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MEC.N - Q2 2022 Mayville Engineering Company Inc Earnings Call

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Nathan Elwell

PRESENTATION

Operator

Good morning. Thank you for attending today's Mayville Engineering Company Second Quarter 2022 Earnings Conference Call. My name is Francis, and I'll be your moderator today. (Operator Instructions) I would now like to pass the conference over to our host, Nathan Elwell, Investor Relations.

Nathan Elwell

Thank you, Francis. Welcome, everyone, and thank you for joining us on today's call. A few quick items before we begin. First, please note that some of the information you will hear during this call will consist of forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 as amended. Such statements express our expectations, anticipations, beliefs, estimates, intentions, plans and forecasts. (technical difficulty) forward-looking statements involve risks, assumptions and uncertainties, our actual results could differ materially from those in the forward-looking statement. For more information regarding such risks and uncertainties, please see our filings with the Securities and Exchange Commission, including our filings on Form 10-K for the period ended December 31, 2021. We assume no obligation and do not intend to update any such forward-looking statements, except as required by federal securities laws.

Second, this call will involve a discussion of certain non-GAAP financial measures. Reconciliation of these measures to the closest GAAP financial measure is included in the earnings press release, which is available at mecinc.com. Joining me on the call today are Jag Reddy, President and Chief Executive Officer; Todd Butz, Chief Financial Officer; and Ryan Raber, EVP of Strategy, Sales and Marketing. Jag will begin with his opening remarks followed by Ryan discussing the company's end markets and new business outlook. Then Todd will review our financial results and guidance.

With that, I'll hand the call over to Jag. Please, go ahead.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Thank you, Nathan, and good morning, everyone. I have been in my role for 2 weeks now, and my excitement on joining the company just continues to grow. There are many reasons I am so excited to be here. Let me share just a few. MEC has built a strong business and legacy over 77 years. We are the undisputed industry leader with highly skilled people and great assets. Macroeconomic trends such as reshoring and outsourcing by major OEMs are in our favor. With our differentiated offerings and footprint, we are uniquely positioned to deliver significant value for our customers and our competitive advantages continue to grow.

But really, my first priority is to listen and learn. I will be visiting as many of our locations as possible in the coming months to meet the teams and understand what is working well and what needs improvement. I will be meeting with our customers and partners to see what more we could do

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to help them achieve their goals. I want to build upon our customer-first mindset with a renewed focus on innovation. I am confident in our ability to be nimble, grow profitably and continue to expand both our customer base and offerings.

My initial focus will be on accelerating our use of innovation, technology and lean manufacturing initiatives to help drive profitable growth. With that said, I want to congratulate the team on another impressive performance this quarter, and I am pleased to report that our outlook for rest of the year remains positive.

Now I would like to turn the call over to Ryan Raber to discuss our end markets and new business outlook.

Ryan F. Raber - *Mayville Engineering Company, Inc. - EVP of Strategy, Sales & Marketing*

Thank you, Jag, and good morning, everyone. We currently serve 5 major end markets, all of which continue to forecast strong demand outlooks. The commercial vehicle market is our largest market and continues to forecast strong demand through 2023. Current ACT forecasts predict 300,000 units per year being produced despite the recent supply chain disruptions that are expected to continue throughout 2022, along with some weakening of freight fundamentals. We have continued to see sequential improvement due to robust backlogs at OEMs.

Powersports continues to be a robust market for us. Overall strength in retail demand, coupled with low dealer inventories are leading to increased volumes. Our customers are striving to satisfy this demand and also start to restock, which will stretch for the second half of 2022 and into 2023. The powersports market is sensitive to discretionary spending and interest rates, and we are keeping a close eye on this industry with the continued inflationary pressures. The construction and access end markets have continued to show strength. Residential construction is down slightly as expected with the recent rise in interest rates, but we are seeing both nonresidential and oil and gas projects showing some signs of improvement.

We believe that we will continue to see steady to increase volumes in the near term based on low dealer inventories and the need to restock fleets. We continue to see strengthening demand in the ag market, advancements in equipment productivity, combined with low machine inventory, low global crop inventories and strong crop prices will continue to drive volume growth for the foreseeable future. Our military segment remains a stable market for us. Our customers have solid backlogs for U.S. government contracts, and we continue to see opportunities based on near-term planned vehicle updates.

While supply chain disruptions persist throughout our customer base, we anticipate volumes will gradually improve as 2022 progresses. Importantly, our new business pipeline remains strong. We continue to build relationships and convert on new opportunities to expand our customer base in the markets we serve. There are multiple sources of new business projects we're involved with, including new model and program launches, new product line offerings by customers, reshoring by OEMs, outsourcing by OEMs and takeover business with several top customers.

Let me walk through a few of the exciting opportunities we are pursuing. We are currently in the final stages of closing on a reshoring program for ATV and side-by-side components with a major powersports customer that is strategically working to realign their supply chain to a North American focus. In addition to this restoring opportunity, we just won multiple projects with significant content on next-generation products for the same powersports customer. Combining these 2 opportunities, we will more than double the size of our relationship over the next 2 years.

We are awarded a significant outsourcing project from a market-leading Class A truck manufacturer, which will begin production next year. This particular program leverage a cross-selling opportunity or synergy from the DMP acquisition. This outsourcing project has our customer removing their in-house capacity for this component to allow them to build more vehicles and will become a great new program for us in 2023 and beyond. MEC is currently investing in new capital to support this program, which is included in our 2022 capital expenditure guidance.

While MEC has historically been focused more on the heavy and medium-duty truck market, we recently secured a significant new business award on a new program for the light-duty truck market through a market-leading engine manufacturer that will continue to provide further diversification within our commercial vehicle market. We are successfully building our relationship with the new powersports customer we added in 2021. We were recently awarded a significant share of content on a new side-by-side model using our engineering and manufacturing expertise to quickly grow this new relationship.

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Reshoring also continues to generate additional opportunities, many of which are in the early stages of negotiation. These opportunities are in a variety of markets that we currently serve but are opportunities for us to secure new customers. In addition to our current markets, we are continuing to work with new customers in new industries. And in some cases, we've started making prototypes as part of developmental steps. We have also seen traction on EV, primarily in our traditional markets of commercial vehicle and powersports, and we expect further engagement in electrification as the industry continues to shift. Overall, it is clear that both our business with current customers, plus our pipeline of new projects with both existing and potential customers remain very strong as we look towards the second half of 2022.

Now I will turn the call over to Todd for a review of our second quarter financial results.

Todd M. Butz - *Mayville Engineering Company, Inc. - CFO, Secretary & Treasurer*

Thanks, Ryan. I'll begin with a look at our second quarter. We recorded second quarter net sales of $138.3 million, a 15% increase over the second quarter of the prior year, which was primarily driven by contractual raw material price pass-throughs to customers, commercial pricing increases and improved volumes. Manufacturing margins were $18.3 million for the quarter as compared to $16.3 million for the same prior year period. The net $2 million improvement stems from commercial pricing activities as well as increased volumes and labor productivity improvements at our facilities that totaled $6 million.

These improvements were partially offset by the Hazel Park transition costs and other inflationary cost increases of $4 million. Manufacturing margin percentages were 13.2%, which is in line with the 13.5% recorded in the same prior year period. But keep in mind that versus the prior year, we have had nearly 150 to 200 basis points of dilution to our current percentage related to higher material cost pass-throughs to our customers, which increased sales but does not impact the margin dollars. SG&A expenses were $6.4 million as compared to $5.4 million for the same prior year period. The $1 million increase was principally attributable to higher consulting and professional fees.

For the second quarter, income tax expense was $1.8 million and pretax income of approximately $7.7 million. Our federal net operating loss carryforward was approximately $18.5 million as of the quarter end, which was driven by pretax losses incurred in prior years. The NOL does not expire and will be used to offset future pretax earnings. We anticipate our long-term effective tax rate to be approximately 27% based on current tax regulations.

Adjusted EBITDA increased to $18.2 million versus $14 million for the same quarter last year. Adjusted EBITDA margin percent increased by 140 basis points to 13.1%, representing an incremental margin of 22.9%, which is slightly above our historical average of 22.5%. The progression to our stated goal of 15% EBITDA is taking hold, and we are confident we are on the right path to reach that goal. Basic earnings per share were $0.29, a $0.13 increase over last year.

Now let me address our capital expenditures, balance sheet and liquidity figures. Capital expenditures for the first half of the year were in line with our expectations at approximately $26.4 million as compared to $17 million for the same prior year period. The increase primarily relates to the build-out and repurposing of our Hazel Park Michigan facility and our continued investment in technology and automation. We are finalizing the repurposing of our investments in the Hazel Park facility and are transferring projects with current customers to that facility to support the growth of our base business. We are on track to ramp up production in the fourth quarter to support meaningful volume in 2023 and beyond.

In addition, I am pleased to report we have already [sell-leased] approximately 1/3 of the Hazel Park facility with a 4-year lease term, which will provide more than $1.8 million in annual lease cost mitigation. We intend to use the remaining 2/3 of the facility of our own projects and remain bullish with the location, the skilled workforce we are hiring and are pleased with the progress we've made already. As of June 30, 2022, total outstanding debt, which includes bank debt, finance lease obligation and financing agreements were $79.1 million as compared to $46.2 million at the same point last year.

The increase in debt relates to working capital increases due to higher steel prices and production levels as well as capital spending. Finally, we continue to see a solid pipeline of interesting M&A opportunities. We are focused on potential targets that can introduce new end markets, develop new relationships with new blue chip customers to possibly expand our geographic reach. Strategic fit and rational valuation remain our top considerations. We will continue to pursue logical deals as the year progresses.

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Now I'd like to discuss 2022 guidance. We are reiterating the financial outlook we first provided in February and continue to expect net sales of between $480 million, and $530 million, adjusted EBITDA between $58 million, and $70 million. Again, it's worth repeating that our outlook assumes no revenues or recoveries associated with the fitness customer. For the full year 2022, we continue to expect our capital spending to be between $55 million, and $65 million, which will be focused primarily on investments in new technology and automation, the addition of equipment related to new programs with existing customers and the repurposing of assets at the new Hazel Park, Michigan facility. I think it's important to note that we are nearing the end of this unusually high CapEx cycle and expect 2023 to return to more normalized spending model.

In summary, our second quarter results continue to reflect steadily improving volume trends, which, in conjunction with the commercial pricing increases we implemented over the past 9 months has led to improved results. While supply chain disruptions and inflationary pressures persist, end market demand signals remain strong over the medium term, and we continue to believe our volumes will gradually improve as we move through the second half of 2022 as the supply chain challenges facing our customers start to subside. We continue to pursue significant new business opportunities and remain ready to increase our production volumes as needed. At the same time, we are investing in the right technologies and facilities that will allow us to successfully address this demand.

That concludes my comments, and I will now turn the call back over to Jag.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Thank you, Todd. I am convinced that MEC is uniquely positioned to help our OEM customers as they streamline their supply chains with reshoring and outsourcing initiatives. We are focused on profitable growth into new platforms, margin expansion with lean initiatives and innovation to drive competitiveness. I am very excited about the future of our company.

Now let's open the lines for any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Mig Dobre with Baird.

Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

It's Joe Grabowski on for Mig this morning. Jag, welcome to MEC. I know it's early days, but I'd be curious to hear more about what attracted you to the company and how your prior experiences prepare you to lead the company?

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Well, thank you, Joe. I'm excited to be here, Joe. What attracted me to the company really our leadership in the space, the industry trends of reshoring and outsourcing by our OEM customers and the potential for MEC to continue to grow and expand into exciting new opportunities and platforms. Now I have worked over the last 25-plus years, I worked in automotive, aero defense, general industrial and many other industries that MEC currently operates in, right?

I have worked with many of these customers that MEC currently works with in my past as well. So it was a great fit. I'm a manufacturing engineer by training, a mechanical engineer by education. Every time I walk into any of the factories that MEC has, right, I feel really proud of the work we do, and I look forward to continuing to help the company grow and help our customers continue to achieve their goals.

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Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Well, great. Again, welcome, and we look forward to working with you going forward. A question for Todd. Todd, year-to-date sales are about $275 million. If we [drop] that $550 million, which is $20 million above the high end of the guidance, I know there's some seasonality first half versus second half, but just kind of doing that math, is there any reason the higher end of the guidance range does (technical difficulty) sense?

Todd M. Butz - *Mayville Engineering Company, Inc. - CFO, Secretary & Treasurer*

Good question, Joe. Keep in mind, steel prices are a big variance in that range. So when you think about the first half of the year, we have about almost $30 million of material price inflation passed through to our customers. So you look historically compared to 2019, that's driving up the sales dollars without really providing any bottom line performance. And then as you look into the second half, the expectation now is that, that steel price will continue to come down, which yet again, we'll have to give that pricing back to our customer in line with our cost.

So there is that risk if that drops further or quicker than we expect that the sales dollars could be a little bit lower, which will still keep us in our guidance. And if supply chains continue to improve, there's still issues out there, it's we're not out of the woods on that front yet. But if that does improve, I wouldn't say we wouldn't be on the higher end of that guidance.

Joseph Michael Grabowski - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Got it. No, that makes sense. And then a final question for me. Kind of along the same lines, the EBITDA margin in the quarter was 13%. That's the strongest quarterly margin in several years. Were there any cost through pass-throughs -- pass-through drags in the quarter? Or have you sort of caught up on that?

Todd M. Butz - *Mayville Engineering Company, Inc. - CFO, Secretary & Treasurer*

I think from a cost perspective, we're really caught up on, we think inflationary pressures. We've done a very good job and we sit in a good position at the end of the quarter. But supply chain, those disruptions at our customer level is driving some volatility in our plants. So there is a little bit of cost rate still continuing in the quarter even though it did improve a little bit from Q1, but that does drive inefficiencies at the plant. So getting a normal-wise order pattern from our customers will be helpful. And keep in mind, at 13%, as I noted, there was 150 to 200 basis points of dilution because of material pass-through, but there's also the inflation. And so we've covered that in commercial pricing that also increases sales but doesn't increase the bottom line. So in a normalized state, I feel very good about our progression of 15% adjusted EBITDA.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Let me add to that, Joe. We have done -- the team has done a fantastic job of fully covering our inflation, right, with price pass-throughs, right? We feel confident in our ability to value, sell our products and services to our customers and capture the value through price.

Operator

The next question comes from Larry De Maria with William Blair.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

As it relates to the sublease -- the financial impact in a little more detail, I think if you said $1.8 million cost mitigation. Was that -- do you guys already back out some of that from adjusted EBITDA? And when does that begin? And then how that flow? And then what's the visibility on filling the other 2/3 of Hazel Park with your own business?

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Todd M. Butz - *Mayville Engineering Company, Inc. - CFO, Secretary & Treasurer*

Yes. So the lease began at the end of June, and it's $1.8 million, let's say, rental income, which is lease cost mitigation annually that begins in the second half of this year. Again, it's a 4-year term. We're confident on that filling the other 2/3 space, and we begin to ramp up production here in the back half of this year, and we think we'll have meaningful volume in 2023. And we think that facility could produce in excess of $100 million in total capacity at some point, depending on mix and products. So again, we're very pleased with that location. The hiring so far has been phenomenal and it's what we've expected.

Ryan F. Raber - *Mayville Engineering Company, Inc. - EVP of Strategy, Sales & Marketing*

Larry, maybe -- this is Ryan, just to add something there. I think we described starting out. We are putting some work in there from other facilities just to manage risk and get them on their feet. As we talked in the prepared remarks, there are some significant new business opportunities that we've either already won or in the process of negotiating and some that we discussed today are targeted to go in the Hazel Park facility. So we remain confident in our ability to fulfill 2/3 of that plant over the next few years.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Okay. So then can you back into a net number? I know you're moving some business from other facilities and you're getting some new wins. But from where we stand now, is there an extra $10 million, $20 million, $30 million in incremental sales that we can already bank on for next year?

Ryan F. Raber - *Mayville Engineering Company, Inc. - EVP of Strategy, Sales & Marketing*

Yes. I mean we're not really guiding anything into next year yet, but I'll say we -- today, we still have a solid backdrop of market demand. And certainly, we're evaluating that as we think about what transitions. So the internal, I'll say, product moves, the internal moves of customers, those will be a little bit fluid as things settle in over time. So we can't really delineate what would be new business versus transferred from others, but we'll continue to push the new business activities. If the market softens or the market stays strong, that's really the throttle for us on getting Hazel Park filled up.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Just to add to that, Larry. The team has done a phenomenal job of pivoting since February to not only reequip the Hazel Park facility to refocus on core businesses, but also, right, lease out about 1/3 and mitigate our rental costs as well. So overall, I think we're in a really great shape to bring some production into Hazel Park in second half of this year and continuing to ramp up with new business and core business next year.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

And then I appreciate that, Jag. And then Ryan's comments is just further strength ahead. And I know you don't have guidance for next year, but just maybe talk high level, I mean, look, for next year, truck orders are weakening. There's powersports or consumer oriented, which is weakening. Resi, that we're seeing some softness. So can you talk about maybe some of the puts and takes? Are you seeing any softness anywhere? And could you still feel -- do you feel like your core markets will grow volume next year?

Ryan F. Raber - *Mayville Engineering Company, Inc. - EVP of Strategy, Sales & Marketing*

I mean, as we sit here today, Larry, and we're in constant communication with our customers. There was a, I will say, a slowdown in July orders for commercial truck. But I think we've been coming off some pretty low orders, the months previous to that. We're really at a point where there's

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about 9 months of backlog out there. Obviously, the OEMs have been concerned about price and cost and limited some of the orders they would actually take for '23. So I don't know that, that one point makes a trend.

Certainly, at an overall level, there's inflationary pressures that we remain vigilant in reviewing and discussing with our customers. But commercial truck, we'll watch. I think that was one point and that certainly doesn't make a trend. Powersports, retail, some description of retail softening. But a lot of discussion around inventory being 60% to 70% of pre-COVID levels, and I'm sure business models will change a little bit. But at some point, there'll have to be dealer inventory, put back in the pipeline.

And then resi, you mentioned, yes, that's down, and I think that's down as expected with the change in interest rates. But we are seeing non-res as well as oil and gas also start to pick up. So I don't know if those will completely offset each other, but there's certainly some buffering going on. I think as we think about a potential downturn, one important thing to keep in mind is as we cycle through, I'll say, the last downturn here, a big impetus to that was the amount of inventory that existed at the end customer level. And as we talk to our customers and listen to their -- the way they describe their business inventory today is low and it's dramatically different than the last downturn.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Okay. Good luck, Jag.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Yes. But your point is well taken, Larry. And we are vigilant. We are watching the demand trends. We're talking to our customers. And if we see any softness coming through, right, we're prepared to take cost actions and we're prepared to adjust our production schedules to be in line with our customer demand.

Operator

The next question comes from Vlad Bystricky with Citigroup.

Vladimir Benjamin Bystricky - *Citigroup Inc., Research Division - VP and Analyst*

So maybe just for Jag. I know it's probably too early to ask you around specific thoughts on capital allocation plans. But can you talk maybe at a high level how you approach thinking about capital allocation and what you see as some key capital allocation priorities for the company here in the early days?

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Sure. I think as Todd laid out, Vlad, we are -- we're in the middle of our big capital spend given the Hazel Park initial investments but also refocusing Hazel Park away from our fitness customer, right? So that spend continues this year. We're at a peak. I would say that there's probably a little bit of given the long lead times of some of these equipment drive, there will be a bit of a leakage into next year of some of these invoices and things like that, right? So if we exclude that, the way I think about capital allocation, particularly capital investments, rather, is really around maintenance replacement repair, safety and any of infrastructure investments, right?

But those are really small for us overall. And the next chunk of capital investment we would like to make are really around automation and smart manufacturing, things like that. So if we put all of that together, that on a run rate basis has to be much lower than where we are this year, right? So the guidance we have provided is significantly higher than what we expect on a run rate basis in the coming years.

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Todd M. Butz - *Mayville Engineering Company, Inc. - CFO, Secretary & Treasurer*

And one comment I'll make there, Vlad, is -- to Jag's point, historically, we've always commented that at that normal run rate is probably in that $20 million range. So excluding that tail that -- the invoice that Jag spoke to, that's really where we think we'll be next year from a capital perspective.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

Yes, you mentioned capital allocation, right? If I think about it more broadly, right, we're not prepared to make any further comments on that. But as we think about pulling back on some of these high capital spend, right, that will open up our balance sheet for potential acquisitions and things like that. We are fully focused on cash flow generation and how we effectively convert our EBITDA dollars, right? So I think we'll continue to work on our fine-tuning of our capital allocation for next year.

Vladimir Benjamin Bystricky - *Citigroup Inc., Research Division - VP and Analyst*

Okay. That's really helpful color. And then maybe just as a follow-up. In terms of the reshoring activities, I think if I heard correctly, you highlighted some activity with the powersports customer going into next year. But can you just talk more broadly about -- are you seeing customers actually begin to execute reshoring plans and go out to bid for help with those activities? Or is it still more in the planning and discussion phase? And I guess the crux of the question is, how soon does reshoring begin to be kind of a meaningful growth tailwind for MEC?

Ryan F. Raber - *Mayville Engineering Company, Inc. - EVP of Strategy, Sales & Marketing*

Yes. And reshoring is something we've talked about for a few quarters now, and I think I've described it generally as I would definitely say the quotation and the inquiries increased throughout the course of 2022. As we sit here in the midyear point, we are executing supply agreements, purchase orders with customers. So from our eyes, it's definitely a real thing. I mentioned certainly one on the call, there's been others with multiple other customers, too. So this is not just a singular, isolated event. It won't really materialize to revenue to us until next year just given lead times of making tooling and inventories that the customers have coming in from offshore. But definitely as we move into '23, there'll be incremental revenues related to new business tied specifically to reshoring activities for us.

Operator

(Operator Instructions). There are no questions waiting at this time. So I'll pass the conference back over to Jag Reddy, President and CEO, for any further remarks.

Jagadeesh A. Reddy - *Mayville Engineering Company, Inc. - President, CEO & Director*

In closing, I would like to say I am proud of the work accomplished in the first half of the year and excited about the opportunities for growth at MEC and look forward to working with all of you. Thank you for your time today and your continued interest in MEC.

Operator

That concludes the Mayville Engineering Company Second Quarter 2022 Earnings Conference Call. Thank you for your participation. You may now disconnect your lines.

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