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Quad/Graphics, Inc. (QUAD)

Q1 2022 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to Quad's First Quarter Conference Call. During today's call, all participants will be in a listen-only mode. [Operator Instructions] A slide presentation accompanies today's webcast, and participants are invited to follow along, advancing the slides themselves.

To access the webcast, follow the instructions posted in the earnings release. Alternatively, you can access the slide presentation on the Investors section of Quad's website under the Events and Recent Presentations link. Please note that this event is being recorded.

And I'd now turn the conference call over to Katie Krebsbach, Quad's Investor Relations Manager. Katie, please go ahead.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

Thank you, operator, and good morning, everyone. With me today are Joel Quadracci, Quad's Chairman, President and Chief Executive Officer; and Tony Staniak, Quad's Chief Financial Officer. Joel will lead off today's call with a business update, and Tony will follow with a summary of Quad's first quarter 2022 financial results followed by Q&A.

I would like to remind everyone that this call is being webcast, and forward-looking statements are subject to Safe Harbor provisions, as outlined in our quarterly news release and in today's slide presentation on slide 2. Quad's financial results are prepared in accordance with generally accepted accounting principles. However, this presentation also contains non-GAAP financial measures, including adjusted EBITDA, adjusted EBITDA margin, adjusted diluted earnings per share, free cash flow, net debt, and debt leverage ratio. We have included in the slide presentation reconciliations of these non-GAAP financial measures to GAAP financial measures.

Finally, a replay of the call and the slide presentation will be available on the Investors section of quad.com shortly after our call concludes today.

I will now hand over the call to Joel.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Thank you, Katie, and good morning, everyone. Beginning on slide 3, I am pleased to report we delivered a fourth consecutive quarter of sales growth, achieving a 9% increase in net sales when excluding divestitures. This sales

growth reflects print segment share gains from new clients, net sales growth and targeted print and agency solutions, as well as increased pricing in response to inflationary cost pressures. Throughout the quarter, we continued to face macroeconomic headwinds such as ongoing inflationary cost pressures and supply chain constraints. We worked diligently to mitigate these impacts while also making investments to prepare for our seasonally busier second half of the year. These investments included increasing inventory levels for paper and other key manufacturing materials and hiring and training employees for our manufacturing operations far earlier than usual. As a result, our net earnings and adjusted EBITDA during the first quarter were negatively impacted.

Given the pace of inflation we implemented another across the board price increase, which will go into effect on May 15. Slide 4, shows how we continue to diversify our revenue into higher value and higher margin offerings while growing net sales 9%. Each of our product and services lines within targeted print and integrated solutions grew from first quarter last year to the first quarter this year, while we continued to manage for expected organic declines in large scale print.

Turning to slide 5, we are proud of the company's transformation and continue to evolve how we operate and communicate our value. Quad is unique. We are a marketing experience company that helps brands reimagine their marketing to be more streamlined, impactful, flexible and frictionless through an integrated marketing platform featuring distinct core specialties that includes business strategy, insights and analytics, technology solutions, managed services, agency and studio solutions, media, print, in-store and packaging. Our transformation was validated once again last week through our ranking as number 16 on the world's largest agency companies list compiled annually by Ad Age.

On slide 6, we highlight our three competitive advantages integrated marketing platform excellence, innovation and culture and social purpose. We continue to strategically invest in our platform to give brands and marketers a more efficient, effective and frictionless way to go-to-market and reach consumers and scale our competitive position. These investments include bringing onboard new talent. For example, we recently welcomed Rachel Winer as our new Senior Vice President of Business Development. Rachel is a powerhouse with nearly three decades of advertising, brand, marketing and communications experience, including head of office roles at Edelman and BuzzFeed and brand team leader roles at Leo BURNETT, JWT and BBDO.

We also continue to invest in our creative, strategic, analytic and production capabilities. These investments include but are not limited to advancements in data insights and analytics, industry leading client technology solutions and next gen printing capabilities, which include high quality, high speed digital process for variable print. These processes are a real game changer for our in-store group, which continues to grow by helping clients create unique shopping experiences that drive engagement and revenue.

To strengthen our brand as a marketing experience company we're making investments on how we market ourselves including introducing Quad to new and expanded audience as shown on slide 7. This year we participated in South by Southwest in the Consumer Electronics Show. And soon we'll be at the Cannes Lions International Festival of Creativity. Introducing Quad to other industry marketers allows us to create brand awareness [indiscernible] (06:15) innovative story, build new client relationships, and further increase revenue in growing vertical industries.

We also continue to host our own client events and conversations on timely and relevant topics for brands and marketers. For example, last week, Rise Interactive, our performance marketing agency, hosted preparing for the Metaverse through Augmented Reality Advertising. The marquee event was produced in partnership with Meta, Facebook's parent company and a visionary in the social connection space.

The content gave attendees an exclusive look at the long term Metaverse roadmap, along with near-term opportunities for taking advantage of AR advertising as a real time way for brands to connect with their customers. This week we are hosting our 22nd Postal Conference, a multi-day event related to knowledge sharing and solutioning around postage, our clients' single largest print manufacturing related expense.

US Postmaster General Louis DeJoy is the featured speaker on the state of the agency and priorities for the future. I invite you to watch our website for conference updates. I am pleased to share that the Postal Service Reform Act was signed into law last month. The act saves the Postal Service approximately \$50 billion over the next 10 years and forgives both the debt and the non-payment of the healthcare prefunding. This puts the agency on a path to financial stability and reverses a crisis of confidence in the future of mail delivery. As one of the Postal Service's largest clients, we are proud to have helped advance this bill into law, the product of years of hard work, including testifying before Congress multiple times.

Quad has a unique advantage point that sits at the intersection of optimization, insights and innovation. On Slide 8, we show an example of how we help the global energy drink and media company known for creating unique experiences transform its marketing operations, paving the way for us to rapidly expand our relationship into other marketing services. When we were first introduced, this brand's US operations needed a point of sale marketing solution to support hundreds of field sales reps responsible for managing thousands of retail locations. Specifically, the brand needed the ability to keep all campaigns in line with global brand standards, while simultaneously providing localized flexibility for events and point of sale partnerships.

Our client technology team got to work and delivered an easy-to-use mobile accessible platform. Now field sales reps can manage consistent point of sale experiences, including hyper localized promotional materials. Our solution also consolidates all orders to maximize production economies of scale, and tracks and manages budgets nationally, regionally and locally. Having earned this client's trust, we have since put employees on site who serve as an extension of this client's US marketing team. Additionally, we have been engaged for other marketing services, including consumer research, campaign strategy, and creative for digital assets. We look forward to further expanding our relationship with this client as well as to continue to use our client technology solutions as an entry point for conversations with other global brand marketers.

Turning to Slide 9, another way in which we are helping our clients reimagine the marketing experience is through their sustainability efforts. Sustainability has been a core focus at Quad since our founding more than 50 years ago and is a foundational element of our ESG strategy. Other companies seeking to advance their own sustainability efforts often engage us for our expertise on this important topic. Last month, Quad appeared on stage with our clients CVS Health at SPC Impact 2022, the Sustainable Packaging Coalition's flagship event. The conversation centered on how companies can get started on their sustainability journey by lifting what they do well every day and then shifting that into sustainability efforts to accelerate progress and achieve results.

At Quad, we are proud of the transferable skills we have built over time to meet our clients' sustainability objectives. We have a strong ESG strategy and we will continue to grow this very relevant and profitable area of our business.

On slide 10, we show how Quad has been driven by a commitment to culture and social purpose throughout our more than 50-year history. We take seriously our role in creating a better way through our approach to ESG matters. I am pleased to share that we have just released an immersive online experience on quad.com captures how we are driving positive, sustainable change in our business. I invite you to check out this experience, which will be expanded over time to keep all stakeholders up to date on our ESG commitments.

When it comes to the environment, we continue to focus on responsible sourcing and reducing impacts, including expanding responsible forestry practices and lowering our overall carbon emissions intensity. In the social space, we continue to work hard on numerous strategies to retain employees and attract new talent with diverse social identities and experiences. This includes our work to develop a more comprehensive and sustainable diversity equity inclusion strategy. Our ongoing work in the social space not only benefits our employees, but also the clients who trust us with their business and the communities [ph] we call home. (12:06)

Before I turn the call over to Tony, I want to thank our employees once again for continuing to focus on performing well for our clients in the face of ongoing challenges. In particular, I want to recognize our Poland based employees, a number of whom are native born Ukrainians, as the war persists in neighboring Ukraine. I am heartened by our employees overwhelming show of support for displaced Ukrainians through a variety of efforts, including serving as host families.

With that, I will turn the call over to Tony for a review of our financial results.

Anthony C. Staniak

Chief Financial Officer, Quad/Graphics, Inc.

Thanks, Joel, and good morning, everyone. Slide 11 provides a snapshot of our first quarter 2022 financial results. As Joel mentioned, we delivered net sales growth of 9%, excluding divestitures, a fourth consecutive quarter of net sales growth. We ended the quarter with strong liquidity of \$138 million of cash and \$397 million in unused capacity on our revolving credit agreement, which enabled us to pay out the remaining \$209 million outstanding of our unsecured 7% senior notes on May 2nd.

We will remain disciplined in our operational execution, while reducing debt and making investments to accelerate our growth, as a marketing experience company. Net sales were \$744 million in the first quarter, up 5% from 2021. Excluding the June 2021 divestiture of QuadExpress, a third party logistics company that was a small part of our overall logistics business, net sales increased 9% from 2021. The growth during the quarter was due to price increases implemented in response to inflationary pressures, print segment share gains from new clients and net sales growth in our targeted print and agency solutions offerings.

Adjusted EBITDA was \$49 million in the first quarter of 2022, as compared to \$70 million in the first quarter of 2021. The decline in adjusted EBITDA during the quarter was primarily driven by supply chain disruptions, investments in hiring and training labor in advance of peak production season in the second half of the year, and cost inflation, partially offset by net sales growth. In response to increasing costs to service our clients, we have implemented an additional price increase effective May 15, 2022.

Adjusted diluted earnings per share was \$0.04 in the first quarter of 2022, compared to \$0.19 in the first quarter of 2021. The decline was primarily due to the supply chain challenges, investments and cost inflation previously mentioned, partially offset by net sales growth, lower depreciation and amortization, and lower interest expense due to debt reduction.

Free cash flow was negative \$36 million in the first quarter of 2022, a \$92 million decrease compared to 2021, primarily due to higher working capital. We also invested \$19 million during the first quarter in capital expenditures consistent with our long-term automation strategy. We will continue to invest in our business to seize opportunity and accelerate our growth. As a reminder, the company historically generates the majority of its free cash flow in the fourth quarter of the year.

Slide 12 includes a summary of our debt capital structure. Net debt increased by \$40 million to \$664 million at March 31, 2022, as compared to \$624 million as of December 31, 2021. And the debt leverage ratio increased 38 basis points to 2.77 times at the end of the first quarter. The increase in net debt and debt leverage ratio was primarily due to the investments in working capital, talent and equipment to enable continued sales growth. As a reminder, our long term target leverage range is 2 times to 2.5 times and we plan to achieve 2.25 times in the middle of that range by the end of the year.

As of March 31, our blended interest rate was 4.6% and we maintained our strong liquidity with up to \$397 million of availability under our revolving credit agreement, as well as \$138 million of cash on hand. This strong liquidity enabled us to pay out the remaining balance of \$209 million of our unsecured 7% senior notes on May 2, after we proactively repurchased \$2.4 million of the notes during the first quarter to save on interest payments. This repayment is part of our multi-year debt reduction plan and results in a lower blended interest rate of approximately 3.8%, an improvement of over 80 basis points, which will lower our interest expense moving forward. Our near significant debt maturity is now \$91.5 million occurring in January of 2024.

Our 2022 guidance is unchanged as shown on Slide 13. We will continue to be nimble with our pricing to mitigate the negative impacts of supply chain disruption and cost inflation. As a reminder to what I told investors during last quarter's call, adjusted EBITDA and free cash flow will be lower in the first half of 2022 compared to the previous year as we make strategic investments to expand our offerings and to drive higher revenue, profitability and cash in the second half of 2022 during our seasonal peak. Our financial objectives remain unchanged, including driving earnings through sales growth, effective cost management and productivity improvements, as well as reducing debt through the generation of strong free cash flow. All of these efforts will further strengthen our balance sheet and liquidity, enhancing our financial flexibility to accelerate and scale our strategy, as a marketing experience company and drive shareholder value.

With that, I'd like to turn the call back to Katie for questions.

QUESTION AND ANSWER SECTION

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

A

Thank you, Tony, because we compiled questions in advance of today's call, we will not ask for callers to enter the queue. Thank you to everyone who submitted a question. We have four top questions that were submitted. Our first question relates to industry and segment trends that asks, can you provide more insight on the trends you saw across the various segments of the business during the first quarter?

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Yeah. Thank you, Katie. And as I usually do, I'll start with large scale print, which really is comprised of retail inserts and magazines and I'll remind people that that is the segment that we expect to have continued organic decline of a larger extent compared to the other lines of business that we're in. The retail inserts for the quarter were off about 20%, magazines off about 7%, there is a [ph] few titles (19:25) experienced closure. But again, those were somewhat expected. The important thing about the relationships we have here, though, is that they use all sorts of other services and other areas of media. And so while specifically with retail inserts, as you see a decline in that use of advertising dollars, oftentimes we're helping those clients shifted to things like direct mail, in-store or performance marketing with things like Rise Interactive.

And as I look at like the targeted print segment, which all fared fairly well, our catalog business for the quarter was up 3%, but for the trailing 12 months was up 20% because of segment share wins. On the direct mail side for the quarter were up over 21%, again same story in terms of segment share wins, packaging was about 4% with in-store continuing its sort of growth with segment share wins of 22%. So again, as you watch us over time, as you listen to us talk, the services side as well as the targeted print side is where the shift is going as you can see in the slides we provided. Even though we have decline in retail inserts and magazines, there's still a cash flow, an important part of the business, but also an important opportunity to continue to sell the other services and products.

Katie, next question.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

A

Thanks, Joel. Our next question is regarding products and services offering that ask you mentioned that Quad is in a unique position as a marketing experience company. Can you give more detail on what you mean by that?

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Yeah. It's a question we get a lot and how are we different? And that as we've kind of grown up into towards the big holding company agency offerings or the consulting offerings of workflow and content creation, what's missing out there is a one-stop – more of a one-stop shop that not only has the front end of planning and content creation, but also the back end of execution. And so when we talk about through the line and we talk about that marketing experience, the through the line means, we can work with the brand all the way from the beginning, all the way to the end of their process of marketing their customers and sort of the marketing experience is about making it integrated. So there's not that big break in the chain for our marketers, it's something that's much more concise

fluid, which means that we're taking time out of their marketing schedule and allowing them to iterate their messaging faster. And so when we talk about being unique, there really isn't an offering like we have because of that connectivity between sort of the front end of marketing and the back end of execution.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

A

Great. Thanks again, Joel. Our next question is regarding paper, it asks, can you give more insight on the impact that paper constraints had on the quarter and what has factored into your guidance in terms of paper availability?

Anthony C. Staniak

Chief Financial Officer, Quad/Graphics, Inc.

A

Thanks Katie. I'll take that one. So when we think about paper, it's a reminder that 50% of our paper is supplied by clients and the other 50% we purchase on behalf of our clients. Then on that 50% that we purchase for our clients, we pass through paper cost increases to our clients. As a result, when you think about the guidance, the main area you're going to see the impact is on our net sales, which was, our guidance was a 3% to 7% increase, which we're very pleased with, 9% increase in the first quarter, but that would have even been higher if not for limits due to paper constraints.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

[indiscernible] (22:58) I'd say Tony also, I mean, we've been very active in managing that because, whether there was one supplier with a strike in Europe or just shortages here, we purchase a significant amount of product and therefore really have great relationships with our mills and really look at it from a supply chain standpoint of streamlining. So we've been, I think, pretty successful about working through the issue as best we can, and we continue to see that as a place of opportunity.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

A

Thank you, both. Okay. Our last question is on new investments. It reads, can you go into more detail on the growth investments you're making to distinguish your marketing platform, as you mentioned earlier?

Anthony C. Staniak

Chief Financial Officer, Quad/Graphics, Inc.

A

Thanks, Katie. So, yeah, we see opportunity to grow our business and we talked about paper and materials that we are purchasing and putting in inventory to be able to service our clients during peak season. But in addition, we've invested \$19 million this quarter alone in capital expenditures guidance for the year \$55 million to \$65 million, and that's in automation and faster printing presses to enable us to become more efficient and maintain the platform that we've assembled. We've also done a lot on the labor side, with a best in class workforce that is additional \$50 million in investment over the past 12 months. That includes higher wages for, when we start people, in our experienced folks, sign on bonuses, referral programs, training investment in those people, all to be able to service our clients well, during, now and the upcoming peak season.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Well, and labor is just such a crucial topic these days, I think, in any industry. And the second half of last year, many companies really struggled with getting enough people. And so, the fact that we are consistent about

spending money on automation over the years and that we continue to do it, helps us, in terms of managing that relative to our competitive set, but also, [indiscernible] (25:05) we're hiring for the second half of the year. We'll start that in July or June. Last year we did it early June and I thought that was early. This year we started in January, and so that's where we referenced the earlier hiring that we're doing and the amount of training that's involved in that, we've upped that as well so that we're ready to go with the segment share increases we have and with the busy season coming. And so that's what we're doing in that investment stage.

I'd say that the other part of the investment that's really important is to grow the company, it's on the services side in some of the product offerings that we've added. So it's less about thinking about acquiring companies. We've done that. We'll always consider in the future. But right now, it's about scaling our talent on the services side. So as I mentioned, Rachel joining us, we have a whole slew of other people who are joining us from the consulting world or the agency world that is going to allow us to scale that continued growth in the services side.

Katie Krebsbach

Investor Relations Manager, Quad/Graphics, Inc.

Great. Thank you, both. This concludes the Q&A portion of today's call. And now, I would like to turn the call back to Joel for closing remarks.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Thanks, Katie, and thank you, everyone, for joining today's call. I want to close by reiterating my thanks to our employees for their continued hard work and ability to adapt and adjust to change, something we're always doing. I'm confident in our team, in our strategy and our future as a marketing experience company. Our integrated marketing offering continues to be a competitive differentiator and a key driver behind our company's overall organic growth. In the face of ongoing supply chain and other disruptions, we will continue to work thoughtfully and diligently to mitigate these impacts while staying focused on managing our clients' needs and expectations.

With that, thank you again and have a good day. We look forward to speaking with you again next quarter.

Operator: Ladies and gentlemen, that does conclude today's presentation. You may now disconnect your lines.

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