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PPG Industries, Inc. (PPG)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

Thank you. I would now like to turn the conference over to John Bruno, Vice President of Investor Relations. Please go ahead, sir.

John A. Bruno

Vice President-Investor Relations, PPG Industries, Inc.

Thank you, Lauren, and good morning, everyone. Once again, this is John Bruno. We appreciate your continued interest in PPG and welcome you to our second quarter 2022 financial results conference call. Joining me on the call from PPG are Michael McGarry, Chairman and Chief Executive Officer; Tim Knavish, Chief Operating Officer; and Vince Morales, Senior Vice President and Chief Financial Officer.

Our comments relate to the financial information released after US equity markets closed on Thursday, July 21st, 2022. We have posted detailed commentary and accompanying presentation slides on the Investor center of our website, ppg.com.

The slides are also available on the webcast site for this call and provide additional support to the brief opening comments Michael will make shortly. Following management's perspective on the company's results for the quarter, we will move to a Q&A session.

Both the prepared commentary and discussion during the call may contain forward-looking statements reflecting the company's current view of future events and their potential effect on PPG's operating and financial performance.

These statements involve uncertainties and risks, which may cause actual results to differ. The company is under no obligation to provide subsequent updates to these forward-looking statements.

This presentation also contains certain non-GAAP financial measures. The company has provided in the appendix of the presentation materials, which are available on our website, reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures. For additional information, please refer to PPG's filings with the SEC.

Now, let me introduce PPG Chairman and CEO, Michael McGarry.

Michael H. McGarry

Chairman & Chief Executive Officer, PPG Industries, Inc.

Thank you, John, and good morning, everyone. I would like to welcome you to our second quarter 2022 earnings call. I hope you and your loved ones are remaining safe and healthy.

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I will provide some comments to supplement the detailed financial results we released last evening. For the second quarter, we delivered record net sales of $4.7 billion and our adjusted earnings per diluted share from continuing operations were $1.81.

To quickly summarize the quarter, our sales performance was an all-time record, driven by continued realization of real-time price increases that are now fully offsetting total cost inflation.

Total cost inflation includes generational high commodity cost inflation, energy, logistics, and other employee-related cost inflation. In addition to pricing, our top and bottom lines continue to benefit from recent strategic acquisitions, including our traffic solutions business, which delivered a record quarter.

We achieved strong sales results despite softening consumer demand in Europe, longer than anticipated COVID-related disruptions in China, and unfavorable currency translation.

While we included the European demand realities and our financial guidance we issued in April, the impact of the extended China restrictions and the currency translation was negative by about $0.10 per share versus our original guidance.

Our sales were aided by above market volumes in several of our end-use markets, including our PPG-Comex business, which delivered another record quarter as concessionaires continue to add new locations.

In addition, our global automotive refinish, traffic solutions and US packaging coatings businesses each set all-time quarterly sales record in the second quarter. This highlights one specific example of PPG technologically advanced products. That is our packaging business, where we have won positions on about 75% of the new metal can packaging lines in North America over the past two years.

Also, our aerospace business continues to benefit from year-over-year improvements in domestic travel in various countries resulted in higher aftermarket demand, and we expect further aftermarket and OEM growth as the industry demand remains well below pre-pandemic levels.

Although still challenging commodity supply disruptions continue to ease in the quarter, and we expect further improvements as we progress through the second half of 2022. This includes much better raw material availability as inventories at most of our suppliers have vastly improved. We achieved adjusted earnings that were toward the upper end of our April financial guidance and would have been in line with the second quarter of 2021, if not for the negative impact of foreign currency translation. This reflects the benefit of our strong commercial discipline regarding pricing and continued focus on cost management.

Our earnings performance was aided by higher selling prices of about 12% year-over-year, marking the 21st consecutive quarter of higher selling prices. Our selling prices are now up over 15% on a two-year stacked basis, reflecting our continued actions to offset persistent cost inflation. We anticipate by the end of 2022, we will fully offset all cumulative total inflation from 2021 and 2022. More importantly, we are converting higher prices to improve margins.

During the quarter, our operating earnings improved each month. This strong progress is being reflected in the positive momentum of our operating margin recovery as we improved sequentially – sequential quarterly margins by 200 basis points and anticipate further improvement in the third quarter.

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Also aiding our second quarter earnings performance was continued realization of acquisition related synergies and cost savings from previously announced programs, which together totaled about $30 million of incremental benefit.

During the second quarter, we also implemented cost mitigation initiatives in Europe, reflecting the slower demand in the region and have additional contingency plans ready in the event of a broader economic slowdown. The efforts around cost management resulted in a reduction of our overall – of our selling [indiscernible] (07:04) cost by 100 basis points as a percent of sales compared to the prior year second quarter.

Our acquisitions are also performing well, including the traffic solutions business, which achieved 15% sales growth in the second quarter. We remain excited about future growth opportunities for this business as in the next few years, we anticipate increased infrastructure spending and expect further US adoption of mandatory expansion of traffic marketing for safety purposes.

During the quarter, we continued to progress our launch of the expanded pro painter initiative with The Home Depot. [ph] Albeit (07:40) later than we wanted in the paint season and despite continuing raw material constraints, we were able to fully load PPG products at all US locations with our full PRO product assortment by the end of the quarter.

We have already had some meaningful early wins of some large pro contractors and our near-term target list includes more than 1,000 pro contractors that have expressed interest in buying our products at The Home Depot. We're excited about teaming up with The Home Depot, and collectively, we see opportunities for significant growth in the coming years.

In the second quarter, our net debt was consistent with the first quarter and our working capital was sequentially higher, mainly due to the higher dollar value of inventories, reflecting inflationary effects and higher receivables given our selling price increases. As the supply chain disruptions continue to improve in the coming quarters, we expect our working capital to return to more normal seasonal patterns and cash flow generation improve as we progress through the end of the year.

We repurchased $135 million of our stock at attractive prices during the quarter and continue to manage our acquisition pipeline. In addition, we have progressed our key capital expenditures during the second quarter focused on productivity and growth and now expect total spending to be about $450 million for the full year. Consistent with our past practices, we'll deploy cash in most accretive manner for our shareholders, including some debt reduction.

In the second quarter, we further enhanced our company's corporate governance as we receive the necessary shareholder vote threshold for board declassification and elimination of supermajority voting requirements. We had worked on soliciting our shareholders for years to pass these proxy votes, and we're pleased to see our efforts pay-off to further solidify our corporate governance.

In addition, we continue to advance our sustainability strategy and proudly announced PPG's commitment to setting near-term company-wide emission reductions, in-line with climate science through the science-based target initiative. We plan to communicate new 2030 goals that will define our decarbonization strategy over the coming months.

Looking ahead, in most major regions and end-use markets, underlying demand for PPG products is expected to remain solid. We anticipate strong sequential growth in Asia due to higher industrial production compared to the

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second quarter that was heavily impacted by COVID restrictions. We're closely monitoring the current COVID situation in China. And at this time, we only expect minimal impact to our sales and operations from any further restrictions.

In Europe, we expect economic conditions to remain soft, including normal seasonal demand trends versus the second quarter. Also, positive demand trends are generally expected to continue in North America, aided by stronger sequential automotive OEM production, further aerospace recovery and continuation of recent trends in auto refinish sales as we work to fulfill strong back orders.

In the second half, year-over-year comparisons will be aided by the sharp declines we experienced last year during the height of the supply disruption that impacted several industries, particularly in the US. Outside of a few commodities, we expect supply chain conditions to continue to improve, including better raw material and transportation availability as our suppliers' production capabilities are returning to a more normal condition.

Also, in the second half and specific to PPG, we expect several businesses, including automotive OEMs and aerospace to deliver strong growth due to large supply deficits and low inventories in these end-use markets. Other PPG-specific positives for the second half are continuing acquisition synergy realization and additional cost savings from previously announced restructuring actions.

In the third quarter, our two-year stacked raw material inflation is expected to be about 40%, up a low-single-digit percentage sequentially versus the second quarter. We'll continue to prioritize implementing further real-time selling price increases, and we expect a quicker offset versus historical lags similar to what we delivered in the second quarter.

Importantly, we expect that our sequential quarterly momentum on operating margin improvement will continue in the third quarter as we work back towards our historical margins. And also, even with significant unfavorable currency impacts expected to continue resulting in about $0.10 EPS impact in the third quarter, we are forecasting our adjusted earnings to increase on a year-over-year basis.

While near-term challenges exist, I remain confident about the future earnings capabilities of PPG as the earnings catalyst that I referenced in the past remain fully intact, and we certainly see a path to return to prior peak operating margins with opportunities to exceed them.

As a reminder, this includes continued recovery in the automotive refinish, OEM and aerospace coatings businesses. Continued sequential momentum of positive price versus cost as commodity raw material costs moderate, in the event of an economic downturn, they should moderate in a more rapid manner. A lower cost structure resulted in strong operating leverage on any sales volume growth, accretive earnings and further growth from our recent acquisitions.

In closing, as we look ahead, our team of 50,000 employees remain focused on serving our customers and supporting our stakeholders. Every day, I'm inspired by our teams around the world who are making it happen, are providing products that are helping to protect and beautify the world. Thank you for your continued confidence in PPG. This concludes our prepared remarks.

Now Lauren, would you please open the line for questions.

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QUESTION AND ANSWER SECTION

Operator: Of course. [Operator Instructions] Our first question comes from David Begleiter from Deutsche Bank. David, please go ahead.

David Begleiter
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you. Good morning. Michael, you discussed a path to $9 of EPS in 2023. Has that now been pushed out given the current economic backdrop and weakening we're seeing in Europe?

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

Well, David, it's certainly going to make it a little bit more challenging. But all the conditions are still there, right? You have refinish that's going to have an improved outlook. Miles driven are closing on 2019 levels. Automotive OEM is still light – I mean, we got 24.5 million builds in China. We have a supply deficit in the US. The fleets haven't been rebuilt, so that's still there. Aerospace is coming back at a very strong level. And I'm sure you saw the Farnborough announcements about the new planes. So you're going to have not only aftermarket doing better, but OEM doing better.

You have the synergies we've talked about. We have $30 million in synergies just in the quarter alone, productivity and manufacturing and then price raws, even though we haven't built that in, I'm sure somebody is going to ask later on the call about that. We see certainly raw material pricing getting a little weaker in China. We know it's going to get weaker in Europe, and that's going to free up additional. And then we still have ability to have cash deployment. So I think all options are on the table, and I think we're still pretty confident that the outlook remains good for PPG.

Operator: Thank you. Our next question comes from Ghansham Panjabi from Baird. Please go ahead.

Ghansham Panjabi
Analyst, Robert W. Baird & Co., Inc.

Q

Yes, good morning. Thank you for the time. On the weakness in Europe that you saw in 2Q and market concerns over a recession in the region, Michael, how do you think this particular business cycle could be different in a continued slowdown scenario given that some of your end markets never fully recovered to begin with?

And then related to that, can you also comment on the current raw material supply situation in Europe just given concerns over not just the supply of natural gas, but also issues with logistics and the water levels and so on and so forth in the rivers? Thanks.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

Sure, Ghansham. Let's start with the fact that what's going to be different this time is, look, in the US, we have full employment, and we have people with a lot of money in their pockets. And so even if the Fed over-tightens, I'm still looking for people to maybe partially slow down, but it's not going to be anything significant.

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I would say that right now, there's a strong likelihood that people are going to continue to spend money in the US. Certainly, we see a slowdown coming in Europe. I got to be honest, I'm not as worried as other people are about gas rationing in Europe. And the reason for that is when you think about the size of the automotive business, the size of the chemical business, these are hugely important to people in Europe. And if you got into a significant gas rationing over there, you would have an economic event that would not be pleasant. So I'm anticipating the government is going to ask people to turn their thermostats up substantially during the summer. They're going to turn them down in the winter. People are going to start conserving. So I'm not worried about raw material supply from that standpoint.

The other thing I would tell you is I'm already starting to see some rotation of raw materials out of China to Europe in anticipation of this. So that's going to provide additional supply, and that additional supply will help ease some of the projected challenges. So I'm, obviously, paying attention, but I'm not nearly as worried as some people are.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.
A

And specific to the European demand, Ghansham, the US, we are seeing, obviously, slowness. We were down about 10% in Q2. We're projecting to be down in Q3. And we have some markets that are improving on a go-forward basis, as Michael alluded to. Our auto OEM business, we expect to improve certainly over the next, call it, 12 months. We know aerospace is improving in that particular region as well as globally. So we have some offsets to what's already a weak environment. And so again, on a go-forward basis, we expect some puts and takes.

Operator: Thank you. Our next question comes from Christopher Parkinson from Mizuho Securities. Christopher, please go ahead.

Christopher Parkinson
Analyst, Mizuho Securities USA LLC
Q

Great. Thank you. Just back to corollary of Beg's question. There have been three variables affecting your margin outlook, including end market mix with refinish and aero improving, but still below or maybe just at 2019 levels. Some manufacturing inefficiencies, especially in the second half due to auto OE and then, of course, price cost. When we take a step back and just think about these for this – not only for the second half, but into 2023, going back to that $9 question. Can you just give us the key highlights and how you're thinking about these right here, right now and perhaps just highlight how you're thinking about them a little bit differently versus the past three to six months? Thank you so much.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.
A

Christopher, I mean, obviously, the mix is improving every single day. So that's a positive for us. As you know, refinish and aerospace are very good businesses for us. And you have improved pricing in automotive, which is improving that mix as well. So I think from that standpoint, that's going to be good.

The second one, if you think about our manufacturing situation, we've had to adjust manufacturing schedules on very short notice or no notice, in some cases, because of supply disruptions force majeures. And as supply gets better, we're able to plan better, scheduling is better. Obviously, COVID is not a challenge anymore. We don't have as many call-offs.

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So, from that standpoint, our manufacturing is going to improve. And as you see, our price is dropping to the bottom-line. So, margins improved 200 basis points in Q2, you're going to see a significant improvement in Q3. You're going to see an improvement in Q4.

So, from that standpoint, that is going to continue to be positive momentum and we're expecting raw materials on a sequential basis only be like up low-single-digits in the third quarter. So, I think there's a lot of positive momentum here and I'm feeling pretty good about that.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

And Christopher, I just want to – this is Vince again. I just want to add that we are still down 10% in volume versus 2019. So, again, you said we were close to parity and just huge incremental margins on that volume recovery. Again, auto and aerospace are two of the biggest declines versus 2019 or pre-pandemic.

Operator: Thank you. Our next question comes from John McNulty from BMO Capital Markets. John, please go ahead.

John McNulty
Analyst, BMO Capital Markets Corp.

Q

Yes, thanks for taking my question. So, I guess what I'd like to focus on is the price versus raws dynamic. I guess can you help us to understand what portion of the portfolio still has more pricing that it needs to get to catch up. It seems like you did really well in 2Q. I guess I'm curious what else you need to kind of hit on.

And then equally important, it looks like you're on track for raws to be up about $2 billion or so over the last couple of years. I guess when we start to see raws coming off, I guess, how much of the pricing associated with that do you think you hold on to versus having to give back? Is there a way to think about that? Because it just seems like it's a really big number.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

Yeah, John, this is Vince. I'll start, and then Michael could add some color. We still have targeted pricing that we will inject in Q3. Some businesses, we have perennial pricing that typically occurs toward the end of the season. So, you'll see that both in performance.

We still have some catch-up pricing in some of our industrial and auto businesses that will take place in the quarter. And so there will be higher – we expect higher pricing on a percentage basis and certainly on a two-year stack for Q3.

With respect to the inflation, I think your numbers are directionally correct in terms of the inflation we've absorbed over the past, call it, 18 and soon to be 24 months. We anticipate offsetting that fully with price. But not just that, as Michael mentioned in the opening remarks, we're offsetting logistics.

We're offsetting employee-related inflation and so in packaging inflation. So again, our pricing will overcome that by the end of the year. And we typically have sticky pricing as we progress through the economic cycle.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

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So, maybe, John, to add a little bit to that. Your premise that you're trying to understand is how much of this $2-plus-billion are we going to keep. The thing that we're talking to our customers about is raw material inflation is just one piece of this. And so when you add the things that Vince talked about, logistics, labor, energy, packaging costs, we need to continue to recover that.

So, I fully expect, and I will be fully engaged and Tim will be fully engage with the businesses to ensure that we're going to be keeping a large percentage of this in our pocket. And that is a key deliverable for our business unit leaders. Everybody is well aware of it, and it's been signaled well ahead of time. So, this will not be a surprise to our customers. So, I'm feeling pretty good.

Operator: Thank you. Our next question comes from Kevin McCarthy from Vertical Research Partners. Kevin, please go ahead.

Kevin W. McCarthy
Analyst, Vertical Research Partners LLC

Q

Yes. Good morning. In your guidance for the third quarter on slide 10, you're baking in volume assumptions of flat to down a low-single-digit percentage. I was wondering if you could just speak to the buildup to that assumption, maybe in terms of geography, assumptions around China lockdowns, you lack thereof, European macro, but also in terms of your individual businesses and which ones you expect highest or weakest volume growth in the third quarter?

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

Yeah, Kevin. Good morning. This is Vince again. So, on a year-over-year basis, probably a couple of big movers. Again, we expect Europe to be down double digits, close to double digits versus the prior year. But we do expect, if you recall, we did have the peak of the chip shortage in our automotive OEM business last year, and that's recovering. Not fully recovering, but it's recovering this year Q3.

We also have improvement in aerospace, as we've talked about several times already on the call. Those are three of the bigger movers. And then we have a variety of puts and takes by business. On a sequential basis, what's important is we do expect – for us, China was down for essentially two months in Q2. We do expect China to be fully up and running with just modest, very modest impact from COVID in Q3. So that's the biggest mover sequentially.

Operator: Thank you. Our next question comes from Josh Spector from UBS. Josh, please go ahead.

Joshua Spector
Analyst, UBS Securities LLC

Q

Yeah, hi. Thanks for taking my question. I was wondering, within architectural coatings, could you discuss some of the volume differences in DIY versus trade markets, I guess, specifically looking at North America and Europe. And I guess given some of the commentary about Europe, where you're still seeing declines on technically easier comps from last year, what does that say about your thoughts about DIY and how that holds up in a recession, this cycle potentially? Thanks.

Timothy M. Knavish
Chief Operating Officer, PPG Industries, Inc.

A

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I'll take that one, Josh. This is Tim Knavish. Thanks for the question. The biggest driver of the volume issue in DIY is clearly Europe. We've seen a double-digit decline in DIY volumes in Europe. And frankly, we expect that to continue. We called it at the end of the last quarter, that was accurate and we expect that same phenomenon to continue. The trade volumes in Europe are a bit stronger. It depends on some by country.

We're seeing some softness in some countries of trade and other countries like France, we continue to do very well on the trade side of the business. So that's more mixed. And when you come over to this side, to the United States, we've also seen DIY, I would call it more normalizing, where Europe was down because of a number of issues, whether it was coming out of COVID or consumer confidence because of the war. Here in the United States, it's more normalizing in a post-COVID environment, whereas in the trade side of the business here in architectural US, we still see very good backlogs.

We do a survey of our professional painters every quarter. And about 80% of the professional painters that we surveyed here in the US this quarter have as much or larger backlogs than they did last quarter. So DIY normalizing here, but still good trade backlogs.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.
A

This is Vince. A couple of other color points here. In the US, we were still impacted early in the quarter in our US architectural business by supply challenges. April, May are still in the heart of the paint season. And in Europe, based on what we've seen to-date, we're very comfortable with our share position.

Operator: Thank you. Our next question comes from Frank Mitsch from Fermium Research. Frank, please go ahead.

Frank J. Mitsch
Analyst, Fermium Research
Q

Thank you and good morning, folks. I appreciate the level of details. Coming to the use of cash, Tikkurila is rolling off as a driver – as part of the M&A increase. And I know that M&A is important to PPG. You did mention that you stepped up buybacks in a quarter at attractive prices. But I'm just curious as to what the outlook is on the M&A front that's out there.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.
A

Frank, this is Michael. The M&A front continues to be what I would call steady. You saw there were some deals done in the past 90 to 120 days. We've obviously looked at those and decided those [ph] weren't (29:27) value creating from a PPG's shareholder perspective. And we continue to look at our portfolio. You probably noticed that we sold a couple of businesses. You saw we sold [indiscernible] (29:38) and another small one.

And so we're always looking at our portfolio. So – but we're going to do what's best. So this quarter, paying down debt and buying back a little stock made the most amount of sense. We're going to continue to look at our portfolio and decide what we're going to do. The pipeline remains what I would call steady, and we're continuing to talk to the board about the options that are out there.

Operator: Thank you. Our next question comes from Laurent Favre from BNP Paribas. Laurent, please go ahead.

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Laurent Favre
Analyst, BNP Paribas Exane

Q

Yes. Good morning, all. I had a question regarding this contingency plan on the European side. I mean, I hope you're right on, I guess, the lack of big curtailments of chemical production and all the mess that would be related to that. But I was wondering if you could talk about two things. One is, are you thinking about raw materials inventories and stocking up perhaps into a more turbulent time.

But also in terms of areas where you may have single sourcing, I know that there was a big surprise last year in the US, I'm wondering if you plan from the US side and that now all of your European operations can run on dual sourcing, for instance, so that you can indeed import all those raw materials from elsewhere? Thank you.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

So, Laurent, this is Michael. First of all, it's virtually impossible to be dual source on everything because we make some unique chemistries. On those that we are single source, we have a contractual relationship with our suppliers to provide that protection that we need. But we have been in a mode of being conservative on inventories right now. In Europe, though, we are going to be moving toward a mode of destocking over the next few months. We've already started to see availability of raw materials get better. We anticipate that prices, we've seen some prices already soften in China. We anticipate some softening coming up in Europe. And so the plants have already put in place contingency plans. They've enacted some to lower costs. And so from that standpoint, I think we feel very comfortable. We have some additional plans in place as well.

Operator: Thank you. Our next question comes from Arun Viswanathan from RBC Capital Markets. Arun, please go ahead.

Arun Viswanathan
Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my question. I guess, I just wanted to go back to the bridge potentially to maybe $9 or something close to that in 2023 or 2024. If you think about that that seems to be likely that it would have to be composed of something around $2.50 for Q2, Q3 and $2 for Q1, Q4, I guess, is that correct? I mean, that would imply kind of like a 20% improvement on a quarterly run rate basis. And if you think about that 20%, is that maybe a third volume improvement and two-thirds kind of margin recovery from price cost? Or how should we think about that path to getting back to that kind of earnings power?

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

We'll try to take another stab at this, Arun. This is Vince. So look, we're down 10% in volume versus 2019. We expect the vast majority of that to return. Again, because of some of these decremental items are in very large businesses for us and businesses that are showing today, and we expect on a go-forward basis, good recovery momentum, again, we talked about auto. We talked about aerospace. There are a couple more that are smaller. We do expect positive business mix as part of that equation as well.

To your point on price, raws recovery, we've talked about it couple of times. We're still down in Q3 on a cumulative basis. We expect to be at least at parity by the end of the year on price raws, so that will pick up several points. And then I don't want to underemphasize what Michael talked about with respect to manufacturing.

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We typically have productivity improvements year-over-year from our manufacturing operations. If you look at the past 12 months, we've had decrements in manufacturing. So we expect to fully recover those decrements and move back to our legacy of producing productivity. So those three things, coupled with synergy capture and coupled with some cash deployment, gets us to $9 plus of earnings power we've talked about.

Operator: Thank you. Our next question comes from Prashant Juvekar from Citi. Prashant, please go ahead.

P.J. Juvekar
Analyst, Citigroup Global Markets, Inc.

Q

Yes. Hi, good morning. You talked about European DIY being slow. You've talked about that for a while. How did European industrial business do throughout the quarter? Did it slow down as the quarter progressed? And then a related question to that is, are you seeing a rebound in industrial activity in China? And do you think that China activity or industrial activity can grow if US and Europe are slowing down? Thank you.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

Yeah, P.J., we saw declines in architectural in Europe, obviously, as Tim talked about, automotive on a year-over-year basis and our industrial business on a year-over-year basis were also down, let's call it, mid-single-digits due to some of the same issues that caused call it economic slowing in the region.

On a go-forward basis, auto, we expect to recover at some point. It's still going to be choppy in the back half of the year in Europe. It's going to certainly recover in the US and in China. Our industrial activity, we expect at least at parity. We are seeing a very rapid recovery in China from the COVID shutdowns and expect growth on a year-over-year basis in Q3.

With respect to with Europe slowing, would China grow? Again, we think China is becoming more of an internally consumption market, and we still feel good about the US economy. So, there are some offsets to a European slowing that would allow China to produce good industrial activity results.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

P.J., this is Michael. I think if you think about this from a China macro standpoint, China government is under significant pressure right now because of some of these COVID lockdowns. And they're injecting money, reducing the amount of bank restrictions and they're putting pressure on the building industry as well.

So, they are showing every sign to make sure that the local economies in China continue to recover. So, I feel pretty good about the fact that China is committed to having a better second half of the year than they had the first half of the year.

Operator: Thank you. Our next question comes from Michael Sison from Wells Fargo. Michael, please go ahead.

Michael Sison
Analyst, Wells Fargo Securities LLC

Q

Hey guys, nice quarter. It does feel like a recession is the consensus view pending these days and your portfolio has changed. So, just curious, overall, how do you think the current portfolio would – in terms of volumes, would

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hold up in a recession? And given you've got $2 billion worth of inflation, is it possible that you could potentially offset that entire volume decline because you get a lot of this inflation back and maybe PPG's earnings look a little bit more resilient than maybe in the past?

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

Well, Mike, I think we certainly have built a more resilient company to start with that as a basic premise. Second, I do think that we're going to keep a lot more raw materials in our pocket. So, if you do see a raw material decline, I think that's going to flow through the P&L a lot quicker than you think. And I think that's a little bit of what people are missing in this analysis.

And quite honestly, this recession, if there is one, which I still don't think there's going to be a significant one, if there is one, we have a different portfolio right now. So, think about traffic solutions. I mean that business runs no matter what happens. And they are behind on that, plus you have demographics where they're going to have thicker lines more – the lines are going to be longer. So, those things are going to be positive.

You also have the fact that we have a supply significant deficit here in the US of cars. That's going to be different. And we have a significant deficit of planes, and that's going to be different. And the new planes that are coming out are much more fuel efficient than the old planes. So, it's not a matter of whether they're going to keep the old planes in the air, they're not going to do that. They're going to replace these because of the fuel efficiency.

And so if you believe that $100 oil is here for long – moderate period of time, the plane guys, those are economics they cannot afford to miss. So that's why they're going to be replacing these planes. So, I think that's all good.

And you know what's interesting about this work from home stuff is that the, the dynamics are – people are driving in the suburbs more and less on the highway, which leads to more lower speed collisions. So, totals are actually down right now. So, totals were down 2% and I anticipate totals continuing to decline, and that's good for our refinish business. And oh, by the way, if you're getting an accident right now, you better be prepared to wait because there's about a six week the average backlog to get a car repaired is about six weeks right now. That's assuming they get the parts. So, I'm feeling pretty good about that.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

And Mike, this is Vince again. I just – your comparison and we'll just compare to the last recession. Obviously, there was a housing overhang globally in the last recession. There was an auto overhang in the last recession. We're not seeing those. Michael talked about aerospace. We expect that to be in a recovery mode, auto in a recovery mode as it relates to PPG's portfolio and a different – in addition to traffic solutions versus the last recession, we have PPG-Comex, which is a very steady business for us. We also have some other businesses in other parts of the world that are more steady. So again, I think Michael's comments at the outset that we've built a better portfolio, more resilient portfolio takes into account some of those things.

Timothy M. Knavish
Chief Operating Officer, PPG Industries, Inc.

A

Yeah. And Mike, it's Tim. Just to pile on here, even one more business from a recession or a potential recession resiliency standpoint, the military part of our aerospace business, given what's happening in geopolitically, tremendous backlog there, too.

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Operator: Thank you. Our next question comes from Jeff Zekauskas from JPMorgan. Jeff, please go ahead.

Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

Thanks very much. Your volume expectation in performance coatings for the third quarter is flat to down a low-single-digit percentage. Isn't that too low? And that I understand that European Deco is weak, but is an aerospace better and auto refinish. And last year, they were very – there are shortages in raw materials in the North American architectural market. Shouldn't volumes be up in the third quarter? And then for Vince, inventories and receivables are going up at maybe about a 10% rate and payables are maybe going up at half that. Is that a trend that's going to continue? And why the difference?

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.

A

Yeah, Jeff, I'll take the second question first. Again, on inventory, we came into the quarter – we came into the year with a focus on having excess inventory where possible in order to have supply to our customers. So, we're certainly looking at that as we go to the back half of the year. We'll ratably work that down as supply conditions have improved and continue to improve. Receivables are up simply because our pricing is up, and we have a bigger book of business.

I think receivables were up $600 million or $700 million on a year-over-year basis. We'll collect those, and we're not seeing any significant deterioration on collections. So, the high receivable balance, Jeff, will turn to cash in the third and fourth quarter. Payables, again, we're timely with our suppliers, so nothing to speak of there.

As it relates to the performance coatings volumes, there's a variety of different moving pieces. Aerospace up, as you mentioned. We do see DIY down both in Europe, US, also in other mature regions like Australia. We do have a slowing – we do have some challenges in our protective business when you go into Q3, really residual hangover from Q2 in China. So with the reporting segment, you always have puts and takes. It's our best guess at this time. Hopefully, we're being conservative. But that's our best guess at this time.

Operator: Thank you. Our next question comes from Duffy Fischer from Goldman Sachs. Duffy, please go ahead.

Duffy Fischer
Analyst, Goldman Sachs

Q

Yes, good morning. Question just around raw materials. If you could talk about the different buckets, solvents, resins, pigments and maybe packaging. What's your view what's happening with price and availability going into the back half of the year? And then maybe kind of what do you think the two-year outlook is for some of these raw materials that have been quite tight?

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.

A

Well, let's start with the negative first, is that emulsions continue to be a bit of a challenge for us. And there have been a few force majeures. You probably saw the one and all next recently. So it's not – we're not out of the woods on that yet. But we've seen TiO2 and China get weaker. We're seeing TiO2 from China being shipped into Europe.

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I certainly see epoxies in Asia getting weaker as well. I think that there's a number of our solvents that are now flattening out. Availability is much improved, but the pricing is flattening out. And I think the same thing with packaging. Packaging is flattening out. And so I think when I look at our overall, we bucket our raw materials into about 12 different buckets. Last quarter, I had 11 out of 12 were red. Coming into this quarter, we have four or five of them that are yellow. That means the prices have moderated, and we actually have one green on the chart. So – and when we look ahead to the fourth quarter, we see improvement in a number of those as well. So I think we're coming to the end of the raw material inflation, and that's good for us. Sequentially, we see low single-digits in the third quarter, and I think you should expect sequential improvement in the fourth quarter.

Timothy M. Knavish
Chief Operating Officer, PPG Industries, Inc.
A

Hey, Duffy, it's Tim. Just to add to what Michael said. While supply is significantly better than it was at the beginning of Q2 and certainly better than last year, we still have spot supply issues, I would call it, in refinish, in auto, in architectural. So we're not quite back to what you would call completely normal supply, pre-COVID kind of supply situations, although sequentially much better, and we expect that to sequentially continue to improve.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.
A

And Duffy, you asked about – this is Vince. You asked about two years. That's beyond our forecasting horizon. We're typically three to six month window is the best forecasting visibility we have, and we certainly can't go out two years. There is structural commodity supply being built in China, which we expect to fully exploit. But that's the best we could give on a two-year [ph] look (46:55).

Operator: Thank you. Our next question comes from Vincent Andrews from Morgan Stanley. Vincent, please go ahead.

Vincent Stephen Andrews
Analyst, Morgan Stanley & Co. LLC
Q

Yes. Thank you. Just wondering if you can talk a little bit about the cost work you're doing in Europe and whether that's sort of structural or just sort of temporal. And along those same lines, given sort of the normalization in DIY, has there been an opportunity to reduce maybe promotional spending?

I mean maybe that was already being reduced during the hot demand period, or ad spending. Or is anything changing on how you're allocating investment spending into that business?

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.
A

Well, certainly, on the ad spending, as you see the decline, you're also getting near the end of the paint season by the time the quarter is going to be over. So that is on a decline. That's typical, though. So that's not really that much of a difference.

We do bucket our cost reductions in Europe into two things. One is structural and one is short term. The structural ones, you see that flowing through. We have plants that we have targeted to be closed. We have head count that we're taking out. We have productivity initiatives through dispense cells and other high volume packaging equipment that is driving productivity in the plant. All those things are underway.

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And then, of course, we are on a temporary basis. You are reducing head count as you're seeing that lower demand in the architectural segment. So I'm feeling comfortable that we're going to continue to grow margins. If you look at our history in Europe, we have consistently grown our earnings in Europe year-over-year regularly. So I don't think this should be any different this year.

Timothy M. Knavish
Chief Operating Officer, PPG Industries, Inc.
A

Hi, Vince, Tim here, Tim Knavish. We also have continuation of the Tikkurila synergies, which, of course, are structural. We've captured a lot of those. But footprint-wise and back-office wise, we continue to make progress there. And just to put some perspective, margin improvement progression has continued in our AC Europe business, despite the volume challenges, and we expect that to continue as well.

Operator: Thank you. Our next question comes from Mike Leithead from Barclays. Mike, please go ahead.

Michael Leithead
Analyst, Barclays Capital, Inc.
Q

Great. Thanks. Good morning, guys. Just on auto OE. I was hoping you could give some context about your volume levels today versus maybe, say, pre-pandemic. I'm just trying to figure out, if we get back to, say, a 2019 type build rate, what sort of upside does that offer? And maybe just remind us what type of incremental margin levels we should think about broadly for your industrial coatings business today after all the restructuring and whatnot.

Michael H. McGarry
Chairman & Chief Executive Officer, PPG Industries, Inc.
A

Well, Mike, if I remember right, last year, there was about 78 million cars built. We're on a path to have a little bit over 80 million cars built. At the peak, it was 95 million cars, and there is a substantial backlog of vehicles that need to be built.

And plus, I think what you're going to be seeing you're already starting to see some of these electric vehicles being made in China that are being exported to Europe. So you're going to start to see a better mix in our automotive business because of mobility.

And right now, our margins in automotive are improving on a sequential basis. So what I would do is I'd look back at the historical margins in our industrial segment. And automotive is the biggest business in that. So they're going to be somewhat close to that margin, and that's the way I would do the math.

Vincent J. Morales
Chief Financial Officer & Senior Vice President, PPG Industries, Inc.
A

Yeah. And Mike, if I could just elaborate a little bit on what we call the latent demand in auto here. We talked about this last quarter, but US dealer inventory somewhere below – just below 30 days. Typically, that's 60 plus, 70 plus. So the inventories need rebuild. There's a big fleet rebuild process that has taken place in the US that includes just company-owned cars as well as other fleet vehicles. That's a significant impact. There is a European fleet that also, at some point, will be rebuilt. There's a significant amount of employees that have company cars in Europe. So that's another adder.

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And that – those latent things, in addition to the demand where most cars are on back order. So again, we have comfort the next 12-plus, 15-plus months for a solid recovery back toward that, call it, high 80s, low 90s level. So we're still down about almost 20% in the industry versus pre-pandemic.

Operator: Thank you. Our next question comes from Mike Harrison from Seaport Research Partners. Mike, please go ahead.

Michael J. Harrison

Analyst, Seaport Global Securities LLC

Q

Hi, good morning. I was wondering if we could go back to some of the raw material availability issues and specifically dig in on what's going on in the refinish business. It sounds like some of the raw material and logistics bottlenecks that you've been seeing are going to continue into Q3. So maybe just a little more detail on what you're seeing there? What needs to happen to get some resolution to those supply issues? And I guess, is your expectation that, that improvement is going to happen sometime this year? Or is that an early 2023 thing? What's the timing looking like? Thank you.

Timothy M. Knavish

Chief Operating Officer, PPG Industries, Inc.

A

Hey Mike, its Tim. We – despite having a record quarter in refinish, and we expect that kind of performance to continue, we do have persistent, I would call them one-off shortages from a raw material standpoint that have led to some of the backlogs in addition to the backlog of work that our customers have, we've got a backlog just to catch up and rebuild the channel because of these one-offs. That won't get fixed overnight. It continues also to sequentially improve, and I expect us to continue to work our way through that through the rest of this year, which frankly, is some pent-up upside for us because in addition to the high body shop activity levels that we have notably here in the US, we've got this inventory replenishment to catch up on throughout the rest of this year as well.

Operator: Thank you. That is the end of the Q&A session. So I'll now hand you back over to John Bruno for closing remarks.

John A. Bruno

Vice President-Investor Relations, PPG Industries, Inc.

Thank you, Lauren, and everyone, for listening, for your interest in PPG. I look forward to talking and seeing many of you in the coming weeks. This concludes our second quarter earnings call. Have a good day.

Operator: This concludes today's call. Thank you for joining. You may now disconnect your lines.

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