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ATI, Inc. (Texas) (ATI)

Q3 2022 Earnings Call

CORPORATE PARTICIPANTS

Tom Wright
Vice President-Financial Planning and Analysis & Interim Head-Investor Relations, ATI, Inc. (Texas)

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

OTHER PARTICIPANTS

Seth M. Seifman
Analyst, JPMorgan Securities LLC

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.

Gautam Khanna
Analyst, Cowen & Co. LLC

Josh Sullivan
Analyst, The Benchmark Co. LLC

Timna Beth Tanners
Analyst, Wolfe Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the ATI Q3 2022 Earnings Call. My name is Sam, and I will be your moderator for today's call. All lines will be muted during the presentation portion of the call with an opportunity for questions-and-answers at the end. [Operator Instructions]

I'd now like to turn the call over to our host, Tom Wright with ATI. You may proceed.

Tom Wright

Vice President-Financial Planning and Analysis & Interim Head-Investor Relations, ATI, Inc. (Texas)

Good afternoon and welcome to ATI's third quarter 2022 earnings call. Today's discussion is being broadcast on our website. Participating in today's call are Bob Wetherbee, Board Chair, President and CEO; and Don Newman, Executive Vice President and CFO. Bob and Don will focus on our third quarter highlights and key messages.

A supplemental presentation is available on our website. It provides additional color and details on our results and outlook. After our prepared remarks, we'll open the line for questions. As a reminder, all forward-looking statements are subject to various assumptions and caveats. These are noted in the earnings release and in the slide presentation.

Now, I'll turn the call over to Bob.

Robert S. Wetherbee

Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

Thanks, Tom. Good afternoon. We adjusted the time of our call to accommodate Boeing's Investor Day this morning. Thanks for altering your schedule to join us.

Let's go straight to the bottom line. Strong Q3 results confirmed another quarter of solid execution. We're delivering on customer commitments as commercial aerospace gains momentum and geopolitical events trigger significant spending for end-use applications in the defense market.

I'll highlight three key things today. First, strong aerospace and defense market momentum is accelerating and ATI is expanding to keep pace. In the third quarter, half of ATI's revenue came from aerospace and defense, that's the highest level since Q1 of 2020, a very notable milestone. Revenue in these core markets grew 22% sequentially and 87% year-over-year. That's really a truly astounding rate of change. The team has responded to the market opportunity, still early in the ramp or the recovery depending on the market you're in, but phenomenal effort, phenomenal result.

Overall widebody demand for ATI's specialty products, like forgings, billets, bar, rod, sheet, and plate, still lags 2019 levels, but our forward order book increasingly shows early signs of the widebody recovery. Titanium supply is tight and lead times are extending into the second half of 2023. Russia's invasion of Ukraine continues to change the world in many ways. The conflict has prompted the commercial aerospace industry to redirect buying and commit titanium purchases to Western producers.

Defense investment around the world is accelerating. Our competitive position in these markets is strong, whether it's advanced thermal materials enabling hypersonic flight, nuclear propulsion systems on naval ships and submarines, or titanium armor for ground-fighting vehicles, ATI's unique capabilities and material science expertise make us a key partner across multiple strategic defense platforms.

Candidly, if it flies, if it floats or if it rolls as a defense application, ATI's materials are there and they're proven to perform everywhere, every day. Our ability to meet this demand is pivotal to our long-term success. After extensive conversations with customers, government leaders, and market analysts, we concluded that strong demand for aerospace-grade titanium products will challenge available supplies for a significant time. We began to invest in new aero-grade titanium melt capacity at existing ATI operations.

Near-term, say the next 12 to 18 months, we're taking two actions to increase aero-grade Ti melt capacity by 25% over the 2022 baseline. First, we'll reposition our titanium product mix from industrial to aerospace applications. Second, we'll make modest investments to upgrade existing vacuum arc remelt capabilities.

We're investing in new capacity for the long term, too. By late 2025, we expect to produce first ingots on new aero-grade titanium electron beam melting capabilities. Combined, these three actions increased total ATI Ti melt capacity by up to 60% versus the 2022 baseline.

Orders have been placed for major long lead time equipments, significant renewable and carbon-free power has been committed, and for this new brownfield capacity, we expect to break-ground in Q1 2023. Brownfield investments mean we can move faster. It also means modest size investments that fit within our annual capital spend guidance. We'll spend tens of millions of dollars, not hundreds, well-within the annual capital spend guidance that we discussed in our 2022 Investor Day.

We all benefit from this new capacity, both ATI business segments, our global aerospace and defense customers, and the overall supply chain. We're planning to further quantify the impact of these investments over the next several quarters. We've also invested to ensure we have the team in place to deliver. This year, we've added approximately 1,000 new production employees, bringing us to about 90% of our 2023 need. Now, it's all about the cycles of learning and coaching, so they can fully contribute. As that happens, we look forward to increasing levels of productivity and efficiency.

My second point today is that ATI is well-positioned for continued profitable growth. We call it our five pillars of growth, which you'll see on slide 5 of the deck we provided. The first pillar is the transformation of our Specialty Rolled Products business. Our investment in transitioning to a differentiated specialty product portfolio has resulted in far more than just a richer product mix and improved margins. It has fundamentally transformed how our leadership team approaches every aspects of the business.

Pillar two is growth driven by the narrow-body ramp. As platform build rates accelerate to peak levels over the next four to five years, ATI is well-positioned to capture profitable growth. Demand for spare parts for next-gen engines will drive additional sales growth in the coming years, as is production rates for next-gen planes reach steady state levels in the back half of this decade.

Third, the wide-body market is showing early signs of recovery towards what we expect will be impressive growth. ATI's content on all next-gen wide-body platforms will drive significant margin expansion as international travel recovers and global freight growth continues. The defense market drives growth in our fourth pillar. As I mentioned earlier, increased geopolitical volatility has accelerated defense spending across Europe and with US allies around the globe. The near-term opportunities are clear. The long-term opportunities driven by next generation requirements will also drive outsized growth for ATI. Our materials are ideal for the increased demands of strength, lightweighting, and thermal management at the extremes.

Our fifth and final pillar is driven by differentiated applications like medical and specialty energy. These critical adjacent applications have aero-like characteristics that leverage our expertise. We also see growth in metallics beyond nickel and titanium, such as hafnium and niobium. These are used in electronics and space, and we also see growth in zirconium in specialty energy. There are attractive growth opportunities for ATI's advanced alloys. We succeed where the expectations are great and the barriers are high. That's where ATI's extraordinary capabilities perform the best and we see tremendous growth potential. Together, these five pillars define the path to achieving our 2025 goals. I'm confident we're well on our way.

That doesn't mean there aren't headwinds impacting our business every day. Throughout 2022, we've seen macro forces, like inflation and supply chain disruptions. We continue to manage these challenges aggressively. More recently, recession concerns have been in the headlines. We believe the recession question is not if but rather to what extent will it impact ATI, which brings me to my third observation for today. The deliberate repositioning actions we've taken greatly strengthened ATI's resilience in the face of uncertainties. ATI is well-positioned to deal with the challenges we're seeing in the market today. Since 2020 and throughout the pandemic, we've taken strategic action to reshape ATI. We've transitioned to higher-value products and long growth cycle markets. We've consolidated our operating footprint.

The result, API is a significantly leaner, more nimble, and more focused company. And the strength of the company today versus where we were three years ago is unbelievably improved. The team is aligned. We definitely are positioned for the significant growth opportunities that are coming our way. No question, a portion of our portfolio was impacted by recessionary softness in the industrial markets. Our Asian Precision Rolled Strip business continues to be negatively impacted by ongoing zero-COVID policies. That's driving continued market disruptions and is moving demand recovery in that region. The impact of these near-term headwinds is largely expected to be confined within the AA&S segment. Don will share more about these impacts when he shares our Q4 financial outlook.

Before I turn the mike over to Don, let's shift to a quick overview of our Q3 performance by market and set the context for what we see in the quarters ahead. As I shared earlier, in our largest end market, commercial aerospace, demand continues to gain momentum. Jet engine sales grew 26% sequentially and 143% year-over-year as shipments of forgings and materials accelerate to meet increasing demand. What drives that growth for us? LEAP-powered narrow-body airframe deliveries, LEAP engine share gains, and service part demand for wide-body engines. Airframe sales increased as well, growing by 24% sequentially and 84% year-over-year, with modest but steady near-term wide-body demand growth. We expect acceleration in 2024 and 2025 to drive significant growth in airframe revenue.

Defense sales grew 6% sequentially and 4% year-over-year, largely driven by increases in military jet engine and rotorcraft sales. As we look to 2023, we expect strong growth as global defense investment accelerates due to the geopolitical environment I referenced earlier. It's an understatement to say I appreciate all the ATI team and all that they've done to deliver this incredible acceleration in aerospace and defense sales. Each ATI business has contributed to that growth. Beyond our core A&D markets, specialty energy sales contracted slightly on a sequential basis, but grew 16% versus the prior year. Chemical and hydrocarbon processing sales drove growth as downstream refiners work to bring additional fuel refining capabilities online.

Nuclear energy grew, while we saw declining revenue in power generation and renewables. Over the coming years, we expect global energy security needs and the push for reduced emissions to continue driving growth for ATI. Medical sales grew 20% sequentially and 38% year-over-year as elective surgeries recovered from pandemic lows. Looking ahead to 2023, further medical growth is expected as reshoring trends guide new supply opportunities for medical implant and MRI materials. And lastly, electronics sales contracted modestly versus the prior quarter and contracted by 14% versus the prior year. This was in part due to continued COVID lockdowns in China, but also consumer softening and slowing discretionary demand for electronic devices. Based on what we see today, the lockdowns could easily extend into mid-2023.

Now, I'm going to turn it over to Don and he'll walk you through the financials, and I'll be back after that to conclude and take us into Q&A. Don?

Donald P. Newman

Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

Thanks Bob. Let's jump right into the financial headlines: headline one, we've returned to our 2019 revenue levels on a run rate basis; headline number two, we delivered another strong quarter in Q3 and expect to cap off 2022 with a solid Q4; and headline three, we are on track to deliver on the 2025 targets we communicated in February. Our order book and our execution are strong.

Let's dig deeper into these themes, starting with revenue and Q3 performance. Q3 was our first $1 billion quarter since pre-COVID. We reached $1.03 billion in revenue. That's actually the highest quarterly revenue for ATI since the second quarter of 2019. What makes it especially significant? We achieved this even after exiting standard stainless sheet and it's without our divested Sheffield and Flowform businesses. We have great momentum.

Revenue increased 42% year-over-year and nearly 8% sequentially in the third quarter. On a year-to-date basis through September 30th, our total revenue was up 39% from $2 billion in 2021 to $2.8 billion in 2022. Once more, over half, 51% of our third quarter revenue is attributable to aerospace and defense. That's an incredible milestone as we progress toward our target of 65% revenue from A&D. We are moving in the right direction. These data points, along with extending lead times, reinforce that the business is building momentum.

Let's look deeper into the third quarter performance. From the $1 billion of revenue, we generated $141 million of adjusted EBITDA. On the surface, that was consistent with the prior quarter's reported adjusted EBITDA of $143 million. However, there's more to the story. You'll recall that Q2 benefited from $10 million of nonrecurring tariff recoveries and $6 million of COVID relief benefits. If you exclude those nonrecurring benefits from Q2 EBITDA, our adjusted EBITDA improved 11% sequentially in the third quarter from $127 million in Q2 to $141 million in Q3.

Third quarter GAAP EPS was $0.42. Adjusted EPS was $0.53. We accrued $20 million in Q3 for GAAP purposes related to settling a legal matter associated with the Rowley sponge facility dating back to 2016. We accrued another $9 million earlier in 2022 related to the same matter. This settlement puts the lawsuit with US Magnesium behind us. We have excluded this expense in the calculations to derive adjusted EBITDA and adjusted EPS. The Q3 adjusted EPS of $0.53 is consistent with guidance we provided in our prior earnings call. It reflects continued underlying strength in our core business and benefits from our business transformation. Second quarter adjusted EPS was $0.54. Just as I explained about adjusted EBITDA, keep in mind that Q2 EPS included a benefit of approximately $0.11 from the nonrecurring tariff recoveries and COVID relief benefits.

Margins also remain healthy. Third quarter adjusted EBITDA margins were 13.7%. At our February investor conference, we shared 2025 EBITDA margin targets in the range of 18% to 20%. Although, we continue to expand margins to reach the high-teens range by continuing to improve product mix, by growing next-gen jet engine sales, and by increasing wide-body volumes, that's where we see some of our strongest margins. We'll also continue to manage our costs and capture efficiency gains. Strong execution within our operations is this confidence there's growth opportunity there as well. Let me share a recent example of how the team has executed our inflation management strategy. Year-to-date through September 30th, our team has more than offset inflation impacts by relentlessly pursuing pass-through opportunities, capturing efficiencies, and implementing price increases. It is a daily battle and they are executing day in and day out to capture everything possible.

Now, let's discuss segment results. High Performance Materials & Components, or HPMC, had a great quarter. HPMC third quarter revenues were over $457 million, that's up 16% sequentially and 53% year-over-year. Volume, pricing and mix, all contributed to the sales growth. In terms of mix, commercial aerospace sales increased 22% sequentially and 116% year-over-year. Jet engine product sales led this increase. Within the segment, 82% of third quarter 2022 revenue was attributed to aerospace and defense sales, up from 80% sequentially and up from 69% a year ago. We expect HPMC's A&D sales mix to continue to improve as the aero ramp progresses and defense demand grows. With that comes the healthier margins of most A&D offerings. That mix will play a key role in expanding our margins over time.

HPMC adjusted EBITDA was $86 million, or 18.8% of sales. Strong margin growth reflects two things: higher sales of next generation jet engine products and higher operating levels. Third quarter 2022 results do not include COVID relief benefits, compared to $6 million of COVID benefits in the second quarter. Here's the bottom line for HPMC. This segment is in a tremendous growth position. What's ahead? The commercial aero ramp is unfolding, defense demand is increasing, and we continue to enhance our production capabilities and capacity. We are on the right track to accomplish our long-term targets.

Now, let's discuss Advanced Alloys & Solutions, or AA&S. As a reminder, 2021's third quarter was impacted by the labor strike at our Specialty Rolled Products, or SRP business. So, it's more meaningful to focus on sequential rather than year-over-year changes. AA&S third quarter revenues were $574 million, an $11 million increase over prior quarter revenues of $563 million. Sales to A&D markets were 30% higher in the third quarter over the second quarter, led by demand for commercial airframe products. Sales to industrial markets were down sequentially, partially offset by higher medical sales. Third quarter segment sales to energy markets were in line with the second quarter. Sales at our Asian precision rolled strip business continue to be negatively impacted by COVID-related market interruptions.

Third quarter AA&S adjusted EBITDA was $76 million, or 13.2% of sales. Second quarter adjusted EBITDA was $105 million. Let's unpack that $29 million decrease between the second and the third quarters: $10 million was due to nonrecurring Section 232 tariff recoveries at the A&T joint venture in the second quarter; approximately $9 million of the decrease was due to the significant declines of Q2 peaks in commodity prices for multiple metals; roughly $7 million relates to planned maintenance outages in the third quarter, primarily at the Specialty Alloys & Components, or SA&C business unit; finally, approximately $3 million is due to negative impacts at our Asian precision rolled strip business.

The transformation of SRP has reduced metal volatility in our business, fortunate given the movement in commodity prices in 2022. Overall, it's a much better business since exiting standard stainless sheet products. Sales mix has improved, value-added sales were up, and we've significantly increased sales under long-term agreements. Margins should continue to expand for SRP and the AA&S segment as the transformation continues.

Now, three quick points related to our balance sheet. First, we continue to delever. We ended third quarter with a net debt-to-adjusted EBITDA ratio of 2.8 times. This is down 30% from 4 times leverage at the beginning of 2022. Second, we made a $50 million voluntary deposit into our pension plan this week, continuing our pension glide path. Third, we reduced managed working capital another 200 basis points in the third quarter to 36.5% of sales. We're targeting to be in the low-30s by the end of the year. Our team is working hard to get us there.

Let's talk about guidance and outlook. Looking ahead to the fourth quarter, we see continued strength in our core businesses. This is led by commercial aero jet engine and airframe, as well as defense and medical. That said, we expect a few transitory headwinds to negatively impact Q4. I'll take a minute to describe the business drivers creating those results.

First, we anticipate China will continue its zero-COVID policy. This will negatively impact our Asian precision rolled strip business by approximately $0.04 in the fourth quarter relative to our prior guidance. Anticipating that China continues this policy into 2023, there could be impact carryover, but this won't last forever.

Second, we are experiencing lingering effects of the planned annual maintenance outage that occurred in the third quarter at SA&C. Post-outage production has ramped slower than anticipated. The root causes for the slower ramp have largely been resolved and changes in our outage approach could reduce risk of recurrence in the future.

Lastly, when the Russian invasion began in early-March, SRP added safety stock for materials historically sourced from Russia. That was a prudent action in the face of uncertainty. Fast forward to today, our productivity has improved and forward signals are indicating stability in the supply chain.

Fourth quarter is the right time to burn through some of those excess inventories. As a result, we're temporarily turning down production rates in SRP, leading to lower cost absorption in the fourth quarter. SRP will also take advantage of the slower production window and conduct planned annual maintenance and technology upgrades in the fourth quarter. We view each of these items as transitory. They are not expected to create significant impact to 2023.

What does all that mean to Q4 adjusted EPS? We expect it to be between $0.49 and $0.55 per share. That will bring full-year adjusted EPS to between $1.96 and $2.02 per share. We anticipate free cash flow to be in the $90 million range for the full year 2022 versus the previous guidance of $110 million. Primary reason for the reduction is the $29 million litigation settlement, which was not assumed in our previous guidance. Partially offsetting both the settlement impact and modestly lower Q4 earnings expectations is lower capital spending.

We previously communicated full year 2022 CapEx would be in the range of $205 million to $215 million. We are adjusting 2022 capital spending expectations down to a range of $185 million to $195 million. The change reflects continued discipline in capital deployment as well as supply chain interruptions, delaying delivery of some equipment. Those delays, by the way, are not expected to impact growth in any meaningful way.

Before wrapping up prepared remarks, I would like to share some color on 2023 outlook and our 2025 financial targets. Growth and margin expansion have come quickly in 2022, I would say, even quicker than we had generally expected. 2023 should be another good year as we progress toward our 2025 targets. We continue to see strong demand in our core markets of aerospace and defense as well as other key end markets. We've pointed the business where we believe we have fantastic growth and margin potential.

When it comes to a possible global recession, I want to emphasize what Bob said, we have significantly reduced our exposure to recessionary forces. We're well-positioned and we're resilient. We won't be giving targets for 2023 earnings or cash flow today. We'll stick to our normal cadence and provide 2023 targets with our 2022 yearend results.

One item that you may find helpful today is how to think about pension expense in 2023. With declines in pension asset values and discount rate increases in 2022, I know this is on your mind. I want to be clear that we won't know the actual 2023 pension expense until we close out 2022. That being said, given where investment markets and discount rates currently sit, I would expect GAAP net pension expense to increase in 2023 in the range of $30 million to $40 million above 2022 levels.

The increased expense is not expected to change our planned pension contributions in 2023 or 2024. As you may recall, we are planning annual contributions in the range of $50 million both of those years. We will maintain our pension glide path. We have successfully closed the plan to new entrants and reduced pension participants by 60% since 2013. We are committed to efficiently working down our net pension liability.

Looking past 2023, we are tracking to the previously announced 2025 targets. We are more confident than ever about our ability to help solve our customers' greatest challenges. We recognize the value that brings to our customers, to API, and to our shareholders.

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

Robert S. Wetherbee

Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

Thanks, Don. We're proud of our results this quarter. Our teams focus on strong execution day in, day out, plus our continued performance. Let me leave you with three takeaways. ATI's growth opportunities are strong. The next generation aircraft to growing defense investments, fundamental shifts in global supply chains and sourcing, demand for our differentiated materials is growing. We're expanding aero-grade titanium melt capacity to meet demand in both the near- and the long-term. That benefits ATI, our customers, and the overall supply chain. It's one part of a robust strategy to capture organic growth and we're resilient in the face of uncertainty.

The deliberate repositioning actions we've taken have made us significantly leaner, more nimble, and more focused. For the portions of our business that need to navigate the challenges of a softer economy, our new levels of efficiency and performance will serve us well. We're honored to be partners with our customers. We're excited about the significant opportunities ahead of us. I'm confident in our teams' ability to execute on our goals. More than ever, we are proven to perform.

Operator, we're ready for the first question.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question is from the line of Seth Seifman with JPMorgan. Seth, your line is now open.

Seth M. Seifman
Analyst, JPMorgan Securities LLC
Q

Okay. Great. Thanks very much, and good afternoon, guys. Thanks for shuffling the call. I guess, just starting off, strong drop through in HPMC during the quarter. Are those the type of incrementals that we can look for there, exiting the year and into 2023?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

The short answer is I think that they're pretty representative. What we've talked in the past, Seth, about incremental margins is largely for the overall business and I'll just remind you of what those metrics look like. The way to think about our incremental margins as the ramp unfolds is something in the 30% to 35% range for a typical quarter is not unusual. We do have some quarters where it can be significantly better, especially at a segment level or somewhat less for various reasons, but to modeling model, I would say, something in that 30% to 35% range for the overall business as this ramp continues.

Seth M. Seifman
Analyst, JPMorgan Securities LLC
Q

Great. Thanks. And maybe just a follow-up while we're in HPMC, on the topic of engines, there's been some back and forth this week about what rates we're seeing from the engine makers and what rates we're seeing at the aircraft OEMs. What kind of signal are – I mean, it sounds fairly strong, but just to clarify, the type of demand signal that you're getting on the engine front right now, is there any kind of pause or deceleration heading into the year and how do you see that kind of playing out into 2023?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)
A

Yeah. Sure, Seth. It's Bob. Yeah. Good question. It's a question we get asked internally on a regular basis. First of all, we're always happy we're not the bottleneck and that continues to be the case. I think what you're seeing is there's been this rapid acceleration, very fast acceleration, and then there's kind of a period in this industry where it follows a brief period of stabilization before it takes off again, whether it's a program-specific issue or it's an engine program-specific issue, but it's not unusual. The history of the industry would not be a straight line, it would be up and stable, up and stable. And what we see is no one's taking their foot off the gas on our side, because of the strong spares demand. And between spares and the OEM builds, wherever that supply chain is constrained, they're not going to mess up an opportunity.

So, we have not been seeing any weakness in the order book. I think the reality is, if they take their foot off the gas, then you have to restart again, and then you really get kind of a herky-jerky kind of supply chain. So, our order book remains robust. We do see things move around a little bit between parts and programs from time to time, but we're not seeing any slowdown or haven't been asked to really do anything more than kind of yearly inventory correction and/or demand correction, but nothing significant. And like we always say, we just build on the orders we get and that order book is still growing healthy.

Seth M. Seifman
Analyst, JPMorgan Securities LLC

Q

Great. Thanks very much, guys.

Operator: Thank you, Mr. Seifman. The next question is from the line of Phil Gibbs with KeyBanc. Phil, your line is open.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Thanks very much. Good afternoon.

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Hey, Phil.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.

Q

In terms of the AA&S headwinds you're calling out for the fourth quarter, how much of that is incremental to the third quarter? In other words, so is the $0.04 in addition to the third quarter or is it just relative to what you had set out before as your prior guidance?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Yeah. Let me just kind of break down a little bit to help answer that question. So, if you look at Q3, two headwinds I'd call out would be: the SA&C outage costs, the impact that's about $7 million; and then, in Q3, the headwind around the China COVID policy impacts was about another $3 million. And so, if you focus on those components and you see what's going to happen in Q4, Q4 we have a couple of other items that we called out, one is we're going to be turning down production sum at the SRP business. That's going to bring with it some headwinds around absorption. And then, we expect that we're going to continue to have some headwinds around the COVID situation in China. Metal was something else we called out in Q2, I don't see that as a big headline in Q4. But I think as you're looking at the overall Q3 to Q4, you're probably seeing down about $4 million of EBITDA between those different movements.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.

Q

For that segment specifically?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Does that answer your question?

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

Yes. For that segment specifically you're talking about? Yeah.

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

Yeah. That segment specifically. Does that answer your question?

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

It does. And then, on the titanium melt side, did you say you're debottlenecking to have 25% incremental capacity just to serve aerospace specifically, and then, by 2025, you'll have up to 60%?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)
A

Yeah. That's right. So, I think debottlenecking is probably a simple approach to it, but we're focused on the growth in aerospace and defense applications, and in both aerospace and defense, we're seeing very strong defense pull in the armor space. Obviously, some of the rotorcraft, those kinds of things, we'll see increased demand. So, first thing we did is say, you know what, we're going to have to back away from the industrial applications, which we did midyear, now we're going to be able to start moving that capacity to aerospace orders, which are rapidly selling off.

And then, we have quite a few, we call them VAR furnaces that – vacuum arc remelt furnaces where we have a portfolio of different ages and different technologies. So, really pulling some investments forward, we're pulling some upgrades forward, but we really have an opportunity to do that in the near-term. So, by – through the course of 2023, we'll start to see that ramp up, but into 2024, 2025, we'll see about a 25% increase in capacity over that 2022 baseline just from those kinds of projects.

And then, when the new EB furnace comes on, they'll start firing up in mid-2025, get some pretty simple qualifications, given that it's a brownfield operation, then that takes us from the first wave of 25%, all the way up to 60% over the 2022 baseline. So, you're right, it can do anything, but I think the order book for aerospace and defense and titanium is going to be really strong through that period of time. So, we feel pretty good about the return on those investments. Does that help clarify, Phil?

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

It does. But how does – does any of this take into account restarting capacity? I mean, I think you had some higher cost capacity on the West Coast. Is that business turned down permanently or are you restarting some of those furnaces and repurposing those?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)
A

Yeah. There's a portfolio of furnaces, there could be a couple on the West Coast that refire, but the facility itself would not – yeah, we would not refire at all. There's probably just some one or two furnaces could be used to kind of get us through this bridge while we upgrade the rest of the technology, and while we actually get our raw material flow in the right spot, so more of a transitional kind of thing on the West Coast.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

And then, just lastly, where was this litigation charge spawning from?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

Sorry, Phil, you said where was it coming from?

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

The litigation charge that wasn't in your previous free cash flow guidance, where did that come from?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

Well, this dates back to the Rowley sponge facility and a dispute that arose in 2016 when that facility was idled. And so, there was a dispute with the supplier and it was settled – fully settled this last quarter from a – based from an income statement standpoint, we booked the whole charge.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

So, the case is closed [indiscernible] (00:41:38)?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

Phil, by the way, we're going to cut the check for that in Q4. So, the cash flow out of the business in Q4.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

Okay. But there is no other recurring liability associated with that. It's done now?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)
A

There is not. It's all behind us.

Philip Gibbs
Analyst, KeyBanc Capital Markets, Inc.
Q

Thank you.

Operator: Thank you, Mr. Gibbs. The next question is from the line of Gautam Khanna with Cowen. Gautam, your line is now open.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Hey, guys. Good afternoon.

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Hey, Gautam.

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Hey, Gautam.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Got a couple questions. On the titanium melt capacity, you may have said this, but – so, I apologize if I'm asking again, but what is the total capital cost of those upgrades and capacity? And do you have contracts kind of supporting the incremental volume? Have you picked up more business because of the VSMPO dynamic, if you could update us there?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. So, I'll take the second question first and let Don talk about the investments. So, I would say that all the aero and defense customers in the world have been looking for alternative supply. There was kind of a panic mode in, let's say, March, April, May, and then people started to get a feel of who could do what. We're moving away from a highly vertical integrated Russian source to more some fragmented solutions that are going have to be put together from a supply chain. So, once those opportunities became clear, things settled into a normal flow. And yes, we are seeing opportunities both on the defense and the commercial aerospace side related to this, and that's what we're responding to somewhat in terms of what we're doing with our melt capacity.

I would say that the other thing we were seeing was that the commercial aerospace recovery was coming pretty darn fast and we knew it was going to take us a little time to do some of these brownfield investments. So, longwinded answer, but the bottom line was, yes, we're seeing share gain opportunities based on the disruption in the global titanium supply chain. And a lot of fabricated products, certainly, into jet engines as well as sheet and plate into airframes.

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

And this is Don, I'll take the first part of the question, which has to do with CapEx, as I remember, Gautam. So, the way to think about the capital spend, you're right, we haven't shared specific dollar amounts as to the capital for this specific investment. But what I can do is I can tell you, number one, that this is part and parcel to the capital spending profile that we shared with the market in our February Investor Day. And just as a reminder, what we said back then was the company intends to spend about $200 million of capital in 2022. We're going to spend a bit more than $200 million in 2023, and in 2024 after, you're going to see our CapEx start to reduce until it hits above our annualized depreciation expense level, which is in the $140 million and $150 million kind of range. So, the answer is that it's already considered in our spend.

Another important element is to remember that these are not monolithic investments that are being made when we talk about melt assets. These are assets, as Bob calls them, in the tens of millions. They are not in the hundreds of millions. And then, another important consideration is this is a spend that's going to happen over several years and it is consistent with what we've shared in the past, which is our prioritization of melt as well as color capabilities and capacity. We expect we're going to get returns north of 30%.

And then, the last thing that I would mention in this regard is this investment is part and parcel to the extraordinarily strong demand signals that we're getting in aerospace and defense, specifically pointed to our titanium. And it's something we plan to do, because we believe that there would be underlying demand and we're confident in the investment. What's unfolded since that decision has only reinforced that this is a great investment.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

And just to follow up on that, Bob, it sounded like from your remarks that there was kind of a frenzy as soon as the war broke out, and then maybe less urgency among the OEMs to actually close deals and sign up long-term for titanium volumes with you guys and with others. I don't think it's just ATI. So, is it more just opportunity still or is there – have you guys actually signed some contracts, where you're kind of guaranteed a higher volume next year or the year after or is that still just there's a standstill right now to trying to figure out how much they need and how much they're willing to pay and that's maybe tamping down the urgency?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. No. Fair question. I would say that it went from frenzy to deliberate conclusion, right. So, we have – I can think of two fairly large commitments that customers made to us that will impact 2023 deliveries, which is why we're moving ahead to expand our melt capacity. This first 25% will go a long way to supporting some of those opportunities. We'll always have room for some of the transactional types of businesses that kind of pop up from time to time in the distribution community, but the OEMs are committing and we feel good about some of the positions that we've been able to gain, both in aerospace and defense. So, hopefully, that helps with the clarity.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Okay. It does. And I've one more, if I may. Just there was a question earlier which I wanted to get you to expand upon, which is on the jet engine channel. You heard Howmet earlier in the week talk about lower shipments into yearend relative to what they were hoping for. Previously, we've heard that there is bottlenecks in the jet engine supply chain, it looks like it's on the LEAP program, but I can't verify that. But I'm just curious, why won't these issues back up to ATI at some point? Like, what gives you confidence, how far out can you see in terms of your order schedule, and maybe if you can just elaborate on that. Thanks.

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. We're not seeing it, that's true. And before we get on to these calls, we always have a quick debrief with all of our business unit presidents and our COO, Kim Fields, to make sure we're not missing any last minute breaking news. But I think part of it is we are, in many cases, like the forgings, we have a pretty strong vertical integration into our specialty materials business. That helps quite a bit. We have pretty good visibility on our forgings. We've done a lot or doing more on the – I call it lean – leaning into lean with better connections to our jet engine forging customers.

There are cases candidly where we are dependent on another supplier's billet to forge and we do know that they do tend to run late. So, they may – some of our competitors may actually be more dependent on other people's billet than we are. But I think the principal reason is that, for fairly large percentage of what we do, we have the vertical integration opportunity between specialty materials and forging within the HPMC segment, and that was originally the purpose behind acquiring the formerly known as Ladish Forgings. So, in some times, to be honest, when other suppliers fail, then they become opportunities for us. So, I think that team is working well together to make sure they have the right stuff in the right place. So, hopefully, that help a little bit on the clarity side?

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Yes. Thank you.

Operator: Thank you for your question. The next question comes from the line of Josh Sullivan with The Benchmark Co. Josh, your line is now open.

Josh Sullivan
Analyst, The Benchmark Co. LLC

Q

Hey. Good afternoon. Just kind of following up on that...

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Hey, Josh.

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Hey, Josh.

Josh Sullivan
Analyst, The Benchmark Co. LLC

Q

Just kind of following up on that, you talked about aerospace aftermarkets helping as the OEM sales go through this kind of uncertain time period. But if you do the math on your really unique, specific parts that are maybe just unique to one engine, and you see what the OEMs are announcing they're delivering, is the aftermarket piece that would be outside of that within your expectations or is it more than you would expect or is there another X factor there?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. Good question. So, we see spares demand exceeding historical spares ratios, right. So, a good example of that is probably on the wide-body side where, if you look at the parts we're supplying to wide-body engines, there's probably, I'd say 50%, 60% higher than the ratio we'd normally relate to. So, we're seeing outsized short-term demand based on the use of the wide-body engine and wide-body flights. And when we talk to our customers about it, that's the same thing they see service visits, the spares for engines are up.

So, yes, we're seeing an outsized demand for spares really across the board, but for us, it's most pronounced on the wide-body side as they come in for service after pretty heavy use, so not a lot of new planes, but certainly a lot of spares. So, how long will that continue? Probably for a while, we expect it to eventually go back to – all things revert to the mean as they say, but probably we're talking a year or two or three before that happens. Not a lot of inventory out there in the spares world. Yeah.

Josh Sullivan
Analyst, The Benchmark Co. LLC

Q

Right. And then, I'm curious if you're able to see the Boeing delivery assumptions that were released today. You're reiterating 2025 outlook and I know you're not giving 2023 guidance. But looking at Boeing's delivery assumptions, any notable differences with what you guys are looking at or delivering at into next year or so?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. I think it actually confirm them. So, what I heard them say was, about 2025, 2026, they could be hitting 50 a month on the narrow-body and 14 on the wide-body. That's pretty good for – that's better than our assumptions to be honest with you, when we look at the combined narrow-body, wide-body sector. When we got into Investor Day, when we laid out the 2025, our underlying assumptions were more around 100 narrow-bodies and closer to 20 wide-bodies at that time. So, everything we see says we're quite conservative on our 2025 estimates.

I know that makes Don nervous when I say that kind of stuff publicly. But I think there were some good news on how they see the, I call them the grounded fleet, the 787s and the 737s, how they see those being put into service and how they see the production ramp coming, that actually fits what we see in the 2024-2025 timeframe. So, we should start to see and we are seeing some of that demand. I mean, our lead times for titanium are out to easily the third quarter of 2023. So, we are seeing some uptick on the titanium side that we haven't seen in a long time. So, bottom line, I would say, our estimates are more conservative than what we saw today from some of the Investor Day presentations, but positive trends for sure.

Josh Sullivan
Analyst, The Benchmark Co. LLC

Q

Got it. And then, just one last one, on the lingering effects of the annual maintenance, should we expect these events to have a longer recovery cycle in the future? We've seen this from some others in the industry, the labor hurdle, how are you going to address that going forward?

Donald P. Newman
Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Yeah. This is Don. I'll take the question. The short answer is no. We wouldn't expect that we would see elongated outages. I think we've done a pretty good job maintaining our assets. The one situation I highlighted in this call was related to our SA&C business unit and a delayed ramp in a specific outage that they took. We understand the root causes. We've resolved the root causes. And so, we wouldn't expect that to be a repeat. Typically, very, very good as a team in terms of executing outage – planned outages.

Josh Sullivan
Analyst, The Benchmark Co. LLC

Q

Okay. Thank you for the time.

Operator: Thank you, Mr. Sullivan. Our last question today comes from the line of Timna Tanners with Wolfe Research. Timna, your line is now open.

Timna Beth Tanners
Analyst, Wolfe Research LLC

Q

Yeah. Hey, [ph] Ron (00:55:23). Thanks for the time. I know that Bob posed the question, it's not a question of if we're heading into a downturn, but how much it affects ATI, and I guess I just wanted to see if high level we can try to take a stab at that, because in the past that, even when aerospace is strong, sometimes you can get thrown off by the non-aerospace recession with risky stuff. So, if we think high level about how much of your business could be more subject to slowdown, what do you suggest we look out for that? Is it just anything not A&D or anything not medical and gen, to put a lower margin on that business and that's the risk or is there another approach you'd suggest?

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Yeah. We'll try this approach and Don will jump in if he wants to add any color. So, we actually do look at that pretty regularly, breaking it down by markets within the segment and gen. I would say, today, because of the product mixes, the market shares, the big moves we've made on our footprint, we would say that, at this particular time, the recession is probably going to impact the AA&S segments. The HPMC segment, we might see slow-to-moderate growth, but we're not going to see a downturn. I don't think they're going to take the foot off the gas on aerospace and defense for HPMC.

The magnitude of an AA&S recession would probably impact plus or minus 15% of our revenue base, which is a significantly different place than we were pre-COVID. So, we're not saying we expect our AA&S business to go down 15% in a recession. What we believe is 15% of that end market, plus or minus, would be subject to recessionary downturn. So, you can kind of take that at – what are we about, $0.5 billion in AA&S, probably got about 15% of that or so on a quarterly basis would be recession exposed. And then, you can kind of make an estimate of how much those kinds of markets would decline in a recession. Now, we're seeing some of that, Don pointed it out in China today. So, we already have some of that factored in with the COVID issues or the zero-COVID policy in China. But if you probably talk to us like you did, maybe five years ago, when we had other products in our mix that we no longer produce, we would have been more exposed.

And then, the last part of why we think we're less exposed is we've changed our customer base. We don't have, what I'd call, the full-line commodity-style distributors in our mix anymore. Now, they tend to, as you know well, adjust their demand based on anticipation of market shifts, where we have a lot more OEMs who really only change their demand profile based on actual demand shifts. So, I think we're in a better position than we've ever been, but nearly 85% of ATI's revenue is probably as resilient to recession as we've ever been. Does that help, Timna?

Timna Beth Tanners
Analyst, Wolfe Research LLC

Q

No. That was helpful. Just to clarify then you're saying 85% of AA&S or 85% of ATI as a whole? Sorry.

Robert S. Wetherbee
Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

85% of AA&S for sure and 100% or as close to 100% as we can get on HPMC.

Timna Beth Tanners
Analyst, Wolfe Research LLC

Q

Thank you.

Donald P. Newman

Executive Vice President-Finance & Chief Financial Officer, ATI, Inc. (Texas)

A

Maybe just two things I would add to that, Timna, if you don't mind. So, one thing is the benefit of the transformation we talked about quite a lot is reducing our metal exposure, the metal volatility exposure. And as you know very well, when you're getting into recessionary periods of time, the moves in metal prices can be pretty dramatic. So, not just the percentage that Bob is talking about that's important to understand, but also we've dimensionally changed how metal price movements affect our business and as well as pricing. And so, the short answer is we really have dampened the effect of inflation on our business with this transformation. And so, we think that we can perform really well with great resilience, even if there is a global recession, especially given the strong underlying demand for our core businesses like – our core markets like aerospace and defense.

Timna Beth Tanners

Analyst, Wolfe Research LLC

Q

Okay. Thanks for that color. That's helpful context and I'll leave it there. Thanks again.

Robert S. Wetherbee

Board Chair, President and Chief Executive Officer, ATI, Inc. (Texas)

A

Sure. Thank you.

Operator: Thank you for your question. We have no further questions waiting at this time. So, I'd like to hand the call back over to Tom Wright with ATI.

Tom Wright

Vice President-Financial Planning and Analysis & Interim Head-Investor Relations, ATI, Inc. (Texas)

Thanks again for joining us today. This concludes our Q3 2022 earnings call.

Operator: Thank you for your participation. You may now disconnect your lines.