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Valmont Industries, Inc. (VMI)

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Valmont Industries' Fourth Quarter and Full Year 2018 Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Renee Campbell, Director of Investor Relations & Corporate Communications for Valmont Industries. Renee, please go ahead.

Renee Campbell
Director-Investor Relations & Corporate Communications, Valmont Industries, Inc.

Thank you, Kevin. Good morning and welcome to Valmont Industries fourth quarter and full year 2018 earnings call. With me today are Steve Kaniewski, President and Chief Executive Officer; Mark Jaksich, Executive Vice President and Chief Financial Officer; and Tim Francis, Senior Vice President and Corporate Controller.

This morning, Steve will provide a summary of our fourth quarter and full year results. Mark will provide additional details on financial performance and our outlook for 2019. We will conclude with Steve discussing the Valmont-Prospera partnership we announced yesterday followed by Q&A.

A copy of our press release and slide presentation is on the Investors page at valmont.com, and an archive of today's call will be available for the next seven days. Instructions for accessing the replay are included in the press release. Also please note that this conference call is subject to our disclosure on forward-looking statements, which applies to today's discussion and will be read in full at the end of this call.

I would now like to turn the call over to our President and Chief Executive Officer, Steve Kaniewski.

Stephen G. Kaniewski

President, Chief Executive Officer & Director, Valmont Industries, Inc.

Thank you, Renee. Good morning, everyone, and thank you for joining us. I'd like to begin this morning by thanking our global team of over 10,000 associates for delivering another year of profitable growth in 2018. In what was a transformational year, we made great progress on our three-year growth strategy that we announced last March at our Investor Day.

With that, let me turn to a recap of our fourth quarter, summarized on slide 3 of the presentation. Net sales of $697.4 million were 2.5% below last year. Excluding revenues from the grinding media business that was divested last April, fourth quarter sales were flat with 2017. Sales growth from pricing actions across all segments and higher volumes in the Engineered Support Structures and Coatings segments were offset by lower project sales in both International Irrigation and the Utility segments. Foreign currency translation negatively impacted revenues by $13 million.

Turning to the full-year summary on slide 4, revenues of $2.8 billion were slightly higher than last year, with higher volumes in the Engineered Support Structures and Coatings segments contributing to sales growth.

In the Irrigation segment, North America sales grew more than 4%. Lower volumes in International Irrigation were mainly due to 2017 projects in emerging markets that do not repeat this year. In the Utility segment, sales were impacted by lower volumes from continued demand for smaller structures and a competitive pricing environment in the North European offshore wind business.

Moving to the operations side of the business and slide 5 of the presentation, during 2018, we substantially completed our operations transformation, which was a major part of our strategy to simplify operations, improve efficiencies in our supply chain, and optimize our global business model. These actions primarily impacted our ESS segment. Specifically during the year, we closed five facilities, including three in China, and are in the process of closing an additional two by the end of the second quarter, which led to the increase in pre-tax full year restructuring expenses from $27 million to $42 million.

We brought our composite facilities under the [ph] centralized (00:04:15) operations management team, continuing our commitment to operational excellence and Lean deployment across our sites. We expanded our shared service model for back-office functions and finance, procurement, logistics, and supplies chain. Completing several actions to streamline costs regional management teams and we work to drive additional Lean and Agile methodologies throughout our business, while streamlining and improving our internal processes.

These actions position us well to capitalize on global growth opportunities, enabling us to deploy capital more strategically and to more quickly integrate our acquisitions, all of which would benefit our shareholders long term.

I would now like to turn the call over to Mark.

Mark C. Jaksich

Executive Vice President & Chief Financial Officer, Valmont Industries, Inc.

Thank you, Steve, and good morning, everyone. My comments regarding the fourth quarter and full year 2018 are based on the adjusted results as outlined at the end of the press release. Turning to slide 6. Despite fourth quarter sales decreasing 2.5% over 2017, operating income improved by 3.5% or 9.5% of sales. The improvement in operating income was achieved despite a higher LIFO expense of $1.5 million over 2017 as a result of continued progress on pricing actions across our businesses and cost structure savings as a result of the restructuring actions taken earlier in 2018.

Moving to full year results. Sales were slightly higher than 2017. The net impact of acquisitions and divestitures on sales was minimal as the sales contribution from the 2018 acquisitions was essentially offset by lower sales in the grinding media business, which was sold in April 2018. Adjusted operating income of $269.4 million or 9.8% of sales was comparable to 2017. We are pleased that despite a very volatile steel cost environment this past year, we successfully recovered inflation over the year through effective supply chain, operational and pricing actions.

Turning now to the cash flow highlights on page 7. Operating cash flows through the end of 2018 were $153 million compared to $133.1 million last year and $68.1 million through the third quarter of 2018. The strong finish to the year in cash flows was driven by improvements in working capital and a more stable raw material pricing environment.

Turning to capital deployment. A summary of our accomplishments is shown on slide 8. Capital spending for the year was $72 million, up from $55 million in 2017, driven by investments in the new steel structures facility in Poland and expansion of our irrigation facility in the United Arab Emirates and a new utility concrete structures facility in Fort Meade, Florida, all in support of market growth opportunities. We deployed $143 million towards six acquisitions in 2018 and returned $149 million of capital to shareholders through share repurchases and dividends ending the year with just over $313 million of cash. Our adjusted effective tax rate for the year was 23.6%, slightly lower than our expectation of 25% due to our geographic mix of earnings.

And let me now turn to slide 9 to talk about our 2019 outlook. We expect full year diluted earnings per share to be in the range of $8.10 to $8.90. We have expanded our earnings per share range this year to reflect the growing levels of project business in our International Irrigation market. Revenue growth of 7% to 8%, about evenly divided between organic growth and acquisitions, inclusive of the Larson and United Galvanizing acquisitions completed this year and net of the 2018 grinding media divestiture.

Foreign currency translation effects based on current rates is expected to be unfavorable by about $27 million or 1% of sales. Our revenue outlook does not include other potential acquisitions during the year. We expect a 20 basis point to 50 basis point improvement in operating margins with average raw material costs, including grade, expected to be relatively flat in the aggregate to slightly deflationary in 2019 as compared with 2018. Full year free cash flow, given the raw material cost stability outlook, is expected to approximate 1 times net earnings.

Capital expenditures of $90 million to $100 million include the completion of the expansion projects started in 2018 as well as ongoing Lean and Agile investments to enhance productivity in both the factories and offices. We expect our after-tax return on invested capital to exceed 10%. Our tax rate is expected to be approximately 25% based on current tax laws and our estimated geographic mix of pre-tax income. With respect to the first quarter of 2019, there are a couple of tough comp items we'd like to highlight.

First, specifically for International Irrigation, we will not have the same level of large project sales this year that we had in the first quarter of 2018, but we do expect project opportunities to commence over the balance of the year. Second, specific to the Utility business, a large project related to hurricane replacement work in the first quarter of last year will not repeat in the first quarter of 2019, but our strong global backlog in that segment supports revenue growth through the balance of year. The benefits of our 2018 Operations Transformation plan will accelerate throughout the year with expected total savings in 2019 of about $11 million.

And with that, I will now turn the call back over to Steve.

Stephen G. Kaniewski

President, Chief Executive Officer & Director, Valmont Industries, Inc.

Thank you, Mark. Looking ahead to 2019, we have a positive outlook for sales and earnings growth in all segments, and general sentiment across our served markets is also positive. Turning to the segments, in Engineered Support Structures, growth is being led by continued government investments in infrastructure development, particularly lighting and traffic and 5G wireless communication site preparation.

In North America, we are seeing solid demand in our transportation market. We are encouraged to see lead times of 10 to 12 weeks, nearly double the average, supported by 50% higher backlogs, which is the highest since 2014. We expect market demand in Europe and Australia to be similar to 2018. In the India market, we expect accelerated sales growth throughout the year, driven by improved wireless communications demand and general infrastructure growth.

In China, wireless communication demand will remain challenged ahead of substantial 5G rollout, and we expect sales to be similar to 2018. In Utility, we expect strong market demand from ongoing investments in grid hardening and record levels of the U.S. investment in renewable energy sources. As we all know, project shifts can occur each quarter, but our current global backlog of approximately $370 million supports a positive outlook for 2019.

First quarter profitability will be challenged by a less favorable project mix compared to 2018 and a continued competitive pricing environment in the offshore wind business. With respect to the offshore wind business, we have a good backlog in terms of volume, but margins will continue to be pressured and average selling prices are lower compared to prior years.

Over the past several months, three major competitors in the Northern European region have announced insolvency or have fallen under state ownership. In light of this change, we are continuing our strategic review in 2019 and will provide updates each quarter, as needed.

Moving to Irrigation, we expect North America markets to continue to be muted by low projected net farm income and low commodity prices. We have a good line of sight to a strong pipeline of projects in the Eurasia and Middle East markets, which are expected to accelerate beginning in the second quarter. As always, financing delays can impact timing, but the underlying demand in emerging markets is strong. We also expect an improved market environment in Brazil this year, subject to tradeshow and government supported FINAME financing programs outcomes.

Moving to Coatings, global economic growth is expected to drive higher sales. Profitability accretion from last week's acquisition of United Galvanizing will be realized over time, after consideration of costs associated with the transition from our Brenham, Texas facility.

Turning to slide 10. In Summary, we expect sales improvements across all our segments in 2019, benefiting from the acquisitions completed over the past year. The associated actions taken this year to transform our global operations have simplified and strengthened our businesses, positioning us for long-term profitable growth. These benefits will accelerate as the year progresses.

The long-term drivers for our business in both infrastructure and agriculture remains strong, and we are committed to price leadership throughout 2019. Finally, we continue to drive Lean and Agile deeper into our business, increasing profitability and shareholder return over time.

Yesterday afternoon, we announced a new global partnership with Prospera Technologies. Before we open the call for questions, I would like to take a few minutes to talk about this exciting collaboration as the first step in developing a roadmap to autonomous crop management.

Turning to slide 11, the exclusive partnership between Valmont and Prospera is truly the first of its kind specific to mechanized irrigation. Together, our two companies are charting the course to provide growers with autonomous crop management solutions that will generate greater returns by using fewer crop production inputs and resources. Valley Irrigation currently leads the industry with more than 60,000 in connected global devices. The intelligence shared between these connections and the pivot, along with the integration of data science, machine learning and artificial intelligence, will drive development of real-time crop diagnosis and recommendations, ultimately reducing costs for the grower and increasing yields.

Turning to slide 12, Prospera is an award-winning machine vision and artificial intelligence company founded in 2014, specializing in ag data and analytics. They're committed to bringing advanced machine learning technology to the agricultural sector, helping growers control and optimize their production. With offices in Tel Aviv, Israel, and San Jose, California, the Prospera team has successfully solved crop production issues through their advanced integrated systems and products.

Backed by strategic investors including Cisco, Qualcomm, and Bessemer, the team has developed unique analytics and algorithms to provide irrigation and crop growth recommendations to farmers and their advisers. As we know, the pressure of a growing world population demands higher crop yields and continued constraints on fresh water resources also require greater irrigation efficiency. Water will remain our focus as it is still the number one determinant of crop yield.

Our strategy is to lead the transformation of the center pivot from an irrigation machine to an autonomous crop management tool. Growers and their agronomists will be able to understand more specific crop conditions in the field and ultimately address the needs of each individual plant on a mass scale. This will lead to the pivot becoming a self-learning machine, using crop inputs from the field and grower to deliver appropriate amounts of water, fertigation and chemigation.

An overview of how this technology works can be found on slide 13 and the critical takeaway is that this technology not only has the ability to acquire and analyze data using proven analytics, algorithms, and data layering, it will also send recommendations directly to the field, prompting the grower to take specific actions, which is the first in the industry.

As the global leader in mechanized irrigation, we are investing additional resources to support this strategy. We now have a dedicated team of technology territory managers and sales associates to support and educate growers and our dealer network. We have also appointed a Vice President of Global Technology Strategy, whose team is responsible to grow our portfolio of advanced solutions. And we have committed to invest an additional $4 million in research and development in 2019 towards this specific effort, beyond our customary R&D spend of approximately $5 million in the segment.

The first milestone on our road map will be Anomaly Detection, which is launching this spring. Anomaly Detection provides visual detection of various issues in the field, through satellite, drones, and additional connected inputs that a grower may already have. It will be available through a subscription-based model for all brands of pivots.

Launching specific technology product to the market, like Anomaly Detection, and driving product adoption through our world-class global dealer network are two critical steps on the journey towards autonomous crop management. Through these efforts, we are targeting to reach 1 million acres with machine-learning technology by 2020.

As the market leader, our partnership with Prospera is a critical step in furthering our strategy of addressable market growth, through the development of commercially viable, advanced integrated technology solutions. We look forward to updating you more on the development of our road map and specific product launches in the coming quarters.

I will now turn the call back to Renee.

Renee Campbell

Director-Investor Relations & Corporate Communications, Valmont Industries, Inc.

Thank you, Steve. At this time, Kevin, you may open up the call for questions.

QUESTION AND ANSWER SECTION

Operator: Certainly. We'll now be conducting a question-and-answer session. [Operator Instructions] Our first question today is coming from Craig Bibb from CJS Securities. Your line is now live.

Craig Bibb

Analyst, CJS Securities, Inc.

Q

Hi, guys. Maybe...

Stephen G. Kaniewski

President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Good morning, Craig.

Craig Bibb

Analyst, CJS Securities, Inc.

Q

... [indiscernible] (00:20:24) with Prospera, we could start there. So, what's kind of the timeframe for adding that to your product offering? And then, from the way you're describing their product, you're going to be gathering a lot of intelligence about improving yields for farmers, but your products kind of only address one part of that. I know it's the most important one, which is water. But does this create an opportunity to move towards herbicides and fertilizer and other things that would help improve yields?

Stephen G. Kaniewski

President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Yes, Craig. So, our first product will be launched this spring and that's the Anomaly Detection. And then, we will roll out a series of products thereafter in subsequent quarters and we'll update the market each quarter as to how those are developing. And we see the pivot as the unique item that is already in the field that doesn't have further crop [ph] destruction (00:21:22) if you go out and actually have to remediate the crop. So, it will be gathering a very unique data set on the field. There's not a data set today that is really this active from a field level, where the pivot can look at what's out there in the field and look at specific crop, particularly damage, or bugs, or other things. And it is our intention, as we move forward, to transform the pivot to do more than just water. So, the chemigation, fertigation, we already have some partners in that sphere, but a lot of our R&D spend, going forward, will be on that transformation.

Craig Bibb
Analyst, CJS Securities, Inc.

Q

Okay. And then, on the guidance for next year, you're baking in pretty – 20 bps to 50 bps EBIT margin gain. That seems pretty small relative to the tailwind you could get from lower steel prices. So last year, steel [ph] ripped (00:22:17) starting higher, starting in Q1, peaked in August, has come back down tremendously. Your guidance is assuming flat steel, but is that conservatism or...?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

No. Craig, I'll answer it this way. What you've seen the most price deflation with is hot-rolled steel and then – but [ph] plate (00:22:42) specifically has gone up to very high levels. And so, if you look at the mix of our product between what uses [ph] plate (00:22:49) and what uses hot-rolled coil, it balances out to about flattish kind of market outlook. And much of what we did in 2018 was simply to gain back the price inflation. So, this would be really looking at more true margin enhancement to productivity, pricing, and other actions as opposed to relying solely on steel to give us tailwind.

Operator: Thank you. Our next question today is coming from Nathan Jones from Stifel. Your line is now live.

Nathan Hardie Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Good morning, everyone.

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Nathan.

Nathan Hardie Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Just following up on some of the steel commentary here. If we do end up with a 2019 environment where your overall steel price is flat, which I know is probably not what it'll end up being, are you guys caught up on the price/cost side? Do you still have more pricing actions that you need to take to catch up those steel prices? Just any commentary you can give us on where you're at in terms of price/cost?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

We believe, at this point, Nathan, that we have recovered, across all of our segments, raw material and/or freight inflation across all the different segments. So, it took a while for some of the backlog to come through, which is particularly why we had guided third and fourth quarter as still being somewhat challenged, particularly in ESS, because some of that backlog was fixed backlog that we could not re-price. But at this point, Utility, ESS, Coatings and our Irrigation segments have all put through the price increases necessary to recover that.

Nathan Hardie Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

You mentioned there some lower priced or lower margin, I guess, backlog in ESS. Was that what was responsible for the sequential dip in ESS margins in the fourth quarter or is there something else there?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Fourth quarter is different than third quarter. But when you do look at it sequentially, we did have about a $900,000 plant expense related to fixing a roof that we had to expense in the quarter. So, that was part of it. And then, really if you look at where our geography of improvement came from, a lot of it came from emerging markets, which tend to have a little bit less of a margin than our North American business, which is typically the quality of [ph] runnings (00:25:17) are better. That was really where that differential came from.

Operator: Thank you. Our next question is coming from Brian Drab from William Blair & Company. Your line is now live.

Brian P. Drab
Analyst, William Blair & Co. LLC

Q

Hi. Good morning. Thanks. I just wanted to, first, ask about the vendor quality issue that was discussed in the press release and I think it was $5 million. And could you just talk about what that was and how, as it mention in the release, costs will be recovered going forward? And then, if costs are recovered, will the positives going forward be adjusted out just like the negative was adjusted out in the fourth quarter results? Thanks.

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Yeah. I'll talk first about what the issue is and then Tim can talk a little bit about the accounting. What we had was a third-party quality issue, not just ourselves, but others in the industry. Many others in the industry buy from this particular vendor. The issue was out at the field level and all of us had to make good to the customer on fixing the issue, which we have done and which is behind us at this point.

Then in terms of recoverability, we've worked with the vendor and we believe very strongly at this point that that will be fully recovered, but it will be done over time through discounts on product as we move forward. And so, it's dependent, it's variable, but that is how the majority of the industry players have worked with this particular vendor in order to get the recovery.

And then, Tim, I'll turn it to you.

Timothy P. Francis
Senior Vice President and Corporate Controller, Valmont Industries, Inc.

A

Sure. Thanks, Steve. Brian, what I'd add to that is, as Steve, as we work through resolving this with the vendor, we're expecting them to put a specific discount on every invoice they send to us. And then, from an accounting perspective, we will track those discounts. And if there is a quarter or certainly a year where the discount is meaningful, we will talk about it. But right now, we believe it will take a few years to recover all the $5 million. So, we're not exactly sure how long it will take this to recover just yet.

Brian P. Drab
Analyst, William Blair & Co. LLC

Q

Okay. So, can you say what segment this was in and can you also say anything more about whether – specifically about whether you would adjust for that going forward? It sounds like you wouldn't adjust for that going forward.

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Brian, the majority of it was in our Utility segment. There was a small piece of it in our ESS segment. And we would not adjust, but as Tim said, we would call out, if it was meaningful. Being that it's going to be over time, it probably won't be meaningful any one given year through the agreement.

Brian P. Drab
Analyst, William Blair & Co. LLC

Q

Okay. Thanks. I'm not sure if I'm out of questions, but I'm curious on the guidance, FX impact for 2019 and price impact on 2019 revenue, would be great. Thanks a lot.

Mark C. Jaksich
Executive Vice President & Chief Financial Officer, Valmont Industries, Inc.

A

Yeah. Brian, this is Mark. And on the FX side, we mentioned the revenue side of it and we're expecting to see, based on current rates, about $0.06 to $0.07 of headwind on EPS as a result of that. And then, as far as the pricing, we have a little bit of positive effect on pricing, but really organically it's – when we talk about organically, it's combination of volume and price. And prices are hard one to model at this time of the year since a lot of the work hasn't developed yet.

Operator: Thank you. Our next question is coming from Brent Thielman from D. A. Davidson. Your line is now live.

Brent Thielman
Analyst, D. A. Davidson & Co.

Q

Great. Thanks. Good morning, Steve. Have the expectations changed at all for the various transactions you've done through the year or should we still kind of assume the same accretion? I guess, any sort of update, I know a few of these you look to inject some capital to expand, kind of where you are with that?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Yeah. So when we look across the completed acquisitions in 2018, I would say that all of them are within our parameters for where we thought they would be, particularly in the short term. The Convert Italia, the solar tracking acquisition has the most potential from a volume perspective in terms of growth. The Galvanizing acquisition in New Zealand is doing very well. The Derit Infrastructure acquisition, which was really an asset acquisition, is proceeding as we expected because we had to put money in thereafter to gain welding certifications and the like.

Our Walpar acquisition had a little bit of slowness in some of the core markets. But as we look at the back half of this year, we believe that those are in good shape. And so when you look across the balance of them, they're kind of where we believe they would be. There's integration work. The integrations have gone very well. And then, on the two that we just announced, United and Larson, United is a solid backlog-filled or, let's say, business-filled galvanizers. So, we expect that accretion to be, as you'd expect, any galvanizer [ph] devoid (00:30:39) of some of the costs in the first quarter. And Larson has also proved to be a strong start, particularly as you get 5G site readiness.

And I forgot to mention Torrent in 2018. Torrent was a great acquisition for us in that pump space, designing up pumps, because that's become much more critical to the International Irrigation quoting activity. It's almost mandatory to have a pump solution along with the pivots. So for the amount of capital we deployed, we were careful. We integrated, I think, very quickly and strongly with the new operational model that we have, and no major issues with any of them

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Brent Thielman
Analyst, D. A. Davidson & Co.

Q

Okay. Great. And then, on Utility, and particularly in the North America side, continue to see, [ph] let's say, the really (00:31:31) high levels of bookings in the transmission world, at least among the service providers. Are you starting to see that show up, at least, for the larger projects in your order book yet?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

We've seen some larger bids recently that are more towards the back half of 2019 and into early 2020. I wouldn't say that it's a trend, though, at this point. But there are a couple of nice pieces of work out there for the back half of the year. Much of what we have right now is being driven by – obviously, people understand the issues in California, the grid hardening between Florida and there is driving part of our growth.

The solar and wind increases in generation in the U.S., specifically, are driving both the smaller structures as well as substations. And our substation products, like the Controlled Environment Construction, are doing very well. And then, obviously, on the global front, the solar and lattice is really opening up new markets for us outside of our traditional markets, and we feel very good about that going forward.

Brent Thielman
Analyst, D. A. Davidson & Co.

Q

Thank you.

Operator: Thank you. Our next question today is coming from Jon Braatz from Kansas City Capital. Your line is now live.

Jon Braatz
Analyst, Kansas City Capital Associates

Q

Good morning, everyone. Steve, can you help me out, how does the Prospera partnership, how has that integrated with AgSense? Is it going to be a standalone product, that it'll be additional subscription? Can you help me out there?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

I'm sorry. We will utilize AgSense and BaseStation as the delivery mechanism and compute on the field for the Prospera relationship. So, AgSense is integrated into the offering and it will be a subscription that's an additional one to the AgSense itself or a bolt-on to AgSense, depending if the person already has AgSense in there. So, the data acquisition part will be new. And that will either be through various sources and/or pivot – or cameras on pivots. And then, we'll upload to the cloud, come back with recommendations, and then send them back out through the AgSense unit itself.

Jon Braatz
Analyst, Kansas City Capital Associates

Q

Okay. Okay. And then, secondly, as we look at the Irrigation business this year, here in North America, when you look at the drought map for the U.S., there's plentiful water east of the Rockies, lot of snowfall, lot of precipitation. Will that influence any decisions that might be made by growers here this spring? Will that be a – could that be a negative for the North American business?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

I won't say that it won't. But the likelihood that it will is – they're still going to have to wait until actual growing conditions take place. It will just help with germination at this point. The larger tone that we're hearing from our dealers and from our growers is still around projected net farm income being low and the commodity prices being low. And that seems to have much more of an influence at this point on the purchasing decisions. So, that's why we just expect muted demand, at least, in – particularly in the U.S.

Again now, internationally, Brazil definitely has an optimism around it. We're seeing good order rates coming out of there. And the international projects are substantial and they're numerous. So, we think that that's really where the growth is going to come from this year in the Irrigation segment.

Jon Braatz
Analyst, Kansas City Capital Associates

Q

Okay. Thank you, Steve.

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Thank you, Jon.

Operator: Thank you. Our next question is a follow-up from Craig Bibb from CJS Securities. Your line is now live.

Craig Bibb
Analyst, CJS Securities, Inc.

Q

Hey. Maybe just sticking to Irrigation here for a second. So, your backlog in Irrigation is down 40%. It sounds like, you just said, that you're optimistic about the quantity and the size of the international projects that are out there, but presumably none of that's in backlog now or very little.

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

That's correct. So, we came out of the fourth quarter into the first quarter with lower backlog, but that's almost all International Irrigation. And our optimism is we have very clear line of sight on projects, but we're very conservative when we put it into backlog. We want to make sure that the financing, [ph] payment, not just appeal (00:36:21) is in hand first, and that's when we tend to put it in backlog. And that's the part that takes times with these projects to obtain the financing, particularly in developing economies.

Craig Bibb
Analyst, CJS Securities, Inc.

Q

In the U.S., we've all seen stories on increased farm foreclosures, you're at the beginning of the selling season. Can you give us kind of insight on what you guys are seeing so far?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

So, there's not much in the way of the selling season really beginning. We're kind of still coming off of end of year planning by most of the farmers and purchases there. In the next few weeks is really when the season will kick in. The bankruptcy piece, there is obviously some increases in that, but that tends to be still on the small farms. The farms that are larger than 1,000 acres have been in relatively good shape and they look long term in their capital investment plans. And so, I don't think it necessarily changes their calculus any and they're fairly well capitalized. So, it's still a potential risk and we have to pay attention to it. But nothing that's over-influencing the market at this point.

Craig Bibb
Analyst, CJS Securities, Inc.

Q

Great. All right. Thanks.

Operator: Thank you. Our next question is coming from Nathan Jones from Stifel. Your line is now live.

Nathan Hardie Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hi, guys. Just on free cash flow, I know you guys have targeted 100% conversion to net earnings. I think probably the free cash flow to unadjusted is the right metric to look at to normalize out some of the restructuring expense that you've experienced. 67% in 2017, 86% in 2018. I know you certainly had some headwinds that suck up working capital in terms of the inflation that you've seen in 2018. Fourth quarter cash conversion was much better and better than we hoped for.

When you talk about your confidence at hitting 100% in 2019 maybe is there any upside to the 100% as you catch up some of that – on some of those raw materials or just how we should think about that free cash flow conversion and anything you guys have deployed to ensure that you can get to that 100% number going forward?

Mark C. Jaksich
Executive Vice President & Chief Financial Officer, Valmont Industries, Inc.

A

Right. So, I would say that if you look at this, there's a slide in the appendix that talks about how our cash flows superimpose across things like raw material inflation. So with the assumption, if raw material prices stay relatively flat, there will be no need to take on inventory in advance to protect margins. So certainly in that respect, I would expect to see the cash flow conversion to be better than it was in 2018. In addition to that, we are embarking on some strategies around being able to lock in raw material prices before we have to actually take them physically, through some hedging activities. We had a little bit of a benefit out of that this past year. We'll probably continue to do that if it makes sense with respect to backlogs. And we are starting some activities with our vendors through one of our banking partners to help us get a little better payment terms from our suppliers. So, there are some things [ph] that are going (00:39:47) on the self-help side. But absent a big run-up in raw material prices, we fully expect to see cash flow conversion to be stronger than it was in 2018.

Nathan Hardie Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Thanks for the color.

Operator: Thank you. [Operator Instructions] Our next question is a follow-up from Brian Drab from William Blair. Your line is now live.

Brian P. Drab
Analyst, William Blair & Co. LLC

Q

Can you just give a little more color on Irrigation margins? And looking at the third quarter revenue levels comparable to the fourth quarter, the margins stepped down about 500 basis points. Why was that?

Stephen G. Kaniewski
President, Chief Executive Officer & Director, Valmont Industries, Inc.

A

Part of that is just some of the mix that we had in international and domestic. And so, again, international [indiscernible] (00:40:41) compared to North America. And you'll even get the product mix within North America. It could be the number of [ph] spends (00:40:50), it could be the type of machine that's out there, but no significant trends. And in fact, we announced the price increases in January, which have gone through to the market, not just in Irrigation, but also in our ESS business as well due to the stronger backlog that's there. So, we think that the margins will always approximate a range, but Mark, any further color there?

Mark C. Jaksich
Executive Vice President & Chief Financial Officer, Valmont Industries, Inc.

A

No. I would say, that's the case, and you also get a certain amount of mix between parts and systems, too. But nothing in there in particular that would be considered the trend or anything like that. It's very situational.

Brian P. Drab
Analyst, William Blair & Co. LLC

Q

What's difference roughly on average? I know there's a big range for all these things, but what's the difference on average for margins internationally versus domestically? Thanks.

Mark C. Jaksich
Executive Vice President & Chief Financial Officer, Valmont Industries, Inc.

A

Well, I would say that the margin – the operating margins internationally in Irrigation are not quite as strong as they are in North America, but they're certainly ended well into double-digit territory and have been improving quite a bit over time, largely as a result of our footprint investments in operational activities.

Operator: Thank you. We reached the end of our question-and-answer session. I'd like to turn the floor back over to management for any further closing comments.

Renee Campbell

Director-Investor Relations & Corporate Communications, Valmont Industries, Inc.

Thank you, Kevin. Thank you, everyone, for joining us today. As mentioned, today's call will be available for playback on our website or by phone for the next seven days and we look forward to speaking with you again next quarter. Thank you.

Operator: Included in this discussion are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on assumptions that management has made in light of experience in the industries in which Valmont operates as well as management's perceptions of historical trends, current conditions, expected future developments, and other factors believed to be appropriate under the circumstances.

As you listen to and consider these comments, you should understand that these statements are not guarantees of performance or results. They involve risks, uncertainties, some of which are beyond Valmont's control and assumptions. Although management believes that these forward-looking statements are based on reasonable assumptions, you should be aware that many factors could affect Valmont's actual financial results and cause them to differ materially from those anticipated in the forward-looking statements. These factors include, among other things, risk factors described from time-to-time in Valmont's reports to the Securities and Exchange Commission as well as future economic and market circumstances, industry conditions, company performance and financial results, operating efficiencies, availability and price of raw material, availability and market acceptance of new products, product pricing, domestic and international competitive environments, and actions and policy changes of domestic and foreign governments. The company cautions that any forward-looking statement included in the discussion is made as of the date of the discussion, and the company does not undertake to update any forward-looking statement.

This concludes today's teleconference. You may disconnect your lines at this time. We thank you for your participation today.