

Sensata Technologies

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Samik Chatterjee: Thank you. Hi. I'm Samik Chatterjee. I cover the IT hardware and networking equipment names at J.P. Morgan. The next company we are hosting for a fireside chat here is Sensata. I often like to point out to investors that this is probably the company I've been covering the longest. Thanks to Sensata for sticking around [laughs] with my coverage for that long.

We have the pleasure of hosting CEO Jeff Cote. We also have Jacob Sayer from Investor Relations with us. Thank you both for participating in the conference and making the [inaudible] conference happen.

What I would like to do is maybe start with a brief background, Jeff, on what Sensata is all about, what do you do, just to level said expectations before we dive into more detailed Q&A.

Jeff: Great. Thank you very much. Thank you, Samik, for your long-term support of Sensata as well. We really appreciate it. It's been a good partnership. I know you've gained a huge amount of knowledge about the company over the years.

Let me start by sharing some key elements of our company for some of you that may not be as familiar. I'll try to be brief to allow us to jump into some questions.

There are five key points. The first is that Sensata is 100-year-old company. It's an industrial technology company. Although you may not know us, I can guarantee you that you use our products every day in end products that you use in your home, in your car, in your place of work, in aircraft and other mass transit. You definitely use our products. We keep the environment safe and you safe every day.

We serve a number of end markets. We're serving largely OEMs and tiers in those end markets and more and more so aftermarket customers as well, distributors in end markets such as automotive, heavy vehicle, off-road, agricultural, other recreational vehicles, aerospace, and a

number of industrial markets in segments such as smart buildings, smart factories, clean energy, and other diversified industrials.

The third thing is that we're benefiting as a company from a number of trends in the overall market largely driven by the need for more clean and efficient as well as safe equipment. Many of those trends are regulated by governments around the world.

There are a number of other trends which we benefit as well from, such as the trend toward more electrified equipment, toward more smart and connected equipment which requires more sensor content and other autonomous related features which requires sensors to enable those autonomous features as well.

These trends drive secular growth in our business above what the end markets that we serve would grow. We refer to that as outgrowth or content growth in our business. We have a very well-established track record of significant content or secular outgrowth.

The fourth area is around capabilities that we have. We have a very strong legacy of designing and manufacturing very hard to do, mission-critical sensors in electrical protection, which helps our customers solve their most difficult challenges.

The scope of those capabilities has continued to expand over the years in terms of the sensing dimensions and other services and solutions that we would be able to provide for our customers. More and more, those capabilities are extending beyond just sensor components into subsystems and other areas that we would be able to deliver insight. I suspect we'll get into some of that in some of the Q&A.

The last area is that we have a long history of continuous improvement as well as a company. That allows us to generate value for our shareholders in the form of a very efficient variable cost structure. In our core business but also in the businesses that we acquire, there's often significant cost synergies as well as revenue synergies associated with businesses that we might acquire.

It generates a high profit margin in our business as well. When you compare us to some of our peers, our operating margin is quite high, supporting the fact that we have differentiated solutions. Those profit margins generate significant cash flow because we are not a capital-intensive business.

We have a small portion of our overall cost structure which is fixed. That provides for converting a

lot of the earnings into cash, which provides flexibility for us in terms of other value-creating opportunities in terms of capital deployment. Over the last 10 years as a public company, we've demonstrated the ability to do that.

Those are my introductory comments, Samik.

Samik: Jeff, thanks for that. Before I move to questions, let me remind investors that they do have the option of sending questions in through the Q&A feature. We'll ask it on your behalf. This is the first company I've seen questions come in, even before I prompt the audience. We definitely see already a lot of interest.

Let's hit on the first topic, which is the hot topic everyone wants to discuss. Given the challenges in the automotive market this year -- I totally appreciate the challenges on operating and such, and in the environment -- but, at this point, what are your expectations for how does the automotive market shape up this year? How are you positioning your company right now to navigate in this tough environment?

Jeff: We had our earnings call a couple of weeks ago. We spoke to this topic. We, like many others, have not provided quantitative guidance in terms of the balance of the year, given the overall market conditions that everybody is facing.

However, we did share a fair amount of qualitative perspective. In the automotive market, there is a large amount of third-party data that would be available to us and to all of our investors in terms of having an appreciation for what we're expecting in the markets.

I'll point to IHS data, for instance, which currently forecasts for the year, for 2020, that North American automotive production will be down about 25 percent. Similar levels for the European automotive market. Less so, call it 10 to 15 percent, in the China market. That results in a blended growth rate down about 20 percent on a global market.

In terms of what we've done to prepare for that, we announced on our recent earnings call that we believe that the second quarter will be the low point.

It remains to be seen, but certainly in terms of the indications that we've been watching in terms of our customer and market shutdowns in terms of manufacturing plants, and the expected recovery rate restart of those. We would expect the second quarter to be the low point.

On a short-term basis, we have announced a number of cost actions that we would consider to be temporary. Obviously pretty deep cuts in discretionary spend. Our board, myself, and our senior leadership team have taken pay cuts to allow us to weather what we believe will be the toughest quarter in the second quarter.

As well as all indirect personnel globally have agreed to either pay cuts or time out to the tune of about 25 percent.

Those are the temporary measures that we put in place. We have a very focused effort, given that the second quarter, we believe, will be the low point given the disruption that we're seeing. We'll be able to very clearly weather through that, with lower levels of margin, clearly, but with expectations that will continue to generate positive cash flow here in the second quarter.

The more important question is what more normalized revenue will look like and more normalized demand will look like. We're spending a lot of time as a management team speaking with our customers, understanding what the indicators are, to really look out to fourth quarter, first quarter of 2021 to understand what those more normalized demand levels will be because any cost-reduction actions that we have to put in place.

There will clearly need to be some cost actions that we have to put in place, more permanent cost actions. We'll make sure that we size to what that more normalized demand is.

Aside from the cost structure, we've put in place a number of actions associated with reducing capital spend, managed working capital. We're monitoring very closely our payables, receivables, and inventory levels to manage working capital.

We also, as a precautionary measure, at the end of the first quarter, drew down on our $400 million revolver to make sure that we had adequate cash on hand in any market circumstance that we would be able to face in.

We are currently at about a $1.2 billion cash balance. We feel very confident in not only continuing to generate cash, but if things were to deteriorate more quickly, we would have adequate cash to be able to manage through that.

Samik: Jeff, you mentioned current [inaudible] costs for roughly a 20 percent decline in automotive production globally. That's fairly similar to the 2008 levels in terms of what we saw, automotive production being down in the last recession that we had or the automotive recession

in particular.

When you compare how the company is positioned today versus that time frame...I remember when I've looked the numbers, what it shows is you had actually margins improving, you had positive free cash flow during that time.

Remind us, how do you see this decline in production, and how are you looking at navigating this, and how this is different from 2008 timeframe? Maybe on the costs side or even on the content growth drivers, how are you positioned differently?

Jeff: The market environment has some similarities [laughs] but some stark differences in terms of the speed of the decline. I was the chief financial officer of the company during the '08, '09 downturn. I remember it quite well. It was a period of time over a year or 18 months where we saw continued decline in the overall market. This has been, obviously, much more abrupt.

It adds complexity in this downturn, given the shelter-in-place orders and managing through what our primary objectives have been in the second quarter, which is keeping our people safe and making sure that we continue to serve our customers.

From a company standpoint, we're a more diversified business than we were then, more diversified geographically, more diversified from an end market basis, and also more diversified from a product category in terms of [inaudible] dimensions and solutions that we would provide.

We're also significantly less leveraged. We were not a public company back in '08 and '09. We were private equity owned. We had more debt on our balance sheet. Those are the things that are very different.

There are a number of things that are quite the same. That includes our focus, our strategy around zeroing in on mission-critical, hard to do products. That hasn't changed in the last 10 years since that timeframe.

The design and nature of our products, and therefore the stickiness associated with the revenue that we serve to our customers -- if end markets are down, and our customers are demanding less, that will have an impact -- the stickiness associated with the revenue and the secular growth in terms of content or outgrowth, which you referred to, is similar.

We've been continuing to invest more in that to have steady content growth, overall growth so

that when you do see an environment where the overall market's down, we offset a significant portion of that market downturn with content growth.

Even more so in a recovery cycle where you have content growth and market recovery, you will see more significant growth in our overall business, albeit of a lower base, but you'll see that play through. The variable cost structure of the business is very similar.

Most important, our management intent in terms of looking at the overall long-term demand for the business, acting responsibly in terms of how we run the business, aligning the cost structure appropriately for the business, and making sure that we balance appropriate margin profile with investment in our long-term future are things that have remained the same in terms of how we run the business.

Samik: Moving to then discussing the recovery here, I'll just state the two questions that already have come in because they've hit on the same topic here, the first one being, how are auto restarts progressing versus your expectations?

The second one is on the same lines, but it's more on the sell-through. An investor is asking, how is sell-through in markets that have started production earlier than others?

Jeff: On the auto restarts, we've had more dialog recently with customers regarding their planned restarts and at what levels they expect to restart. We've been modeling that in terms of what we would expect in terms of our overall recovery.

It started with four weeks of shutdown or six weeks of shutdown. As we've been getting closer to when those restarts will occur or have already occurred, there's very specific conversation with our customers in terms of the time of start and also how it will ramp.

I would say that that's panning out pretty similar to how we had expected it. There was a period of time over the last six or eight weeks where there were some extensions associated with the shutdown periods and some reductions in terms of what the start rates were expected to be.

Over the last four weeks, there's been more stability on that front. We're seeing many of our customers start to already re-engage and to start to ramp up their production.

The second part of the question is the important one because customers restarting is one thing, but if they restart, and there's no end-market pull for the product, then they're going to build

inventory. That might help us on a temporary basis, but it's not going to help us long-term views that we'll need to unwind. We're all going to be watching that extremely closely.

The sell-through rates in terms of how you think about North American auto, for instance, we see the data on that. It's not very optimistic right now, but clearly our customers are starting to ramp back up with production. My sense is that that production will stay constant because they don't want to lose share as consumers come back and start to buy.

There are some very specific dynamics associated with the environment we're in where the auto market might be benefited. The desire to do more social distancing, perhaps less mass transit, those are factors that would potentially bode well for recovery. I'm not expecting a very sharp snapback, nor is anybody else, but certainly from a consumer demand standpoint.

A place for where we can refer to in terms of what we would hope that recovery would look like, we have a market that we serve in China that is recovered quite nicely. It's certainly not back to its fourth quarter of 2019 run rate, but we've seen a snapback.

Our factories are operating. Our customers' factories are operating. There are a number of incentives that have been put in place both with the OEMs and with some of the governments to incent more vehicle or other equipment purchases.

Based upon what we're seeing in the North American markets and European markets in terms of the federal support and the government support, we're expecting that there will be a recovery here.

Samik: Moving to the bottom-line impact that you've had here as demand has come down or production has come down, the first quarter itself you had very high decrementals. Some of that is associated with the costs that are still there, which obviously, in this environment, some of the costs are tough to take out.

If we do end up having a slower-than-expected recovery or an extension of the downturn in volumes we're seeing, help us think through, what can you do to moderate those incremented margins? What are we looking for as we go through the next quarter or the one after that?

How much can you compress those decremental margins and what levels can you pull before we finally start to go up on the recovery and focus on the incremental margins on the way up?

Jeff: The speed of decline has a negative impact on the decrementals. Paul Vasington, our CFO, on our most recent earnings call talked about what makes up our cost structure.

There's obviously a big part of that cost structure that's purely variable. It will move largely with the volume that we see in terms of demand from our customers. There are other portions of the cost structure that are semi-variable, meaning that they need management intervention in order to align those costs.

Given the dramatic drop that we saw during the first quarter and into the second quarter, we hadn't aligned our cost structure. We saw more dramatic decremental margins in terms of the impact, to the high 50 percent range in terms of drop through of the volume to the bottom line.

We've talked in our call about the fact that we're not planning to size the organization to the second quarter run rate because we think that's the low point. Decrementals into the second quarter will continue to be quite high.

As we start to come out of the second quarter, depending on the pace of the recovery, if we align our cost structure, and then we get to more normalized margins, and then there's a recovery, you won't see the snapback in margins because we will have normalized those margins in terms of sizing for the overall business.

If there was a quick snapback, then you would expect to see that come back very quickly. If it takes us a quarter or two because there's a new normal in terms of demand, you'll continue to see, not to the extreme that we've seen in Q1 or in Q2, but you'll see margin profile in terms of what you'd normally expect for Sensata to be a little bit muted.

Then, once we get that cost structure in place, we'll get back to more normalized margins. Then you would see more of a variable recovery along with volume from that point.

Samik: Let me move to the segments or the end markets in particular here. One of the end markets, the heavy truck market, was challenged even pre-COVID, in some sense.

Wanted to get your thoughts or how you're thinking about the magnitude of decline in sale and when you start to expect a recovery because some of that downtake doesn't seem to be COVID related. It seems to be more of a usual business-cycle-related downtake that you are seeing.

Jeff: It's a good point because we started to see some of the impact associated with the cycle, if

you will, in the heavy vehicle, off-road market starting in the second/third quarter of last year.

At that time, we had talked about what we historically have seen in terms of market cycles in that end market to be somewhere in the 18-month period. Take the COVID situation out of that, as you go through the balance of 2020 and start to enter 2021, you'd normally expect to see some level of recovery.

In terms of 2020 now, in terms of third-party forecasters, some examples would be on the on-road truck in North America they're expecting a 2020 decline at 40-45 percent, on-road truck in Europe again around 40 percent. China is less so, around 20. These are all numbers end-market focused rather than net because, remember, we have very strong content growth.

On the first quarter in the heavy vehicle, off-road market, we saw about 900 basis points or nine percent content growth, which offset these market declines, but pretty significant overall market declines. Across agricultural and construction, again, forecasters would predict somewhere in the 15 to 20 percent decline range during 2020.

These are a fair bit steeper, given the COVID impact, than we would have originally anticipated. Nonetheless, the market cycle would continue. As we start to think about this market going into the first quarter of 2021, we would start to see some level of recovery in those markets from that point forward.

Samik: Maybe then on the heavy truck market, because you started to see the declines even pre-COVID, as we look at the recovery in this end market, are you differently placed, given the combination of higher content growth as well as the cost structure being more aligned to get higher incremental margins in that business on the recovery?

Jeff: That business is pretty consistent with the overall margin profile of the company. We have a number of different end-market segments.

The heavy vehicle, off-road market is pretty consistent in terms of the overall margin for the company. If you look at that business segment on a standalone basis, it's not dramatically different from some of our other business in terms of the mix of the overall cost structure.

Certainly, in a higher growth recovery market, you do tend to see a little bit more leverage in terms of your fixed cost structure in the business. Higher growth will benefit us in terms of being able to manage through that.

It's important to highlight, though, that we're constantly balancing what we invest in the future. These are all very long-cycle businesses. This is one which we see lots of future opportunity. It's also an area where many of our megatrend-related areas is focused in terms of on-road truck.

There's a lot of investment that's occurring. We'll moderate what drops to the bottom line in terms of long-term growth investment associated with the future.

What we can promise is high levels of differentiated margin profile. The balance between how much we invest and how much we drop to the bottom line will be something that will be based upon what we see for opportunity.

Samik: You mentioned the megatrends. That's been a focus for Sensata for a while here. Given this disruption, are you seeing any need to push out the investments on the megatrends because the customers are looking to push some of that as not being that high priority at this point? Anything moving on that front?

Jeff: We've been focused on megatrends associated with efficiency, and safety, and so forth for our tenure as a company. Those have been megatrends we've been focused on more recently.

Two, three years ago, we've started to focus in on more associated with electrification, smart connected, autonomy related as megatrends which we think will be opportunities for us in the end markets that we serve.

We're seeing no evidence in terms of our customers meaningfully changing their point of view as to where they need to go on these megatrends. I know there's a lot of talk around the world in terms of potentially pushing out some of the regulation associated with emissions because of COVID related. We're talking about pushes that are 90 days, sometimes six months.

They're not meaningful changes in terms of the regulation that our customers need to meet and the customer pull that they're seeing associated with these other features associated with electrification and others.

The interesting thing is even with oil prices where they are, our customers want to continue to invest in platforms going forward associated with electrification because, at the end of the day, that's really about emissions management as opposed to the oil price.

Clearly, total cost of ownership comes into play on that, but we're getting to the point where there's cost-to-parity associated with that even into lower ranges of fuel price.

Samik: Let me remind investors that you can still send in questions through the Q&A feature. I can ask it on their behalf.

Jeff, continuing on that megatrend thought, relative to a few years ago, I remember we had to consistently defend the bear thesis content on electric vehicles for Sensata. That's an aspect where the company's made significant strides over the last few years.

Help us understand what those big changes have been and right now how you're positioned if the industry does still more towards electric vehicles, in fact, in a more assertive manner coming out of this. How do we see the Sensata position for that?

Jeff: Thank you, first, for acknowledging our progress on this megatrend. I feel as though we've made huge progress as well.

If you rewind the clock to three, four, or five years ago, the notion of electrified vehicles was always viewed as being something that was much further out, primarily due to the fact that the range of these vehicles and the charging times associated with these vehicles didn't meet consumer expectations.

As well, the infrastructure associated with being able to charge vehicles had not been invested in at the level that would allow that to be a viable option.

Obviously, all of that has changed. The cost, the battery pack cost, the range of the electric vehicles has changed dramatically. We acknowledged that very early on, given our intimate understanding of what was going on in the automotive market. We started investing organically in capabilities that would allow us to serve this.

Our mantra has been quite simple. It has been that as there's a shift from combustion engine to electrified platforms, that should be a significant tailwind for us as a company rather than a headwind. We knew that if we didn't invest in capabilities, in solutions that would allow us to be able to maintain our significant relevance in the automotive market in an electrified world, that we would fall behind.

There were a number of investments organically. There were some very strategic inorganic

investments, such as the acquisition of GIGAVAC, which is one of the three or four global players in high-voltage contactors, which is a mission-critical application for electric vehicles.

That was a strategic acquisition that we did at the end of 2018 to allow us to make sure that we were able to go to investors, go to our people, and tell them that the trend toward electrification was going to be a tailwind.

I feel good about that. We've been sharing some data points that prove that out. For instance, in the first quarter of 2020, about half of our total new business wins in the first quarter of 2020 applied to electrified platforms.

That's not only in the automotive space. There are other trends in other end markets. The charging infrastructure in our industrial business is a very fast-growing business that also uses high-voltage contactors and other products and solutions that we have.

We feel good about the progress we've made and the position that we have in electrification broadly as a trend impacting our customers.

Samik: Jeff, another megatrend that we've seen Sensata significantly ramp up on is the Smart & Connected megatrend. You've steadily built a portfolio that has started to gain traction with customers on that front.

Maybe help us think about what's driving the traction, how much of this is relevant to the heavy truck market versus the automotive market. Where do you see this portfolio eventually sizing up in terms of, are you looking for more acquisitions on this front, or is this going to be more of an organic opportunity longer term as well?

Jeff: We've labeled Smart & Connected. Think of it as an IoT play. IoT is a very broad topic. It's impacting all of these end markets. At the core, it's about the desire and need for more data to make operations more efficient, to make vehicles more efficient, and to just drive more efficient-safe environments.

Where this was born for Sensata is out of what was an acquisition we did back in 2015 of our entire pressure-monitor business. We bought the Schrader tire-pressure monitoring business.

When you start to think about tire-pressure monitoring being required outside of a light-vehicle environment into an on-road truck environment, there were significant added complexities

associated with moving to tire-pressure monitoring. It's an 18-wheel vehicle with sensors being further apart and also having tractors and trailers not to be permanently mated with each other.

The ability for a tractor to back up to any trailer and have a seamless connectivity between those two pieces of equipment to be able to do tire-pressure monitoring. As we engage with our OEM customers on the implementation of tire-pressure monitoring in an on-road truck environment, that turned into more the development of a vehicle area network.

Think about a mechanism to enable that pairing, to collect the wireless sensor data, connect it to a telematics device whether it be OEM-owned or after-market, and feed a broader telematics ecosystem. That vehicle area network then clearly has the capability to collect a lot of other sensor data. It's not limited to just tire pressure.

It started as an opportunity with our OEM customers. We've got significant traction there. We talked about that in our last call that we have over $90 million of one business associated with our Smart & Connected initiative. This is where our Smart & Connected initiative is within the company in our OEM business.

Even more exciting, we have a number of engagement with fleet customers. We have five pilots going today with some of the largest North American fleet managers to implement this solution in an after-market scenario and to collect other sensor data.

We've been working with them on the critical applications other than tire pressure, load management, and also wheel-end monitoring to make sure you don't have a bearing wear or failure situation, which obviously can cause a major disruption in terms of the overall logistics chain. We're working with them to collect data and to pursue this.

It's all with the notion of feeding a broader telematics system to provide more data to improve operations and safety in fleets over the world but in North America primarily today.

Samik: Jeff, as we start to wrap up here, the last question that I definitely wanted to hit on is over the [inaudible] Sensata there has been this initiative to look for acquisitions to diversify the business outside of the automotive market.

Not necessarily that you want to stay away from the automotive market, but given the higher growth in the automotive, it naturally increases the exposure, so you want to diversify to some extent. How are you thinking about that as a long-term priority? Do you want to explain that?

You've just recently taken over the CEO role. How are you thinking about that as the timeline of that priority?

Jeff: It will continue to be an important part of our long-term strategy, M&A. There's no question. We're good at it. It allows us to diversify add-on additional end markets that we might serve and making sure that we do that in a very shareholder value-creating way. It's not just diversification for diversification's sake.

We have a very strict and appropriately strict methodology to understand the rate returns that we'll be able to generate, that it will be a good return for shareholders. We also temper that given overall market environments.

In the current market environment, we're not stopping our M&A activity, but how big the moves would be, we're making sure that we do it in a very responsible way so that we don't do anything that would be endangering the core part of the business, which is so valuable. It will continue to be important. We'll continue to be very focused on the areas that will provide significant growth for us going forward.

Samik: Jeff, Jacob, thank you. We're running up against time. I do want to keep everyone on schedule given our back-to-back kind of how the meetings are. Thank you both. Thanks a lot for attending the conference and making the virtual conference happen. We can't do it without you guys. Thank you.

Jacob Sayer: Thank you.

Jeff: Very good. Thank you very much for having us.

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