Management's Prepared Remarks
Second Quarter 2020 Conference Call
August 4, 2020

Tabitha Zane
Vice President, Investor Relations
On the call today are Jerry Volas, Chief Executive Officer, Robert Buck, President and Chief Operating Officer, and John Peterson, Chief Financial Officer. We have posted senior management's formal remarks on the Investor Relations section of our website at topbuild.com.

Many of our remarks will include forward-looking statements concerning the company's operations and financial condition. These forward-looking statements include known and unknown risks, including those set forth in this morning's press release as well as in the Company's filings with the SEC. The Company assumes no obligation to update or supplement forward looking statements that become untrue because of subsequent events.

Please note that, other than as otherwise specifically stated, the financial measures to be discussed on this call will be on a non-GAAP basis. The non-GAAP measures are not intended to be considered in isolation or as a substitute for results prepared in accordance with GAAP. We have provided a reconciliation of these financial measures to the most comparable GAAP measures in a table included in today's press release and in the presentation accompanying this call.

Jerry Volas
Chief Executive Officer
Good morning and thank you for joining us today. Let me begin by acknowledging the ongoing impact that COVID-19 is having on our employees, their families, and all of our other stakeholders. We understand it is a difficult time for everyone. Here at TopBuild, we continue to manage every aspect of our operations to provide a safe environment for our employees, our supplier partners and our customers. At our Branch Support Center in Daytona, we continue to work remotely with technology keeping us connected and effectively supporting our broad network of branches throughout the country. At every one of our branches, we have implemented best practices in terms of sanitizing and disinfecting and we enforce social distancing, there and on job sites.

As we look back on the months since our last call in early May, we've seen the resiliency of the residential new construction industry. We started the second quarter with extreme uncertainty as the country was under a national lockdown, our installation and distribution businesses were deemed non-essential in four states and unemployment reached levels not seen since the Great Depression.

Yet, as we reported to you in May, our April financial results were still relatively strong and they continued to improve as the quarter progressed. We are also encouraged that while second quarter housing starts are lower than last year, our builder customers are reporting a steady increase in traffic and orders. This should lead to improving housing starts as the year progresses.

Historically low interest rates, very little inventory and a growing desire to escape cramped urban environments are many of the key factors contributing to this quick rebound. While we recognize that there will likely be bumps in the road as our nation continues to manage through the pandemic, we remain bullish on the overall fundamentals of the U.S. housing industry.

Turning to our second quarter financial results, net sales declined 2.1%, primarily as a result of the COVID-19 pandemic. Despite this revenue drop, we continued our strong margin expansion at both TruTeam and Service Partners. For TopBuild in total, our adjusted operating and EBITDA margins increased 130 basis points and 250 basis points, respectively, which drove adjusted EPS to $1.68. We feel very good about this performance, which once again demonstrates the flexibility and strength of our operating model in any type of environment.

On our last call we noted that given the current level of uncertainty, we were hitting the pause button on further acquisitions. We had a full pipeline of prospects at that time and, thanks to the ongoing hard work of our M&A team, that pipeline has expanded over the past few months. With a clearer outlook of the positive trajectory of the housing industry and a strong balance sheet with almost $650 million of liquidity, we are resuming our acquisition program and should close on a number of these deals in the next several quarters. And, having developed a core competency integrating acquisitions onto our systems and supply chain, we expect to drive meaningful synergies quickly from these deals.

As a reminder, our primary focus remains on acquiring core insulation companies, though we continue to evaluate a number of glass companies that would fit well within our existing $160 million business in this product adjacency.

Before turning the call over to Robert, I wanted to note that in late June we were pleased to learn that TopBuild was moving from the S&P Smallcap 600 to the S&P Midcap 400 effective June 30. Some of you may remember that at the time of the spin in June 2015, our market cap was approximately $1.1B. Today it is over $4.5 billion, more than a 300% increase. This move is clearly a recognition of our strong growth and the tremendous value we have created for our shareholders over the past five years.

Robert Buck
President and Chief Operating Officer
Before reviewing TruTeam and Service Partners' financial results and our continued operational response to COVID-19, I want to thank our entire TopBuild Team for their dedication, teamwork and ongoing push for operational excellence, especially during these difficult times. Everyone from our installers, to our warehouse workers, drivers, office and sales staff, field leadership and branch support center team have pulled together to deliver our very strong second quarter results.

As we respond to the current environment, our cornerstone value of safety for our employees, their families, our customers and supplier partners remains the guiding principle for all decisions. We enforce social distancing and sanitizing both in our branch operations and on job sites, and our work-from-home policy at certain operating facilities, including our Daytona Branch Support Center, remains in place. Internal communications have become even more important, bringing our employees together with central themes including safety, diversity and inclusion. We push these values throughout every level of our organization, building a stronger team, creating a better workplace and helping us win in the marketplace.

I want to stress that our strong results are due to many factors, most importantly:

- Our flexible business model, enabling us to quickly adapt to changing market conditions;
- Our ability to attract and retain labor;
- Our integrated systems that allow us to share labor, equipment and inventory;
- Our strong supply chain which ensures we can meet customer demand;
- Our long-term customer and supplier partner relationships; and
- Our company-wide focus on operational efficiency and sales and labor productivity.

As such, when the pandemic hit, we were confident in the steps we needed to take to care for our employees, serve our customers, and ensure the financial health of TopBuild.

We entered the second quarter operating in all but four states; New York, Pennsylvania, Washington and Michigan, where residential and commercial construction had been deemed nonessential. As a reminder, Washington represents our fourth largest state in terms of annual sales. At that time, in response to the shut-down and overall uncertainty due to the pandemic, we began pulling multiple levers to take costs out of the business, including eliminating most discretionary spending and non-essential capital expenditures, cutting overhead, and reducing labor in those states where construction was deemed non-essential.

We also implemented a COVID-19 Leave Plan, paying impacted team members for a period of time to help provide assistance to them and their families. We did this to create goodwill and to increase the probability they would return to TopBuild when conditions improved. It has definitely been a success, enabling us to quickly ramp up in those four states where construction has again been deemed an essential service.

As we moved through the quarter, our branches stayed busy, most working on a strong backlog. In addition, our builder customers' optimism grew steadily as they saw buyer traffic and orders increase along with consumer confidence, fueled in part by very low interest rates. Moreover, based on recent builder surveys, there appears to be a shift of buyers moving to more suburban and rural areas. We are optimistic this shift will stimulate demand for single family homes. Along with this good news, by late May/early June the four states that had deemed construction non-essential had reopened and our crews quickly got back to work.

Looking at TruTeam's second quarter results, sales declined 3.4%, in large part due to our being shut out of commercial construction in several metropolitan areas in addition to the four states I mentioned previously. Sales improved as we moved through the quarter, and June revenue increased compared to the same period a year ago.

Despite this drop in revenue, TruTeam's adjusted operating margin improved 100 basis points in the second quarter to 15.2% and increased 110-basis points for first half of the year to 14.0%, clearly demonstrating the strength and flexibility of our business model and our focus on bottom line results.

Turning to Service Partners, in the second quarter total sales grew 1.3% and for the first half of 2020, sales increased 3.0%. Service Partners' adjusted operating margin for both the second quarter and first half of the year was 11.6%, an increase of 170 basis points and 160 basis points, respectively.

We introduced a new product line at Service Partners, professional grade sanitizing and disinfecting supplies and equipment. We are marketing to contractors who are already in the commercial cleaning industry as well as to contractors who may see this as an opportunity to create a new revenue stream. While relatively small in terms of revenue generation thus far, it demonstrates our team's creativity and flexibility in meeting new market demand with minimal investment.

Our commercial business, on a same branch basis, declined 12.9% in the second quarter and is down 6.9% for the first six months. We have seen a number of large commercial projects delayed or slow to ramp up due to new guidelines governing the density of construction crews on site. Pre-COVID-19, it was not uncommon to have 10-12 trades working on a job site at the same time. Obviously, that has changed with social distancing rules, elongating project timelines. We have also seen some projects cancelled, but during this same timeframe we have been awarded a number of new projects that will help offset some of these cancellations. As a reminder, comps this quarter and last were very difficult as commercial revenue increased almost 22% in the second quarter of 2019 and close to 25% in the first quarter of that year.

On the heavy commercial side, bidding activity remains strong and we are looking at potential jobs with start dates through early 2022. A lot of the projects we are working on and have been awarded are distribution centers, healthcare facilities, and infrastructure projects. Overall, the commercial recovery will be slower than residential, but we remain confident in the long-term growth of our commercial business.

Material costs are holding steady and it is too early to predict whether we will see a second cost increase this year. Labor is still tight, though in certain markets, particularly those hit hard by the steep declines in the oil and gas and hospitality industries, we believe there could be an increase in the available labor pool. However, this will depend, in part, on the federal government's subsidies of unemployment benefits which are yet to be determined.

Looking ahead, we, like all of you on the call, are closely monitoring housing starts and are optimistic the industry will continue to strengthen as we move through the year. Thank you again to the TopBuild Team and congratulations on another strong quarter.

John Peterson
Chief Financial Officer
Good morning everyone. As both Jerry and Robert have noted, our strong financial performance is a direct result of the hard work of our outstanding team, both in the field and at the branch support center, and provides great evidence of how we can quickly flex our business model to respond to changing market conditions. With 70% of our costs being variable, we are able to initiate cost savings fairly rapidly, which we did in March as the pandemic hit. These savings helped bolster our robust margin expansion this quarter. To a lesser degree, the margin expansion also benefited from Covid-19 curtailed expenses, such as travel and entertainment costs, which at some point are expected to return to normalized levels.

In the second quarter net sales decreased 2.1% to $646.1 million primarily due to a 3.6% reduction in sales volume driven by the impact of COVID-19, partially offset by revenue from three acquisitions, Viking Insulation, Hunter Insulation and Cooper Glass. For the first six months of 2020, net sales increased 1.6%, primarily driven by increased selling prices and acquisitions, with overall volume flat due to the negative impact of COVID-19. As a reminder, we were still shut out of four states at the beginning of the quarter and were not operating in all of our markets until late May/Early June.

Adjusted gross margin increased 130 basis points in the second quarter and first half of 2020 to 27.8%, and 27.1%, respectively, driven by increased operational efficiencies, cost reduction initiatives and lower insurance costs, partially offset by higher depreciation expense.

Adjusted operating profit in the second quarter grew 9.3% to $83.5 million, with a corresponding margin improvement of 130 basis points. For the first six months, adjusted operating profit increased 13.5% to $153.8 million with a corresponding margin improvement of 120 basis points. In addition to the items discussed in adjusted gross margin, operating margins were favorably impacted by lower travel and entertainment costs.

Adjusted EBITDA for the second quarter was $107.8 million, compared to $94.0 million in 2019, and adjusted EBITDA margin expanded 250-basis points to 16.7%. For the first six months of 2020, adjusted EBITDA grew 16.4% to $196.1 million, and adjusted EBITDA margin was 15.1%, a 190-basis point improvement over first half 2019.

Second quarter SG&A as a percent of sales was 15.1% compared to 15.0% in the second quarter of 2019. The year-over-year increase was primarily the result of lower sales volume and higher restructuring expenses, offset by savings from cost reduction initiatives and lower travel and entertainment costs.

Depreciation for the three months ended June 30, 2020 increased $6.1 million compared to the same period a year ago. This increase in depreciation expense was primarily related to the reduction in the carrying value of older assets that the Company was no longer utilizing, and an increase in expense on assets the Company has purchased over the last twelve months. On a six-month basis, depreciation increased $7.8 million compared to the same period a year ago.

Adjusted income for the second quarter was $55.7 million, or $1.68 per diluted share compared to $49.5 million or $1.43 per diluted share. For the six months of 2020, adjusted income was $101.6 million, or $3.04 per diluted share, compared to $86.1 million, or $2.49 per diluted share.

Second quarter and first six-month 2020 adjustments were $3.0 and $3.6 million, respectively, primarily related to restructuring costs as a result of COVID-19.

Our effective tax rate for the quarter was 23.2% and 20.5% for the first six months of the year. The 2020 effective tax rates are lower than the normalized tax rate we guide to of 26% due to a discrete tax benefit of $1.4 million and $6.9 million related to share-based compensation for the three and six months ended June 30, 2020.

Interest expense in the second quarter 2020 declined from $9.6 million to $8.3 million versus prior year, primarily driven by a 188-basis point decline in the average interest rate on our term loan compared to the second quarter of 2019.

CAPEX for the first six months of the year was $20.9 million, 1.6% of sales, below our targeted long-term range of 2% to 2.5%. As we noted on our last call, with the advent of the pandemic, we pared back our planned 2020 CAPEX spend.

Working capital as a percent of sales for the trailing twelve months was 10.5% versus 11.9% a year ago. This decrease was due to improved collections and reduced past due amounts across the TruTeam portfolio as well as lower volume in our commercial business which tends to have longer receivable terms.

We ended the second quarter with net leverage of 1.21 times, using trailing 12 months adjusted EBITDA. Total liquidity at June 30, 2020 was $648.5 million, including cash of $258.8 million and accessible revolver of $389.6 million. Operating cash flow was $178.2 million for the six months ended June 30.

Due to continued uncertainty related to the COVID-19 pandemic, we are not providing revenue and EBITDA guidance for 2020 at this time. However, as Jerry noted, we remain bullish regarding the long-term health of the residential and commercial markets we serve and are confident TopBuild's flexible business model will continue to drive our strong performance.

Jerry Volas
Chief Executive Officer
Our business is strong, our team is focused and our future is bright. We recognize there is still a great deal of uncertainty related to the pandemic, but we are confident we will successfully meet whatever challenges lie ahead. Many people are looking to escape crowded urban living and with historically low interest rates, now is a great time for them to pursue their dream of owning their own home.

As we move through the second half of 2020, TopBuild will continue to focus on achieving operational efficiencies while keeping our employees safe. Our flexible business model, combined with our team's creativity and hard work, will remain key cornerstones of our success. Operator, we are now ready for questions.