our priorities really are focusing on revenue growth, and we're accomplishing this via investing across all of our end markets to expand our addressable markets, grow share, and drive the adoption of fully automatic transmissions outside of the U.S.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Perfect. That’s good.

<<Jacalyn Bolles, Executive Director of Treasury and Investor Relations>>

All right.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

I couldn’t decide if I wanted to start on demand or supply and I decided supply. So Fred, I’m curious, but could you maybe talk about what you’re seeing from a supply chain perspective? And then Jackie, you kind of mentioned this in the prepared remarks, but you’re in a way over-indexed to the medium duty market in North America. And I think the OEMs have certainly emphasized the more Class 8 markets. So maybe could you talk about those two dynamics and how you see that play out into 2023?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Sure, Felix. So, supply chain, obviously, three years running the battle. You’d like to believe it’s improving. I think all of us in the industry have improved on how we deal with the challenges. The biggest challenge right now is labor. We’re primarily North American sourced which certainly was an advantage for us during the pandemic. But there’s significant labor challenges on the hourly side. So in our situation, we’re satisfying a lot of this demand with really high overtime levels. Our suppliers are being asked to raise their production by us and others and are really struggling to get the labor in order to accomplish this. And then, our OEMs are really having to rely on all of the suppliers in order to meet what is very, very robust demand.

Our assumption in our guide for 2023 is that there’s not going to be significant improvements to the supply chain challenges. Our volume assumptions look very similar to 2022 volume. But the demand is there. You mentioned medium duty. Clearly, for the last couple years, the OEMs have built their more profitable products. Heavy duty, Class 8. We’ve benefited from that in Class 8 straight truck. They’ve also been focused on over the road line haul, whereas Jackie mentioned in her prepared remarks, we really have no exposure, at the expense of medium duty. I will tell you, we’re seeing very robust medium duty demand in Q1. The lease rental players fleets are very aged at this point, and they seem very motivated to be able to field new units.

From a Class 8 straight truck standpoint, I mean, the demand is solid. What’s really exciting about that is we’ve really yet to see the infrastructure impact on Class 8 straight truck. So you look at our North American revenue, which is 50% basically of our total revenue, our North American on-highway end market between Class 8 straight and Class 6-7, that’s almost 80% of that end markets revenue with both really good backdrops from a demand standpoint with the caveat of really getting the supply chain to be able to respond. So – if we can satisfy that, you can build more, I think the bigger thing, or equally as important is the inefficiencies associated with the supply chain.

So, we’re still experiencing significant expedite costs from a freight standpoint and our manufacturing operations are not running as efficiently as they have historically. And you’re in situations where you’re short parts on straight time having to make that up on overtime. So I think, once you see the supply chain, not only are you going to get the incremental benefit of the volume and the strong incremental drop throughs we have, but then you're going to have an opportunity to get after what is some pretty low hanging fruit from a cost containment standpoint.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Yeah. That's interesting. And the medium-duty comment was specifically interesting. I guess just to piggyback on that, I've always thought about your North American on-highway end market exposure as being quite over-indexed to municipalities in a way. Could you maybe talk about that sort of what's your exposure there as you sit today and where you think the demand drivers are really coming from?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Sure. In a typical year, we're about 30% to 40% exposed to municipalities in North America on-highway, fire trucks, refuse packers, DOT, dumps, transit, school bus. The nice thing about that book of business is it's very steady. So in any sort of downtime, you still typically have the municipalities out there purchasing. Likewise, when you even think outside North America there's a lot of government spend in the type of business that we're going after, whether that be refuse, fire and emergency, transit as well.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Yeah, that's helpful. And then, the other part of the supply chain dilemma over the last couple of years, coupled with frankly, raw material inflation has been that the trucks are quite a bit more expensive than they are, call it, two, three years ago. And I had always thought about an automatic Allison transmission, your end customers have to think about it relative to the total cost of that vehicle from a payback perspective. So I guess my question to you is, how are you approaching pricing holistically in that context? Does that actually raise the value of an Allison transmission?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

No, I think you're dead on, I mean, when, if an OEM's going to choose to charge X percent more than what they did a couple years ago, we definitely, our payback has quickened. So obviously there's an opportunity you can do two things with that. You can price, you can take share, we intend to do both. Pricing, think about us historically, we've been able to get 50 basis points to a 100 basis points pricing in a stable inflationary environment really driven by adding more value, continuous improvements to our products. But now you have the situation where the vehicles cost more. They're priced higher and that immediately if they want to price it 10% more, our values in effect is increased by that 10% because we make the vehicle more productive.

We get from point A to B quicker, less downtime. Ultimately, what you need is you can size a smaller fleet with the fully automatic. If we think about how we price, we have the vast majority of our North American on-highway business under long-term supply agreements. And we've honored those agreements, while we've faced inflationary pressures. But as those come off, and they cadence off, we're in a position where we're definitely able to garner, higher than historical pricing. And we need to do that because we continue to see cost inflation. We're running the business as if inflation is going to be sticky and providing ourselves optionality from a pricing standpoint.

You think about last year when we were at this conference, we were talking about 275 basis points of price for 2022. We ended up with 425 basis points of price. So, while seeing those costs coming at us, we were able to do mid-year actions. I would tell you, our guide we have revenue up 4% year-over-year. That's primarily price. But we're in a very similar position to where we were last year. We're still actively looking for opportunities to be able to achieve higher pricing.

We are certainly embedded in our guide. We're price cost favorable. Our midpoint EBITDA is up about $35 million. If you think 4% on revenue is roughly a $100 million. So we're outrunning costs by about $35 million. And we'll see ultimately what inflation we get from our supply chain and we'll price and take price action accordingly to that.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

So can you maybe clarify some of the long-term contracts and how it works?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Sure.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Just trying to think through, if you do see input costs come down, what's the impact to margins? And I know there's a bit of a lag impact to your pricing.

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

And let me start with what we do with our suppliers. And we've done this for multiple years where we allow passthroughs on commodities, real time within the quarter. And the reason we implemented that is what we found is when raw material would go up, the supply chain would be screaming for increases, and then when it would come back down they were very quiet, right? So we set up a mechanism, so it's a clean passthrough. We negotiate with them just on the value add. With our long-term agreements and I think North America, over 90% of our volumes on long-term agreements, North America on-highway. We don't do a 100% passthrough, but typically it's in sort of a 75% passthrough range.

So, looking at total book of business, about 60% of the raw that we take from our supply chain is passed through to our end users. But to your point, there's a lag. Real time passthrough from the supply chain in the quarter six-month to 12-month lag with the – with our end users. So, what we've talked about publicly is, if commodities return to pre pandemic levels, those mechanisms set in place will result in 225 basis point improvement to our gross margins. And in the near term, it'll be more significant because you'll have that six months to 12 months where you received the cost downs, but you have not passed on…

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

But you hold the price, yes. Okay. That’s super helpful. You mentioned revenue growth in your opening remarks, and I really wanted to talk about that. I think over the last couple of years you’ve introduced really an array of new products, I would call it. Certainly talked about international FracTran, Regional Haul. Could you maybe talk to us about those pockets of opportunity and if there’s a way to size maybe the market size or incremental revenue opportunity to Allison?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Certainly. We’ve quantified, as you said, multiple opportunities. The – we have a new transmission clean sheet design for fracking. Our FracTran product that’s being released in the second half of this year. We expect to be able to get an incremental a $100 million in revenue from that product, primarily by being in a position to take share. And that may sound like a lot, but a frac transmission is going to go for north of $200,000. So, we believe it's – that's very reasonable. That's not – it's not going to be light switch, 2024 type numbers, but over three year to five year timeframe.

Within the North American on-highway business, the regional day cab market. We have a variant of our 3000 series, our 3414 Regional Haul that’s going to be able to go at a subset of that market. And we see that as another $100 million opportunity. What’s really exciting about that is one, we’re getting the releases. So we have that product available in Daimler and Volvo. What’s critical there is they’re vertically integrated with their own in-house AMTs, and they’ve chosen to release our product.

It’s primarily running with 12 and 13-liter engines. And they see our product as a very good fit for their customers. We’re also released at Navistar, and it’s a variant. So it’s running off of our base 3000 series footprint. So we understand the cost profile. And you’re starting out with already a defined cost profile, be able to get a slight premium over other 3000 series vocations.

And then we talked about the activities in China with the wide-body mining dump. And we talked about that being a $50 million incremental opportunity. We’re off to a really fast start. That drove – definitely drove some of the growth for us in China. There’s 10 OEMs building wide-body mining dumps in China. Our product is available on all 10. Within about 18 months, we’ve been able to go from zero share to over 10% share. And at this point in time, we’re ready to upsize that market opportunity from $50 million to $100 million.

So just collectively, those three represent $300 million in opportunity. Two of them are variants. So the wide-body mining dump is a variant of our 4000 Series 6-speed, a 7-speed variant that’s been – had some design changes in order to allow it to live in a 100-ton dump.

That product as it’s an on-highway product is running through our outside North America on-highway. And just to think about the success we’ve had in China, the China commercial vehicle market down probably 50% last year, our revenue was up close to 60% in China.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Super helpful. And then if I think about that $300 million bucket of incremental opportunity, just to be crystal clear, is that the market size or is that the opportunity to Allison? In other words, one of the things that I think is so unique about Allison is your market share in a lot of your North American vocations are upwards of 60%, 70%, 80%. Are these type of markets, markets where we could see Allison-type share?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

I think the answer is potentially. But like, for instance, with the wide-body mining dump, right, we've got about 10% share today. Getting to $100 million revenue opportunity is something closer to a 25% share. So we do believe that there is a portion of that market that's probably going to run – continue to run with manual product. But as we get out there and we show how we can keep the vehicles up and running – is there an opportunity to continue to expand? I think so.

We've had certain vocations – if you take Australia, for instance, share in Australia in medium duties are getting close to North American share. So there definitely are – there are opportunities to take share that high. But you're coming off a low basis. What we have in Class 6-7 and Class 8 straight in North America roughly 75% share of all – of everything.

We're in 75% of the trucks. Fully automatics are still just about 5% penetrated outside North America, and that's why it's such a key opportunity for us. We were up 22% last year in that end market. And we're going to be very disappointed if we can't drive it double-digits every year.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Yes. No, that's super interesting. I did want to ask you about your off-highway exposure in general. I know it sits within various line items of your business. Could you maybe talk a little bit about that sort of what sits within that service business versus what sits in other line items? And how are you thinking about that business over the next couple of years?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Yes, it's a—our off-highway exposure is a mix of pressure pumping, think hydraulic fracturing and mining. So in North America, it's 95% pressure pumping, we're really – there's not a lot of OEMs producing rigid dumps and mining equipment that we don't sell – on the mining side, we don't sell to too large captives, CAT and Komatsu, but we sell pretty much everybody else. With where commodity prices are, we feel that, that's fairly well positioned.

I think we're going to have strong revenue for the, I'd say, midterm. Over on the frac side, it's a lot of its driven by the price of oil and gas. The two largest markets are North America and then in China is the other significant. We got a decent amount of equipment that ends up down in Argentina, some in the Middle East. But the two places where they take typically new frac rigs are there.

We haven't really seen from a North American off-highway standpoint, we haven't seen a lot of new frac rigs built. What we're seeing is a refurb of existing frac rigs, primarily complete repowers – They'll put on a brand-new transmission. So while in past cycles, you've seen the growth in off-highway kind of lead in service parts from the overhauls of the transmissions.

Now you're seeing that flow through our – because it's a new unit sale flow through our North American off-highway market. Service parts, is still meaningful for us. And the off-highway – the global off-highway piece of service was probably close to $50 million last year. But looking at service parts, still heavy north – it's global on-highway where we have obviously a larger field – the largest fielded population. And then there's a portion of that end market that supports the installation of new product that really is driven by the volume that you sell to the OEMs for their support equipment.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

And so, the international story, I think, certainly resonates with me as effectively automatic transmission penetration goes up, you would think that's an opportunity. One of the pushbacks we get is well, are some countries going to skip that phase and go straight to EV. And so, I guess my question to you is how do you view electrification, specifically even in those international markets? And then how do you choose where to play in which vocation specifically?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Yes, let me take the first piece of that and let Jackie hit on the second piece. The idea of them just skipping over fully automatics, it really depends on where you're at. But in these emerging markets, you go to some of these countries, India, the idea that they would have the grid, the infrastructure to just skip right over. I don't think that's, in a lot of emerging markets, that's probably a top priority from an infrastructure standpoint and where to invest.

So we do view that the next step off of manuals is going to be some form of automaticity. The AMTs will win some, but fully automatics are going to be very successful in the more difficult duty cycles and then on your broader question on where to play in EV.

<<Jacalyn Bolles, Executive Director of Treasury and Investor Relations>>

Yes and Felix was that where to play in EV or just how do we choose the vocations to kind of target...

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

You can talk about either, we can talk about both.

<<Jacalyn Bolles, Executive Director of Treasury and Investor Relations>>

Okay. Yes, I wasn't sure. So our thoughts on EV for us are a little bit that it's more of a medium to long-term opportunity for Allison. The good news is we think we've invested in the right architecture with our eGen Power family of products, which are really what I referred to as e-axles, right? So they sit down between the wheels that you've got more space for the battery there.

But the truth is, right now, the hardware that's being fielded is not end game. It's not where we're going to end up. And we believe that OEMs are going to continue to partner with trusted suppliers such as Allison that are really known for delivering quality, reliability, durability in those products.

And so our focus has really been on partnering with those key OEM customers, fielding units so that we can get the learnings to improve our product, to get it to a more mature state once the OEMs kind of decide on what it is that they want out of those electric vehicles and the volumes are there to support that business.

And so, we're really focusing on – I'll paraphrase it, having the right product at the right time with the intention that, that product is going to be as good, if not better, than our conventional products today. That being said, again, EV we view as a more mid to long-term opportunity. And the adoption of EV in the commercial vehicle space is going to be, I think, a lot longer and be a lot harder than most people have recognized to-date.

And so as Fred has been spending a lot of time talking about, we're still investing in those areas of our business that we view as having a lot more growth opportunity going forward, including in our conventional space and including in electric hybrid and pairing our conventional products with alternative fuels as well.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

And Fred, I think last year at the conference, you said about 50% of your R&D spend was going towards some sort of electrification kind of angle. Do you want to give us an update on that, that would be great? But my bigger picture question is – how do you think about allocating capital to those type of projects? How do you think about the returns on that versus some of your conventional business where your unit economics are frankly very, very good?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Yes, it's – I mean, clearly, there's more unknown in EV. Pace, timing of adoption. The OEMs are still really determining what they want an EV system to be capable of doing. So the R&D that we're spending there and we talk about electrification last year, roughly 50-50. It's still in that range. It's not all though EV. It's electric hybrid. It's – we've got a new platform for Tracked Defense, a clean sheet, eGen Force that it's a traditional tracked transmission.

But a hybrid electric hybrid enabled primarily to be able to move around in silent on the battlefield. So there's different ways that you can use electrification to advantage both your conventional products as well as just outright pure electrification or electric hybrid second generation now can do half of this duty cycle in the EV range.

So – but if you prioritize it, if you can do a variant of a current product, obviously, less risk, less capital invested, more certainty around the cost structure and a proven product. That would be first. Clean sheet, higher risk. And then when you get into clean sheet new technology even further risk.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Fred, we have about 60 seconds left. But I have to ask you about capital allocation. You've been a big purchaser of your stock over the years. Maybe help us understand what do you see as the right debt profile for the business? How do you think about dividend versus buyback?

<<G. Frederick Bohley, Senior Vice President, Chief Financial Officer & Treasurer>>

Sure, I mean we just increased the dividend a few weeks back, fourth consecutive year. But we've done that while continuing to do buybacks. So cash outlay associated with the dividend stayed relatively constant, $80 million to $90 million a year. First priority with capital allocation always is to fund the business. We're doing that from a CapEx and engineering R&D. Prior to 2019, we hadn't done any acquisitions.

We've done four acquisitions since then, largest in size, about $100 million, a couple related to technology, a couple of supply chain risk mitigation. We sit – as we sit here right now, we're less than 2.4 times net leverage. We have a very consistent cash flow stream, driven by the municipal comments we had. So we feel – we will delever as we continue to earn more as a business. The maturities are long-dated, low cost.

We have – of our structure, $625 million variable. We've hedged off $500 million of that. So 95% of our interest is fixed. So as we sit here, like we always say opportunistic is how we're going to behave. But I think if you look at what we've done historically, since the IPO, we've repurchased almost 60% of our shares. So we'll continue to focus on generating more cash and definitely – getting it back to shareholders in the most effective way.

<<Felix Boeschen, Analyst, Raymond James Financial, Inc.>>

Perfect, that takes us to 30 minutes. I'm going to say thank you very much. We do have a breakout session downstairs. Appreciate it.