CALL PARTICIPANTS

EXECUTIVES

Joseph B. Armes
Chairman, President & CEO

Greggory W. Branning
Executive VP & CFO

Adrianne D. Griffin
VP of Investor Relations & Treasurer

ANALYSTS

Brian Lau
Sidoti

Jonathan E. Tanwanteng
CJS Securities, Inc.

PRESENTATION

Operator

Greetings. Welcome to the CSW Industrials, Inc. Second Quarter 2020 Earnings Conference Call. Please note, this conference is being recorded. I will now turn the conference over to your host, Adrianne Griffin. You may begin.

Adrianne D. Griffin
VP of Investor Relations & Treasurer

Thank you, Daryl. Good morning, everyone, and welcome to CSW Industrials Fiscal Second Quarter 2020 Earnings Call. Joining me today are Joseph Armes, Chairman and Chief Executive Officer of CSW Industrials; and Gregg Branning, Chief Financial Officer.

If you have not received the earnings release, it is available on our website at www.cswindustrials.com. This call is being recorded. A replay of today's call will be available, and details on how to access the replay are in the earnings release.

During this call, we will be making forward-looking statements. These statements are based on current expectations and assumptions that are subject to various risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings release and the comments made during this call and in the risk factors section of our annual report on Form 10-K and other filings with the SEC. We do not undertake any duty to update any forward-looking statements.

This call will also include an analysis of adjusted operating income, net income and earnings per share, which are non-GAAP financial measures of performance. These non-GAAP measures should be used as a supplement to, and not a substitute for, operating income, net income and earnings per share computed in accordance with GAAP. For a more complete discussion of adjusted operating income, net income and earnings per share, see our earnings release.

I will now turn the call over to our Chairman and Chief Executive Officer, Joe Armes.

Joseph B. Armes
Chairman, President & CEO

Thank you, Adrianne. Good morning and thank you for joining our fiscal second quarter conference call. I want to start by welcoming Adrianne to our team, as she is our Vice President of Investor Relations and Treasurer. We're pleased to have her in this newly created role, which is part of our leadership team and is a natural progression in our company's growth. And I know she looks forward to meeting those of you listening to this call.

I will begin with a high-level discussion of consolidated and segment-level results, followed by a review of our end markets and then wrapping up with an outlook on the remainder of the fiscal year. I will then hand the call off to Gregg for a closer look at the numbers.

Consolidated revenue for the second quarter of 2020 was $101.3 million, representing 10.6% total growth and 6.3% organic growth when compared to prior year period. Both our Industrial Products and Specialty Chemicals segment continued to see healthy sales growth across end markets with some pressure observed in the general industrial end market. Our second quarter adjusted earnings were $0.92 per diluted share, which marked an increase of 16.5% over the prior year period. This continued growth in earnings per share has been driven by operating leverage from increased sales and ongoing benefits from prior year's efficiency initiatives.

Our capital allocation strategy continues to guide our actions. Our priority is to direct capital to the highest risk-adjusted return opportunities within the categories of organic growth, strategic bolt-on M&A and return of cash to shareholders through our share repurchase and dividend programs.

During the period, we continued to invest in new product introductions, which have been important in continuing to deliver growth in excess of the end markets we serve, as demonstrated by our year-to-date organic growth rate of 8% over the prior year period.

Turning to M&A. I am pleased to report that the integration of both Petersen and MSD remain on plan, and the performance of these acquisitions has exceeded our internal forecast. Our team continues to pursue new M&A opportunities. And while the pipeline is robust, elevated valuations have removed many opportunities from consideration because they fail to meet our required return expectations.

We have continued to return cash to shareholders through our quarterly dividend program, and we paid our second quarterly dividend in August. In October, we declared our third quarterly annual -- quarterly dividend, which is payable on November 14 to shareholders of record on October 31. The quarterly rate indicates a $0.54 per share dividend on the stock for the full year, which is just shy of a 1% yield.

Turning to our share repurchase program. While we did not repurchase any shares in the fiscal second quarter, our program remains active, and we continued opportunistic repurchase activity early in the fiscal third quarter.

Moving to our segment performance, beginning with Industrial Products. Sales grew by 14.7%, of which 7.5% was organic, compared to the same prior year quarter. Higher organic sales stemmed from volume growth in HVAC/R, plumbing and architecturally specified building products as we continue to outperform the markets we serve. Our building products businesses are performing well, evidenced by our bookings that continue to outpace revenue, driving an increased backlog.

The Industrial Products segment reported robust operating performance during the period as we delivered segment-level operating income of $16.4 million or 26.1% of sales compared to $14.2 million or

26% of sales in the prior year period. The continuation of strong operating income margin performance reflects improving sales volume.

Turning to our Specialty Chemicals segment. During fiscal second quarter, sales were $38.6 million, up 4.5% as compared to the prior year period, all of which was organic. These increased sales were driven by ongoing volume growth into the energy and architecturally specified building products end markets, partially offset by softening in the general industrial end market. Adjusted quarterly segment-level operating income increased to $6.4 million or 16.5% of sales as compared to $6.2 million or 16.7% of sales. Adjustments in the period reflect removal of a gain on the sale of a facility during the period of approximately $800,000. Due to the completion of our most significant integration and efficiency projects, we are now delivering operating income margins in the mid-teens range as planned. Over the longer term, we see additional opportunity for incremental margin expansion as we generate higher throughput in our facilities and focus on operational efficiency.

Next, I'd like to review the outlook on each of our major end markets. We have continued to see strong demand across the largest end markets we serve. In HVAC/R and plumbing, demand remains strong and the breadth of our expanding product offerings, coupled with new product introductions, continue to drive growth rates well in excess of the end markets. As broad market concerns have come into focus, it's worth reiterating that our products are primarily used in repair and remodel activity where the installed base continues to grow and is less dependent upon new construction. Therefore, we are relatively insulated from broad market or housing cycles, particularly as repair activity in our categories is less discretionary than many other expenditures.

We have continued to gain momentum in the architecturally specified building products end market, particularly with the addition of Petersen into our product portfolio. Our backlog strengthened in the second quarter, and we continue to view our ability to grow primarily as a function of internal execution rather than market conditions. We would remind everyone that there's always risk in these construction projects for delay that can be related to weather as we approach the winter months or labor shortages that we've seen from time to time. And all of these would then affect the timing of these projects' revenues.

Moving to energy. Rig counts have decreased year-over-year but are flattening, and we've continued to see stable demand for our products. We are monitoring this end market and currently expect volume to remain stable throughout fiscal 2020.

In our rail business, sales primarily consist of trackside applicators and lubricants that generally follow rail traffic for a full year period. As we have noted previously, quarterly rail volume can be volatile based on weather and inventory at distributors. In the second quarter, we saw a modest uptick in sales as compared to the prior year, which has normalized after a very strong first quarter, resulting from seasonal changeover of lubricants. For full year fiscal 2020, we continue to expect GDP-like growth in our rail business.

Finally, general industrial was our only end market to post a decline in the quarter, which was in the mid-single digits. This aligns with widespread reports of weaker industrial demand and shrinking CapEx cycles, which are modestly affecting our business. Most of our general industrial exposure is in our lubes and greases contained within our Specialty Chemicals segment, and we will continue to update investors on the status of the general industrial end market trends as warranted.

We are pleased with our performance in the first half of fiscal 2020, demonstrated by double-digit top line growth, a very healthy, sustained margin profile and the successful integration of two bolt-on acquisitions. We attribute this success to the strategic initiatives we have implemented to drive volume and profit across our business, and we believe we are well positioned to realize continued improvement in free cash flow generation to fund our capital allocation strategy and maximize shareholder returns.

As we look to the second half of the fiscal year, we would remind the market participants it would not be appropriate to extrapolate the first half's total revenue growth rate to the second half. We expect to deliver strong second half total revenue growth that approximates the 7% revenue growth we achieved in full year fiscal 2019, reflecting second half seasonality and a tough comparison to the prior year's strong performance. And similar to the first half of this fiscal year, we believe our expected second half revenue growth rate will be well in excess of the growth rate of the markets we serve.

With that, I'll turn the call over to Gregg for a closer look at the numbers.

Greggory W. Branning
Executive VP & CFO

Thank you, Joe, and good morning, everyone.

Our consolidated revenue during the fiscal second quarter of 2020 was $101.3 million, a 10.6% increase over the prior year period. The higher revenue was driven by increased sales in both our Industrial Products and Specialty Chemicals segments, primarily due to 6.3% organic growth and acquisition-related revenue. By end market, increased organic sales were driven by HVAC/R, plumbing, architecturally specified building products and, to a lesser extent, energy, which was partially offset by the general industrial end market softness that Joe mentioned.

In looking at our quarterly segment revenue, operating income and growth drivers, our Industrial Products segment posted revenue of $62.8 million, which was up 14.7% over the prior year period. Organic revenue accounted for 7.5% of the increase and was driven by increased sales volume in HVAC/R, plumbing and architecturally specified building products. Our GAAP segment operating income increased to $16.4 million, a 15.5% increase over the prior year. There were no adjustments to GAAP results in the current or prior year period within this segment.

Moving to the Specialty Chemicals segment. Revenue was $38.6 million, a 4.5% increase over the prior year period, all of which was organic. Increased sales were primarily driven by increased volumes into the energy and architecturally specified building products, partially offset by the general industrial end market. GAAP segment operating income was $7.1 million compared to the prior year period of $6.2 million. Adjusted to exclude nonrecurring items, including a gain on the sale of a facility in the current fiscal period, segment operating income increased 3.4% to $6.4 million compared to $6.2 million in the prior year period.

Moving to our consolidated results in the fiscal second quarter. Consolidated gross profit increased 12.3% to $47.4 million compared to $42.2 million in the prior year period. The increase was primarily a result of the impact of leverage from increased sales and a nonrecurring gain of approximately $800,000 on the sale of a facility in the current year period. Gross margin as a percentage of sales improved 70 basis points to 46.8% compared to 46.1% in the prior year period. Consolidated operating expenses in the current quarter were $27.3 million or 26.9% of sales and as a percentage of sales improved 40 basis points over the prior year level of 27.3% or $25 million. This improvement was driven by sales leverage and was partially offset by increased personnel-related expenses and costs associated with acquisitions. Consolidated GAAP operating income for the second quarter was $20.1 million or 19.9% of sales compared to $17.2 million or 18.8% of sales from the prior year. The increase in operating margin was driven by leverage on sales and benefits from prior year's efficiency initiatives.

The effective tax rate on continuing operations for the second quarter ended September 31, 2019, was 29.2% and was higher than normal due to taxes on repatriation of some foreign cash. We continue to expect our fiscal 2020 effective tax rate to be in the range of 23% to 26%. Reported net income from continuing operations decreased to $8.8 million or $0.58 per diluted share compared to $12.4 million or $0.79 per diluted share in the prior year period, primarily due to a onetime charge to terminate the company's U.S. qualified pension plan of $7 million or $0.35 per diluted share after tax. Of the $7 million pension plan charge, virtually all of which was noncash, with only $0.5 million being cash. The termination of our U.S. qualified pension plan was the natural next step as we froze the plan a couple of years ago. And by terminating the plan, we've removed future expenses and risks associated with the plan based on market volatility, along with interest rate volatility. Adjusted to exclude onetime items and applying a normalized tax rate in both years, adjusted net income from continuing operations in the fiscal second quarter of 2020 increased 12.9% to $14 million or $0.92 per diluted share compared to adjusted net income from continuing operations of $12.4 million or $0.79 per diluted share in the prior year period.

Moving to our cash generation and balance sheet. Our operating cash flow from continuing operations increased 15.4% to $37.5 million in the second fiscal quarter of 2020 compared to $32.5 million in the prior year period. We ended the quarter in a net cash position of $12.5 million, and we had the full $250 million of borrowing capacity remaining on our revolving credit facility, which provides us ample flexibility to fund our growth and capital allocation strategy, including acquisitions.

With that, I will turn the call back over to Joe.

Joseph B. Armes
Chairman, President & CEO

Thanks, Gregg. The solid foundation of our first half results position us well for the balance of fiscal 2020 and into 2021. We will continue to drive integration and efficiency initiatives, to offer best-in-class products, to serve our customers and help their businesses grow, and to steward well the capital entrusted to us by our shareholders.

I want to take this opportunity to thank all of my colleagues at CSW Industrials for a great job this quarter and remind you that they collectively own over 5% of our company through our employee stock ownership plan. We also want to thank all of our other shareholders for their continued interest in, and support of, our company.
With that, operator, we're now ready to take questions.

QUESTION AND ANSWER

Operator

Our first question comes from the line of Jon Tanwanteng of CJS Securities.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Yes. Can you remind me what percent of sales is general industrial now and if you see that getting worse on a year-over-year decline basis in Q4?

Joseph B. Armes
Chairman, President & CEO

Yes. Let's start -- yes, the big headline number is that industrial year-to-date is about 12% of revenues.

And so if you think about an order of magnitude, HVAC, plumbing and architecturally specified building products, together, are well over 70% of our revenue. So there's limited exposure there.

Greggory W. Branning
Executive VP & CFO

And the other thing I would say, Jon, is well, when we put out our investor deck here in the next day or so, you'll obviously see the pie charts year-over-year. The percent decreased from the prior year year-to-date of 14% down to 12%, part of that decrease was going to naturally be due to the expansion of the larger pie as well as the acquisitions, coupled with the fact that it was down slightly.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Great. And how do you see that trending into the December quarter?

Joseph B. Armes
Chairman, President & CEO

We don't have any better data than what this quarter gave us, so we wouldn't anticipate any immediate turnaround. But I think -- but we also don't hear anything in the marketplace that gives us a dramatic cause for dramatic action.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Fair enough. And the same question for energy and given the declining rig counts, what gives you confidence that your volumes there will be stable?

Joseph B. Armes
Chairman, President & CEO

Yes. I mean it's obviously volatile, but rig counts have been down year-over-year for 2 or 3 quarters now, and they seem to -- rig count seems to have stabilized. And so we had a pretty good quarter for energy. And so again, we're just kind of -- we're seeing kind of a moderation there, not a dramatic decline.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Great. And then did you break out how much backlog you have in the architectural business at this point and kind of what was the increase sequentially or year-over-year?

Greggory W. Branning
Executive VP & CFO

Yes, Jon. This is Gregg. We didn't break it out, but I will tell you that it has grown. And our book-to-bill over the last 8 quarters continues to be positive. And so, it's up and it's continuing to trend in the right direction. That being said, I'll remind you of Joe's prepared comments earlier, where delays can affect us, coupled with as we head here into the winter months, we typically will see delays or can see delays due to weather. And obviously, labor shortages continue to be an issue, despite the fact that we had a nice quarter.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Got it. And are you seeing those labor issues now? Or is it just more of a risk than something that's actually going on?

Joseph B. Armes
Chairman, President & CEO

We get scattered reports. I mean, delays are -- sometimes, it's hard to get to the bottom of why a delay is occurring, but that has been something that's been repeated throughout the last few quarters that we hear. But that's just one that -- those tend to be lumpy, and that part of its outside our control. And so, we're always very concerned about that and cautious.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Got it. Joe, just to clarify, you mentioned the 7% growth rate. Was that for the second half or the full year that you're seeing or you're expecting to see?

Joseph B. Armes
Chairman, President & CEO

Second half.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. So 7% year-over-year for 2H?

Joseph B. Armes
Chairman, President & CEO

Total growth.

Greggory W. Branning
Executive VP & CFO

Yes.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Got it. Okay. And then, Gregg, one for you. Just the impact of the pension termination, was there an ongoing P&L cost or cash flow item?

Greggory W. Branning
Executive VP & CFO

Yes, it was more P&L, just the expenses of having it and then the volatility of the market. So while about a year ago, we had started to move out of equities into more of a fixed income, and so that better positioned us. But as interest rates change, and particularly given the fact that we have seen 2 ticks down with the Fed, timing on it being somewhat fortuitous because the cost goes up as interest rates decrease, and so it simply gets us out of the volatility and noise.

It was an overfunded plan, which is why it only cost us $0.5 million for cash to terminate it. And so the P&L hit, part of that was due to the asset that was on our balance sheet and other assets, coupled with the unamortized cost that was sitting in other comprehensive income.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Got it. Is there going to be an ongoing impact or benefit going forward from this?

Greggory W. Branning
Executive VP & CFO

No, because we did -- part of it, people took lump sums and then the other part went into annuities with a qualified insurance provider. And so all of that risk has moved out.

I will say that we completed it right at the very end of the fiscal quarter. And so there may be a little bit of things that could sprinkle through as we get the final pension plan information from our actuarial provider, but we don't expect it to be anything meaningful by any means.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Great. And then, Joe, just any update on the use of cash and specifically, the M&A pipeline? What are you seeing out there at this point?

Joseph B. Armes
Chairman, President & CEO

Yes. We're pleased with the pipeline. We're having good meetings. I'm personally involved in a number of those. And so I'm very pleased with the pipeline. Valuations continue to be a challenge, and we're going to continue to be disciplined. But we're seeing lots of opportunities, and so I'm very pleased with that. And both on the kind of product line extension and then some other acquisitions, it would be a little more moderate in size. And so again, very pleased with the robust pipeline, just looking for that right opportunity where the valuation makes sense for us.

Jonathan E. Tanwanteng
CJS Securities, Inc.

Okay. Great. Joe, you mentioned -- or earlier this year, you took up your capital expenditures to launch some new products. Have this hit the market yet?

Joseph B. Armes
Chairman, President & CEO

The primary piece of that have not -- or will really be in the build-up for next summer. So you'd see that either in Q4 or Q1 of next year. But the specific project that, that was intended to -- that we invested in there, that has not come to market yet.

Operator

Our next question comes from the line of Brian Lau from Sidoti.

Brian Lau

It's Brian on for Joe Mondillo this morning. Congrats on another solid quarter.

Joseph B. Armes
Chairman, President & CEO

Thanks, Brian.

Brian Lau

Just real quick, forgive me if I missed this in the beginning of the prepared remarks. But just on the Specialty Chemicals segment, looked like ex that facility sale, the margin was down about 20 basis points. Can you just kind of just walk me through the reasoning behind that and how you kind of see that playing out in the rest of the year?

Greggory W. Branning
Executive VP & CFO

Yes, Brian, this is Gregg. So it was primarily mix. You're right, it was down 20 basis points when you pull it out, but it just -- it was simply the mix of products.

We're continuing to be pleased with the mid-teens that we had indicated a number of quarters ago was our expectation. And so I think the only thing to be cautious relative to Spec Chem as well as Industrial Products, and I'll remind you and ultimately, Joe, about is our back half of the year, Q3, in particular, tends to be our weakest quarter. And so margins come down due to the seasonality there. But the key for us is growing top line sales as we move forward, which will give us leverage to drive those margins up even higher.

Brian Lau

Okay. And then just as far as the mix, is that product specific? Or can I think this end market as a whole, with the industrial being down and the energy kind of being a little stronger, is it kind of end market-specific? Or how can I kind of think about that mix?

Greggory W. Branning
Executive VP & CFO

Yes, it was all over the board. When you're dealing with 20 basis points, it's hard to pinpoint it exactly and say it was due to this end market or this given product, if you will.

Brian Lau

Okay. And then just on the Industrial Products, it looks like organic growth might be slowing a little bit sequentially, granted it's coming off a pretty strong quarter last quarter. How do you kind of look at that going forward?

Joseph B. Armes
Chairman, President & CEO

Yes, in effect, you're a victim of your own success. I mean our past growth rates make it just harder to not have that occur mathematically. But that business is very robust. We're very pleased with the prospects, very pleased with our execution and don't have any concern at all on that side of the business.

Greggory W. Branning
Executive VP & CFO

Yes. The other thing I will add on that, Brian -- this is Gregg again -- is that if you go back and look a year ago, our fiscal Q1 comp a year ago was pretty low, which resulted in a really nice -- us posting a really nice growth number in fiscal Q1 of this year. And then fiscal Q2 last year and Q3 were high, and that was because of an order issue that we had with one of our major customers going back all the way to the to fiscal year '18. And so it just -- it kind of made our first half into Q3 somewhat choppy, creating weird comps for us year-over-year. So while you naturally would see some lower -- typically some lower growth in Q2 because sequentially, Q1 is always our strongest quarter than Q2, then Q4, then Q3.

Brian Lau

All right. No, that's helpful. And that makes total sense. Just maybe lastly, I think you guys kind of touched on it a little bit, just maybe the pace of bookings in the architecturally specified building products just kind of going into this quarter, still strong or stronger, slowing at all?

Greggory W. Branning
Executive VP & CFO

Yes.

Brian Lau

Still strong.

Greggory W. Branning
Executive VP & CFO

Yes. No -- the pace of bookings is still really strong. We -- our book-to-bill in the quarter continue to be positive for the last 8 quarters in a row. As I mentioned earlier, our book-to-bill exceeds 100%. And so we're very pleased with that business and where it sits, given it's more of a backlog-based business. So we think we're in good shape.

Brian Lau

And what's the general kind of timing look like for that backlog?

Greggory W. Branning
Executive VP & CFO

So the backlog there can last anywhere -- it can be a short-term project that you can book revenue on in 3 months all the way up to an 18 to 24 months, depending on the timing of the project.

Brian Lau

And is it leaning one way or another right now? Or it's, again, kind of all over the place?

Greggory W. Branning
Executive VP & CFO

It's all over. It's pretty consistent with what we've seen, which is good because it is consistent. And so as backlog builds, that sets us up pretty well to finish this year and go into next year, again, reiterate our cautionary comments that Joe had and I had earlier on the seasonality that we see with weather and manpower shortages. So it can be lumpy, but we're feeling very good about that group of businesses and the strength of the backlogs.

Joseph B. Armes
Chairman, President & CEO

Those projects rarely get moved up. They'll slip in time, but they rarely ever get moved up. So it's -- that's why we caution on that.

Operator

We have reached the end of the question-and-answer session. I will now turn the call back over to CEO, Joe Armes, for any closing remarks.

Joseph B. Armes
Chairman, President & CEO

Great. Thank you once again for participating in our quarterly conference call. We appreciate your interest in our company and look forward to speaking to you again next quarter thank you.

Operator
This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.