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The Timken Co. (TKR)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Paula, and I will be your conference operator today. As a reminder, this call is being recorded. At this time, I would like to welcome everyone to Timken's Fourth Quarter Earnings Release Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

Thank you. Mr. Frohnapple, you may begin your conference.

Neil Frohnapple

Director-Investor Relations, The Timken Co.

Thanks, Paula, and welcome, everyone, to our fourth quarter 2021 earnings conference call. This is Neil Frohnapple, Director of Investor Relations for The Timken Company. We appreciate you joining us today.

Before we begin our remarks this morning, I want to point out that we have posted presentation materials on the company's website that we will reference as part of today's review of the quarterly results. You can also access this material through the download feature on the earnings call webcast link.

With me today are The Timken Company's President and CEO, Rich Kyle; and Phil Fracassa, our Chief Financial Officer. We will have opening comments this morning from both Rich and Phil before we open up the call for your questions. During the Q&A, I would ask that you please limit your questions to one question and one follow-up at a time to allow everyone a chance to participate.

During today's call, you may hear forward-looking statements related to our future financial results, plans, and business operations. Our actual results may differ materially from those projected or implied due to a variety of

factors which we described in greater detail in today's press release and in our reports filed with the SEC, which are available on the timken.com website.

We have included reconciliations between non-GAAP financial information and its GAAP equivalent in the press release and presentation materials. Today's call is copyrighted by The Timken Company, and without express written consent, we prohibit any use, recording, or transmission of any portion of the call.

With that, I would like to thank you for your interest in The Timken Company, and I will now turn the call over to Rich.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Thanks, Neil. Good morning, and thank you for joining us today. The fourth quarter was consistent with the trend that we saw early in 2021, and it ran through the full year with strong revenue across most end markets and geographies, rising costs, particularly in steel and logistics, in an abnormally high amount of inefficiencies across our operations from labor and supply chain challenges.

The result was revenue of \$1.01 billion and earnings per share of \$0.78. Revenue was up 13% from 2020 and up 10% from the prior fourth quarter record. We delivered this revenue growth despite continued supply chain and operational challenges. The revenue strength was broad based, and orders were also strong across almost all markets.

Backlog grew despite the record level of shipments and is up significantly sequentially and over prior year. Ramping up to meet the demand continued to require a significant cost premium as costs increased further in the quarter and price/cost remained negative. Price was up both year-on-year as well as sequentially in the quarter and contributed modestly to the revenue growth, but lagged the cost increases. The result was a year-on-year decline in margins of 280 basis points and a decline in earnings per share of 7% for the fourth quarter.

For the full year of 2021, Timken delivered record revenue \$4.1 billion, which was an 18% increase over 2020 and a 9% increase over 2019, the prior high mark for revenue. We delivered strong revenue levels despite significant challenges with supply chains, including labor shortages, transportation delays and material shortages. The growth was driven by robust industrial demand across most end markets and was boosted further by our outgrowth activities, including delivering a fourth consecutive year of double-digit growth in renewable energy and a 12th consecutive year of completing at least one acquisition.

Our focus in 2021 on responding to our customers' demand and increasing our market position did come with a significant cost premium, cost increased sequentially each quarter through the year. The primary drivers were steel, logistics and supply chain inefficiencies. The challenges ranged from higher than normal absenteeism and onboarding costs within our plants to transportation delays, material shortages and premium costs associated with securing supply.

Price/cost went modestly negative early in the year and, by the second half, had a significant impact on margins. Our price realization in 2021 lagged the cost increases in magnitude and timing due to a combination of factors, including contractual commitments as well as inflation exceeding our expectations. We began increasing prices in the second quarter of the year and price realization increased sequentially each month from April through December. Price for the year was up under 1% and margins for the year declined by 140 basis points as the negative impact of costs more than offset the benefits of increased revenue and price.

Despite the supply chain challenges and rapid increase in costs, Timken did deliver record earnings per share of \$4.72 in 2021 and we're positioned for another record year in 2022. We added 5% more employees to our global plant staffing levels through the course of the year. We also added inventory to serve increased customer demand and to accommodate for supply chain issues. We made progress on mitigating internal and external supply chain constraints and inefficiencies, and we expect productivity gains in 2022.

We have negotiated or implemented price increases for much of the portfolio, which will be evident in the 2022 results. We entered 2022 confident that price realization will be significantly higher than it was last year. Due to strong markets, our rapid response to the increase in demand and our outgrowth initiatives, our backlog grew significantly through the course of the year and we are well-positioned to deliver another year of double-digit top line growth.

During the year, we executed well against our long-term strategy. We completed the acquisition of iMS, strengthening our linear motion offering in robotics. We continued our investment in our digital platform with the elimination of two legacy ERP systems. We advanced our footprint with the closure of a facility in Italy, the opening of a facility in Mexico and the investment of \$150 million in CapEx, including the advancement of our previously announced \$75 million investment in renewable energy. The 2021 CapEx will help us achieve new levels of revenue in 2022, as well as mitigate the cost and labor issues that we faced last year.

We continued to deliver financially and strategically on our acquisitions, including the 2019 acquisition of BEKA Lubrication Systems. Despite the challenges from the pandemic and the supply chain issues which started within a few months of closing, we continued to deliver synergies and value from the BEKA acquisition. We have completed integration of Groeneveld and BEKA's management teams, product lines and sales forces. We've invested in and launched new products that are being well-received by the market, and we advanced the footprint including the closure of our manufacturing operation in the UK and the expansion of our operations in the US and China.

We continue to pursue M&A opportunities and we expect our M&A activity to increase in the next couple of years. We ended the year with a strong balance sheet and would expect capital allocation to be a significant contributor to our results in the coming years. We also advanced our Corporate Social Responsibility program in the year and our Timken team continues to prioritize employee safety and employee diversity, giving back to our communities and advancing environmental sustainability in our operations and through our products. As a result, Timken was once again recognized as one of America's most responsible companies.

Turning to the 2022 outlook, we're guiding to 10% revenue growth across the portfolio. 10% is comprised of 7% volume, 4% price and negative 1% currency. We're expecting almost all markets to be up at least mid-single digits. As I mentioned earlier, our backlog to start the year is high, order flow is strong, customer sentiment is bullish, our growth pipeline is robust and our production, plant staffing and inventory levels are all up. We are still dealing with various supply chain issues, but we're off to a good start to achieving the 7% volume growth, and we have the backlog and momentum to support the revenue outlook for the full year.

On the 4% price, the actions needed to achieve this level have already been implemented or negotiated, and we're confident that we will realize at least 4% this year. The majority of the pricing is in effect today, so it'll be evident in the first quarter results. We're also guiding to \$5 to \$5.40 of earnings per share, which would be up about 10% at the midpoint, with EBITDA margins of about 17%.

In those estimates, we're assuming that the increased cost levels we experienced in the second half of 2021, hold for the full year of 2022. That is what we are experiencing to start the year. We believe we've been conservative in

our cost assumptions. We're including market, inflationary and manufacturing costs, but the supply chain situation remains very dynamic and the range of possibilities remains wider than normal. We remain very focused on both mitigating the supply chain costs and recovering costs with pricing.

In summary, we expect to deliver record revenue and record earnings per share in 2022 in what remains a robust, but very choppy industrial market expansion. And we will do it while continuing to advance and grow our market position as a diversified industrial leader, creating long-term value for all stakeholders. Phil?

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

Okay. Thanks, Rich; and good morning, everyone. For the financial review, I'm going to start on slide 12 of the presentation materials, which includes a summary of our results. Revenue in the quarter was just over \$1 billion and set a Timken record for the fourth quarter. Sales were up 13% from last year and up more than 10% from the fourth quarter of 2019. We delivered an adjusted EBITDA margin of 13.4% and adjusted earnings per share of \$0.78 in the quarter, both down from last year. And as Rich mentioned, Timken delivered record sales of \$4.1 billion and record adjusted earnings per share of \$4.72 in 2021 in a robust yet challenging environment.

Turning to slide 13, let's take a closer look at our fourth quarter sales performance. Organically sales were up nearly 13% from last year as both segments delivered double-digit growth in the quarter. In addition, we saw double-digit growth across both our bearings and power transmission product lines. Pricing was positive while acquisitions and currency translation combined had a modest impact on the top line in the quarter.

On the right hand side of this slide, you can see our organic growth by region, excluding both currency and acquisitions. All regions were up in the quarter versus the year ago period. Let me make a comment or two on each region. Latin America, we delivered strong growth in the quarter, up 21% with most sectors up led by industrial distribution.

In Europe, we were up 17% with off-highway, general industrial and distribution, posting the strongest gains. In Asia, we were up 3% as most sectors were up modestly, while renewable energy was roughly flat in the quarter as expected against a difficult comp last year. And finally, in North America, our largest region, we were up 14% with solid growth across most sectors, led by industrial distribution and off-highway.

Turning to slide 14, adjusted EBITDA was \$135 million, or 13.4% of sales in the fourth quarter, compared to \$144 million, or 16.2% of sales last year. The decline in adjusted EBITDA reflects the impact of significantly higher material, logistics and other operating costs, partially offset by higher volume, positive price mix and favorable currency. EBITDA margins in the fourth quarter were down 280 basis points versus last year as price realization was more than offset by continued cost inflation, supply chain constraints and related inefficiencies.

Let me comment a little further on our manufacturing and operating expense performance in the quarter. On the manufacturing line, we were impacted by higher labor costs and plant inefficiencies, as we continue to navigate through the challenging supply chain environment. This was offset partially by the impact of slightly higher production volume as we continue to ramp up to serve higher demand.

Moving to material and logistics, we saw significantly higher costs in the fourth quarter compared to last year and higher costs in the third quarter. Higher costs reflect continued inflationary pressures, including higher surcharges and other increases from material suppliers and freight vendors around the world. And finally, on the SG&A other line, costs were up year-on-year in the quarter as we had increased spending to support the sales levels and higher compensation expense versus the year ago period.

On slide 15, you'll see that we posted net income of \$63 million, or \$0.82 per diluted share for the fourth quarter on a GAAP basis, which includes \$0.04 of income from special items, driven by pension mark-to-market income in the period.

On an adjusted basis, we earned \$0.78 per share in the quarter, down 7% from last year. Our fourth quarter adjusted tax rate was 21.3%, which brought our full year adjusted rate down to 24%. This reflects our geographic mix of earnings and the impact of tax planning initiatives.

Now, let's move to our business segment results, starting with Process Industries on slide 16. For the fourth quarter, Process Industries sales were \$528 million, up about 15% from last year. Organically, sales were up 14.5% driven by growth across most sectors, with distribution and general industrial posting the strongest gains. Marine and industrial services were also up and heavy industries was up slightly, while renewable energy was flat.

Looking at our non-bearing product lines, linear motion generated the strongest growth year-on-year in the quarter as we continue to win new business and benefit from higher demand. Process Industries adjusted EBITDA in the fourth quarter was \$105 million, or 20% of sales, compared to \$102 million, or 22% of sales last year. The decline in Process segment EBITDA margin was due to the impact of higher operating costs, which essentially offset the benefits of improved volume and price mix in the quarter.

Now, let's turn to Mobile Industries on slide 17. In the fourth quarter, Mobile Industries sales were \$480 million, up 10.6% from last year. Organically sales increased nearly 11%, with off-highway posting the strongest gain. We were up in aerospace, rail and heavy truck as well, while automotive was relatively flat. We also benefited from higher pricing in the quarter.

Mobile Industries adjusted EBITDA in the fourth quarter was \$41 million, or 8.6% of sales, compared to \$54 million, or 12.4% of sales last year. The decline in Mobile segment EBITDA and margins was driven by the impact of higher operating costs, which more than offset the benefit of higher volume and price mix in the quarter. Note that Mobile had more significant material cost headwinds in the quarter than Process, and this impacted its margins to a greater degree.

Turning to slide 18, you'll see we generated operating cash flow of \$103 million in the fourth quarter and after CapEx, free cash flow was \$58 million.

Looking at the full year, free cash flow was \$239 million, down from \$456 million last year. The year-on-year decline reflects the impact of higher working capital to support the record sales levels and longer lead times in the supply chain and to position us for strong growth again in 2022.

In addition, we had higher CapEx to fund growth and operational excellence initiatives, and we also saw a more normal level of payments for employee medical benefits this year. Looking across both 2020 and 2021, we did convert over 100% of our adjusted net income to free cash flow.

From a capital allocation standpoint, during the fourth quarter, Timken paid its 398th consecutive quarterly dividend, and repurchased 500,000 shares of company stock. In total, we bought back almost 1.3 million shares during the year, and we have over 9 million shares remaining on our current authorization.

Taking a closer look at our capital structure, we ended the quarter with a strong balance sheet. Our leverage, as measured by net debt to adjusted EBITDA, was 1.7 times at year end, below last year's level and near the low end of our targeted range. This puts us in a great position to continue to drive shareholder value creation through capital deployment, consistent with our strategy.

Now let's turn to the outlook with a summary on slide 19. As Rich highlighted, we expect strong revenue and earnings growth again in 2022. We're planning for another year of record revenue, up around 10% in total at the midpoint of our guidance versus 2021. Net of currency impact, our guidance implies that revenue will be up 11% organically, which would mark our second straight year of double-digit organic growth. We expect most end markets and sectors to be up year-on-year, and we will also benefit from organic outgrowth initiatives and 400 basis points of net positive pricing. Our revenue outlook is supported by our order book, which is up double-digits from last year, as well as customer sentiment and other external data.

On the bottom line, we expect record adjusted earnings per share in the range of \$5 to \$5.40, which would be up 10% from last year at the midpoint. The midpoint of our outlook implies that 2022 adjusted EBITDA margin will be around 17%, down slightly from full year 2021 as higher price realization is expected to be more than offset by higher year-over-year operating costs, principally in the first half of the year. Recall that material and logistics costs and related inefficiencies accelerated in the second half of 2021. Our outlook assumes that costs will largely persist at these elevated levels through 2022. In addition, we're expecting continued inflation across other costs like wages and energy. But we are planning for some improvement in manufacturing performance from our ongoing operational excellence initiatives.

Moving to free cash flow, for 2022, we estimate conversion of around 70% of adjusted net income. We expect higher free cash flow in 2022 as compared to last year, driven by the impact of higher earnings, offset partially by higher CapEx spending.

We are planning for CapEx in the range of 4% of sales, which includes several growth related projects and higher spending on initiatives to improve operating efficiency. For the full year, we anticipate net interest expense to be roughly in line with 2021 levels, and we estimate that our adjusted tax rate will be around 25% based on our planned geographic mix of earnings.

So to summarize, Timken delivered record revenue and earnings per share in 2021, and we are well positioned to do so again in 2022. Our team is working hard to mitigate the higher costs through pricing and other tactics, and we continue to focus on driving our profitable growth strategy.

This concludes our formal remarks, and we will now open the line for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll take our first question from Rob Wertheimer with Melius Research.

Rob Wertheimer

Analyst, Melius Research LLC

Thank you. Good morning, everybody.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Good morning.

A

Rob Wertheimer

Analyst, Melius Research LLC

So Rich, you've taken probably a very realistic, but maybe more conservative look at supply chain disruption and the outlook in the comments you made. I'm just curious if you've spent a lot of time with your customers and partners and what the general sentiment is out there. I think some are still hoping for a 2x improvement. I'm not sure if that's tangibly founded or just not on the generally good management that's out there. That's one question.

I'll just do my second one as well. If you could just talk us through any changes and strategically how you're looking at pricing as we walk into an inflationary environment? Thank you.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Yeah. Thanks, Rob. Certainly, talking a lot to customers, talking to board members and talking to how others are dealing with this. And as releases come out, we'll digest some of those as well. I think we do have probably one bit of uniqueness to our business model in that, because over half our business is bearings and the steel content. And bearings, we probably are a little disproportionately impacted by steel costs, which would be one of the three big buckets of costs that have hit us.

As you look at our last four quarterly EBITDA walks, our material, logistics costs have gone from negative \$11 million in the first quarter to negative \$27 million to negative \$53 million to negative \$58 million. And so, from \$38 million in the first half to \$111 million in the second half on a little lower volume in the second half. So we are basically assuming that those costs continue. I think for material, it could be some relief there, be surprised if those dropped dramatically in a robust market. I think the logistics one is a little bit more of a wildcard.

I mean, the price is there – the steel is maybe a little higher than what would be normal in a good industrial market for us. It happened a little faster maybe than normal. But logistics is very unique for us in that, things that we were buying a year ago. In some cases, transportation routes are up 200%, 300-plus percent. We've assumed again that that continues; and right now I would say that is the case. We don't see any relief on that in the first quarter, but certainly if we were to see some relief on that in the second half of the year, that would be favorable for us.

And on the flip side, it's not taking a step up today. I don't think it's going to in the second quarter, but it looks good for that. But at this point last year, we weren't expecting what happened as well. So, I think the logistics one,

A

I think it's more likely than not, it would be favorable for us as the year progresses. But we weren't conservative enough on it last year. And then, I think it's a little bit of a different thing as we look at the pricing there.

Certainly, we would fully expect to recover all of material. If logistics remains a structural change in the industry, we would have to recover that as well. I think we're trying to play that one down the middle a little bit and cover some of it and share some pain. And I do think that, that's one of the challenges as we look at the price cost dynamic is there is a significant element of this that – of our cost that I believe clearly are transitory. They lasted longer than what we have expected. We're still dealing with elevated absenteeism in a few of our plants in the US, as well as in Eastern Europe from coronavirus.

In the fourth quarter, we had plants shut down in China from power shortages. We still had premium freight that your plant shut down in China for half the months and you're paying premium freight. I mean, to go to a customer and expect them to pay you for that is a little bit unique. So, certainly we expect to cover normal inflationary cost of material cost, wages, if energy goes higher, steel goes higher, et cetera. We will recover those. On the transitory side, we have to improve them, and I think we are being conservative there. But it lasted longer than what we thought to this point and they're still largely there today as well.

I think when you look at the manufacturing bucket on those four walks that we've had over last four quarters, we were plus \$9 million in Q1, plus \$5 million, plus \$5 million and then minus \$8 million. Typically, the fourth quarter would be lower, and that was a little extreme. So, only a plus \$11 million for the year, and that's where higher onboarding costs are hitting us, the absenteeism is hitting us, having parts that you're waiting for production stuck in a port for a month are hitting us, et cetera, et cetera. And that's an area that's pretty disappointing that given the volume that we are running through these operations, we would typically do much better there.

Again, I think, we've been conservative there. This is an area I think we're good at, whereas Phil said, we're working at relentlessly, tirelessly. We've seen some improvement. And then we see some new issues arise as well. Certainly, I think that and Logistics would be the two upsides to the cost situation. And then the other thing, I think, you know, we are – we had, I would say, normal-ish, maybe slightly on the high end of normal wage inflation last year. We are expecting and then planning for and preparing for a little higher wage inflation around the world this year, and that's baked in there. But on the flip side, we also have a very full as we usually do full self-help story on our cost side as well. The footprint things I talked about that we did last year and that we'll do this year will help us.

So, I hope it is a conservative outlook and we're working hard in the parts of it that are directly in our control, we're doing a lot of, and we have made a lot of progress on it. But as everybody else has talked, I mean, these things are still – they're still out there. On the pricing side, I think, the answer is yes. If, again, you've got this transitory issue versus, true cost increases that we expect to stay in perpetuity. And then, the steel piece. We historically have pretty good model there. That maybe there's a lag on the way up, and a lag on the way down that we benefit from.

And I think that model still works for us because there is a cyclical element to that inflation versus just being like wage inflation typically doesn't go backwards. So, if we're in a situation where we think our costs are going to be going up, we're looking – we're probably looking at about 5% up last year of sales and if we were looking at 4% to 5% a year. I think, our commercial model would have to change a little bit where long-term contracts have generally been a win-win for us and our customers.

And, they flipped last year to a win lose for us in some cases where we were absorbing those costs. So, we would definitely have to change that model going forward. And I think, as this year progresses, we would share more

with you on that. We certainly haven't been signing the long-term commitments without pricing, but we still have some. And I think, the expectation is probably still that that model will remain, but we'll see.

Rob Wertheimer

Analyst, Melius Research LLC

Thank you much.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Thanks, Rob.

A

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

Thanks, Rob.

A

Operator: Moving on, we'll go to Steve Barger with KeyBanc Capital.

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

Hey, good morning, guys.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Good morning, Steve.

A

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

Good morning, Steve.

A

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

You know, just the incremental margins are weaker than people expected. You've been clear on the challenges stemming from the inflationary environment. Should we be thinking significantly better incrementals in the back half as you take these mitigation actions and pricing rolls through, and do you expect EPS will be up year-over-year in 1Q?

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

So, yeah, I think, you go back to my material logistics comment. Looking at last year, roughly \$40 million in the first half, \$110 million in the second half. So that \$110 million, we're planning on that rolling in. So, the cost comps in the first half of the year is significantly higher. We expect some improvement in price through the course of the year, but most of it happening today. So, yeah, I would see year-over-year comp wise a stronger second half than first half, not based really on cost improving, but more on the cost rolling over into the first half and then price extending.

A

Not looking to provide quarterly guidance, certainly would expect revenue to be up. I would expect a sizable step up in margins and earnings per share from the fourth quarter to the first quarter. We've done that the last couple of years and that was without significant pricing from Q4 to Q1. And then I think – so, I certainly would expect a sizable step up, but I don't want to get into the specifics of higher or lower than last year. Obviously, it was a – last year ended up being the high watermark for us for margins in the first quarter, and I'll pause, and let you ask a follow-up.

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

Q

All right. You mentioned that both staffing and inventory are up. Just year-over-year growth in inventory outpaced revenue growth in the back half of 2021, is there any other margin pressure you expect this year a function of slowing production to balance inventory, or will you still grow inventory in excess of sales as the year progresses given the demand environment?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

We would still expect. So, the answer is no, we would still expect to grow inventory more modestly this year than last year. We don't have – some of this inventory is directly a function of longer supply chains, things that used to take two weeks are taking four weeks. So, there is that element. Again, we haven't baked significant improvement in that in our assumptions. But under the assumption that we're pushing 10% revenue growth and optimistic about next year, which as we sit here today, that's what we're thinking for both of those. We would expect inventory to go up this year.

Steve Barger

Analyst, KeyBanc Capital Markets, Inc.

Q

Got it. Thanks.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Thanks, Steve.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Thanks, Steve.

Operator: Moving on, we'll go to Ross Gilardi with Bank of America.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Q

Hey, good morning, guys.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Good morning, Ross.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Q

Just curious, Rich, what – how are production rates – how do they feel right now for your customers? I mean, are they starting to improve and can you just give any color on how or what kind of variations you might be seeing across some of your key markets?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

One, on slide 7, across our markets, you look I think we've got everything up mid-single digits or more with the exception of renewable energy. And that we have flat coming off of a very good year. So, I think when you look across that just about everything is really in the favor – in our favor in terms of overall demand. I think, inventory in the channels and restocking is in our favor. I think, the capital equipment cycle is in our favor. I think, the MRO cycle really started moving more in our favor in the second half of the year.

Our distributors have got much more bullish, are looking to put inventory in and their revenue for the second half of 2021, as well as their outlook for 2022 improved. And then even when you look into some of the submarkets within here, I mean, even some of the markets that were written off as dead maybe a couple years ago for capital, like oil and gas, are showing some signs of life.

So, the overall demand situation very strong. And I think, the – to your earlier point about their issues, they are still dealing with it, and certainly the erratic demand that we were facing at this time last year and probably rolling through second or third quarter, I think, that has definitely improved. I think, a year ago, people were just scrambling and we had a lot more concerns about over ordering, and I think, a lot of that has improved. But everybody is still dealing with the issues, and it is definitely a more erratic or choppy market environment than would be ideal. And I think, that's for us as well as for our customers as well as for our suppliers. But demand is strong.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah. The only thing I would add Ross is, this is still just on inventory is when we think about inventory at our customers, both distributors and OEMs, I mean, we would look at inventory and say it's still relatively low given the demand level. So, while we've added some inventory in 2021 and expect to do so again in 2022 and we do believe our distributors will add inventory and our OEM, the inventory levels, particularly at OEM dealers in the aftermarket channels are still relatively low. So, I think that, that's a favorable factor as well heading into 2022.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Q

Thank you, guys, I mean, I realize quarter trends are still very strong, inventories are low. I was curious more production at your key customers is actually starting to accelerate to service all the backlog or are they [indiscernible] (00:37:42)?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Yeah. And I think the answer to that is definitely, yes. There are – there's the well-publicized issues of chips which has made that market choppy. I think, our first quarter comp for automotive is tough, but by the second quarter, I think, it's one that fell off last year. So, there are some other things out there. There's customers – customers are dealing with some chemical issues, paint issues. But I think, in general, their capital equipment builds are up. And

then and in particular, I think, the MRO cycle is also kicking in pretty strong. So, I think, I'd say to your point of order, demand probably would be higher than our 7% organic. But I think, there's a reality there, what people are going to be able to do to hire people, build, et cetera. And we feel it's pretty reasonable number.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah, when we look at like a market like off-highway, Ross, I mean, off-highway across both 2021 and especially as we look at 2022 and what our customers are doing, we think it's going to be the strongest market since 2011. Now that was a super strong year, as everybody remembers, but we think it's going to be probably the strongest year in off-highway that we've seen since that time. So, it is – our customers are ramping, as Rich said, it's still a little choppy particularly in the on-highway markets, our on-highway, auto and truck customers, still a little choppy, but strong and getting stronger.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Q

Okay. Got it. Thanks. I'll get back in the queue. Thanks.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Thanks, Ross.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Thanks, Ross.

Operator: And next we'll go to Courtney Yakavonis with Morgan Stanley.

Courtney Yakavonis

Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks, guys, for the question. I think, you talked a little bit about first half versus second half incrementals, but Rich, I think, you made a comment that we will see the evidence of pricing in the first quarter results. So, can you just help us pair that comment with how we should be thinking about the sequential step up in margins and any differences we should be thinking about between Process and Mobile, and how that pricing will flow through to margins?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Yeah. So, we do expect – again, as we sit here today, we have the vast majority of the 4% in place, [ph] wasn't all (00:40:08) January 1, we did some distribution pricing that bowled in February 1, but pricing, it would move gradually after the first quarter number. So the second half to be clear, the second half response that I made was on incrementals, not margins, right. So we're not really expecting a step up in margins.

So it's really an issue of the comps on cost that by the time you get to the second half, you had lower margins and all those costs in that, again, we're forecasting, will still be there, so. But the incrementals are better. So it's really an incremental. So I think, as we're looking at the year, a significant step up in performance from Q4 to Q1, and I'd

say some normal seasonality, typically where our revenue declines even a strong year a little bit from the first half to the second half.

Courtney Yakavonis

Analyst, Morgan Stanley & Co. LLC

Q

Okay. I think that's helpful. And then, Phil, I think you had mentioned obviously being fairly conservative with respect to supply chain and wage energy pressures, but you are baking in some improvement in manufacturing performance. Can you just help us think about how to quantify how much of an improvement you're baking in from manufacturing improvement? And is that something other than I would have thought that that was supply chain improvement being reflected in improved manufacturing performance, but is there anything else that would be driving that?

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Well, the two are connected, right. I mean, when you – if you don't have parts flowing into your operations smoothly and we ship parts from one plant to another plant as well, right. We have feeder plants. So I mean, all of that definitely affects labor productivity. But it was, getting on the plus \$11 million we had in manufacturing last year on a double-digit up here. I mean, disappointing that that would not be 2x, 3x more favorable than what it was.

We have definitely not baked in perfection and we would expect – we're still hiring in our plants. So even though we made good progress on the onboarding, we still have some of those costs that we're incurring this year and would expect to incur. And I would also say, I believe that will improve through the course of the year. It's been improving gradually, and I think it'll continue to be a gradual improvement, it's not a step change through the year.

Courtney Yakavonis

Analyst, Morgan Stanley & Co. LLC

Q

Okay. Got it. Thank you.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Thanks, Courtney.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Thanks, Courtney.

Operator: And next we'll go to Chris Dankert with Loop Capital.

Chris Dankert

Analyst, Loop Capital Markets LLC

Q

Hey. Good morning, guys. Thanks for taking my questions.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Good morning, Chris.

Chris Dankert

Analyst, Loop Capital Markets LLC

Q

I think we talked on this a little bit earlier. You mentioned strongest year in off-highway in over a decade here. I guess, is there any comments in terms of growth by segment here. I mean, is it fair to assume kind of a low teens organic in Mobile, just any kind of triangulation you can give us there would really be appreciated?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Between Mobile and Process, we're expecting pretty close.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Pretty similar.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

So, I would say, within the bandwidth of error, I would call them the same.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah. I would say, we're pretty close organically and actually Courtney had asked the question about pricing across the segments, and the 400 basis points of pricing is I would say, relatively similar across Mobile and Process. So on the Mobile side, it's a combination of surcharges on some of our multi-year agreements as well as pricing. And obviously, on the Process side it's more pure-based pricing, but expect roughly. So similar pricing roughly, similar organic volume across the segments.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Yeah. Just to add a little color, I think within the segments, within Mobile Phil already mentioned off-highway, throw in rail, which has been a little slower to come up. But we're seeing that come on strong and we're optimistic about that this year. So, I mean it was probably the two leads within Mobile, but everything up. And then again, in Process, everything up, general industrial, obviously with what's happening and distribution will be the two leads with what's happening with everybody, supply chain, manufacturing, et cetera. Those would be the two areas that we would expect to be the strongest.

Chris Dankert

Analyst, Loop Capital Markets LLC

Q

Got it. That's really, really helpful, guys. Glad to hear that that high margin rail is bouncing back nicely here. And I guess, shifting gears a bit, thinking about SG&A kind of in light of that elevated absenteeism and more generalized wage inflation. When we're thinking about the SG&A growth contemplated in the guide, I mean, how do we think about that? Is kind of high-single digits in the ballpark? Just any comments on how we can think about some of these costs stabilizing a bit and kind of what that means for SG&A for you guys kind of through 2022?

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah. I would say, just a big picture, Chris. I mean, SG&A we would expect it to be up. I mean, really a couple of factors going on. We've got higher wages, as Rich talked about, some wage inflation that's going to be baked in there, higher incentive compensation as we would normally expect when earnings are growing and that sort of thing. And then probably the last element would be just higher spending to support the sales levels. And we do expect, as we move through the year, I would maybe call it a gradual start to return to a more normal level of spending as we start to travel again more regularly and that sort of thing.

So, there's various elements. So certainly, a step up in SG&A. But I think when you look at it as a percentage of revenue because revenue will be up quite a bit as well, I think you will see pretty good consistency across SG&A in terms of as a percentage of sales from 2021 to 2022. So up, but up more or less in line with the sales.

Chris Dankert

Analyst, Loop Capital Markets LLC

Q

Got it. Got it. Thanks so much for the color there guys. And best of luck going forward here.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Thanks.

Operator: And next we'll go to Stanley Elliott with Stifel.

Stanley S. Elliott

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Good morning, everyone. Thank you all for taking the question. A quick question in terms of kind of like the order rates and things that you're seeing. Have you all changed how you're processing these orders, meaning with supply chains being so convoluted and difficult? What's the risk at some point down the road that you're seeing a lot of double ordering? I don't think that's the case now or an issue now, just given how lean inventories are. But curious if you've changed the thought process around that for when the environment does stall a little bit?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

Yeah. Well, it's certainly something we try to monitor and try to control. And with OEMs again, I think our digital platform is a big help for this. If we've been shipping a 1,000 bearings a week to an OEM and all of a sudden they start ordering 2,000, it's hard to imagine that their production rates are going up that level, and we're able to start a dialogue with them.

I would tell you, I think that situation today is better than it was a year ago. There's less noise with that, I think when this first took off, there was a bit of a panic and let's just order more and, yeah, we are ordering more of this, but then we're running out of that. So things – inventory imbalances were worse.

And there's certainly risk to it. And I'm sure there's some of it happening. And on a small scale, we wouldn't have the ability to control it on a small scale. But, with distributors we see their inventory levels, the big distributors with OEMs, we have our salespeople in there, know what they're building or the equipment. So I think we've got a pretty good line of sight to it. And as Phil said earlier, right now, as far as the eye can see, it's a favorable trend for

us but in general, I would say they would like more inventory and they need more inventory. So it's a good thing for us right now.

Stanley S. Elliott

Analyst, Stifel, Nicolaus & Co., Inc.

Q

That sounds fair. And then switching gears. Rich, you mentioned the M&A environment is expected to be a little more active in the next couple of years. Is this – are there larger deals still out there? Is it still going to be skewed towards the process side? How quickly do you think you can act on some of these deals as you've obviously been harvesting? Just curious what to expect in the next near-term?

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

I think you slipped eight questions in on that one, Stanley.

Stanley S. Elliott

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Sorry, I apologize.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

So I think, yes, definitely slanted the process. Certainly, we're looking to mix Mobile up as well but – and the lubrication – automatic lubrication systems have a big Mobile element and it's a great business, but slanted to Process, so the answer there is yes.

On the big ones, I think the answer is no. And one of the reasons – two of the reasons why I think I feel better about where we're going to – that we will be more active in 2022 and 2023 than we were in 2020 and 2021, 2020, we definitely slowed down from the pandemic, the shock, the travel, concern, et cetera. The pipeline pretty much dried up in the – through the middle of the year and really didn't restart till late in the year. Then I would also say we lost a little bit of ground.

We worked on a couple of potentially larger ones that in the end we backed out and chose not to pay the prices that they were going at, and no regrets on that at all. And I think as we sit here today, we're back focused on small to mid-size, which I think was what we were really building some really strong capabilities on. I think the – if we get good niches, good technology, the synergies of the smaller businesses becoming a part of professionally managed corporation with this global scale we have et cetera, I think is better than the large.

And I think that's where we're focused. So we're not opposed to the big and we looked at a couple of big, but we're focused. I'll say on the sweet spot of \$50 million to \$200 million of revenue is where we're focused and I do believe we'll get back. You'll see us get back into that this year and next.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah. And just maybe – just to comment on top of that, Stanley, I think, we look at capital allocation really the same way as Rich said, probably a bias for M&A, but we do have the ability to buy back shares like we did in the fourth quarter. Our full year guide would assume sort of shares at fourth quarter level, so we don't normally include any capital allocation in the guide. So if we were to do M&A or to do any buy back, I mean we would

report on it after the fact and that would be accretive at the time. Obviously, buy back more immediate, M&A a little bit more longer term but I think we view both as viable options again with the bias towards the M&A.

Stanley S. Elliott

Analyst, Stifel, Nicolaus & Co., Inc.

Perfect, guys. Thanks so much and best of luck.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Thanks, Stanley.

A

Operator: And we do have a follow-up from Ross Gilardi with Bank of America.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Oh, thanks. Thanks, guys, for taking it. I was just wondering if you could discuss just the mix impact of renewables under growing the rest of the portfolio. And just maybe explain a little bit more about what's actually going on there in the wind markets. I mean, there's been a lot of developments, it feels like globally with policy in China and subsidies and whatnot, but maybe you can just talk a little bit more about just US versus China, onshore versus offshore, and just how it impacts your business? Thanks.

Q

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

Yeah. First on the mix, as we've said before, renewable energy does mix down process industries but doesn't mix the company down. So it's probably some good mix happening within process with the other elements growing more this year while renewable flattens out. But don't look at – I think, we don't look at renewable as mixing the company down in total on the margin rate. On the revenue again, four straight years of double-digits, I think last year our double-digit was probably a little more self-help.

A

I think the market, particularly in China, did soften in the second half. We were able to offset that and we still grew in the second half. That being said, we saw the slowdown in China in the market and we got a flattish, up a little bit, down a little forecast right now. And that's really based on we expect to start the year down, not a lot, single-digits, but start the year down and that's largely from this slowdown in China. But we saw orders pick back up late last year and that continue into this year.

So we're certainly getting the order flow to a minimum support that if not beat that as the year goes on, we'll see. I think we're – offshore probably is a little bit favorable for us, but we're good with wherever it goes between offshore and onshore, we participate in both. I mean, generally offshore tends to be bigger, more durable and fits our value proposition even better.

But our participation is fine in both, China definitely, it caused the global slowdown, if you will. But I remain very bullish on the China market and global market. When you look at the trends of what's happening with sustainability, what's happening with electrification, which is going to drive not only the need for more power, more electricity, but for truly to be a movement in a sustainable direction needs to come from renewable energy very much.

Look at the China situation as a pause, and it's a pause in growth too, right? It's not a pullback. So we're not seeing any real decline in the market. It's a flattening and still pretty bullish about the next three or four years. And we're pretty small player in the US market. There isn't much of a supply chain in the US for this market. So our customers are not based in the US or they don't produce in the US.

So for us, it's definitely Asia and European market and even what ends up in the US generally comes from there. We'll see how that market develops, but it's – the US is tended to be more stop and start than the rest of the world, which is why we focused on the rest of world more.

Philip D. Fracassa

Chief Financial Officer & Executive Vice President, The Timken Co.

A

Yeah. As I mentioned in my comments Ross, our CapEx in 2021 was up from 2020 and we're going to be higher in 2022 and there is a fair amount of spend in that CapEx plan for renewable energy in particular as we continue to invest for growth as Rich said, as we're bullish on markets long-term and also put in some pretty exciting manufacturing technologies to help improve manufacturing efficiency across those product lines.

Ross Gilardi

Analyst, Bank of America Merrill Lynch

Q

Thanks, guys.

Richard G. Kyle

President, Chief Executive Officer & Director, The Timken Co.

A

I would make one more comment. I think the flattening of wind for year, I mean it also – I think it shows that the strength of our diversity of our portfolio and wind being up and solar being up as much as it was in 2020 was great for our portfolio, when industrial markets were down. And not that I really want renewable to be flattening, but it's a good year for that to happen, we can shift labor, we can shift materials, capacity, et cetera, into these industrial markets and serve them both. So I think it's strength of our portfolio that we've got a lot of things that move in different directions now.

Neil Frohnapple

Director-Investor Relations, The Timken Co.

Okay. Well, I think that's all the questions. Thanks, everyone, for joining us today. If you have any further questions after today's call, please contact me again. This is Neil Frohnapple. Thank you, and this concludes our call.

Operator: Thank you. And once again, that does conclude today's call. We thank you for your participation. You may now disconnect.

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