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PPG Industries, Inc. (PPG)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Carla and I will be your conference operator for today. Welcome 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, Carla and good morning, everyone. Once again, this is John Bruno, and we appreciate your continued interest in PPG and welcome you to our second quarter 2023 financial results conference call. Joining me on the call from PPG are Tim Knavish, President and Chief Executive 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 20, 2023.

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 opening comments Tim 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 this 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.

The 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 President and CEO, Tim Knavish.

Timothy M. Knavish

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

Thank you, John and good morning, everyone, and welcome to our second quarter 2023 earnings call. I would like to start by providing a few highlights on our second quarter record financial performance, and then I'll move to our outlook.

The PPG team delivered all-time record financial results in the second quarter, including sales of $4.9 billion, adjusted earnings per diluted share from continuing operations of $2.25 and year-to-date cash generation of about $620 million. Our adjusted EPS is about 24% higher than the second quarter of 2022, and cash generation of $750 million higher year-over-year.

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These strong financial results were achieved despite operating in an environment of variable global economic demand. Industrial production was muted, reflecting cautious consumer buying behavior in Europe and slower than expected recovery in China and softening demand in certain end-use markets in the US.

Overall, our results were supported by good growth trends in several of our technology advantage businesses and leading brands. PPG's strong positioning in these end-use markets led to record second quarter sales in five of our nine businesses; aerospace, automotive, automotive refinish, PPG Comex and our protective and marine coatings business. We implemented incremental price increases in the first half of the year, primarily in the Performance Coatings segment and our aggregate two-year stack pricing for the company is now about 20%, which is offsetting historically high cost inflation.

We expect selling prices to remain positive in the second half of 2023, recognizing prior year price increases will reach anniversaries as the year progresses. As I said in my CEO investor briefing in May, margin recovery is the top near-term priority and we have made great progress this year in improving our segment margins toward our historical profile.

Our aggregate segment margins in Q2 were about 16%, which is 330 basis points higher than the second quarter of 2022. This included the Performance Coatings segment delivering margins of near 18%, the highest since 2016. Another key priority for our team has been to return to our legacy of strong cash generation. And through the first half of the year, we delivered record operating cash generation of about $620 million. This was supported by our record net earnings, but we also lowered our inventory levels by about $100 million on a sequential quarterly basis.

Despite this reduction, our raw material inventories remain elevated and we are executing various action plans to further reduce these inventory levels over the next several quarters as commodity supply availability has improved significantly this year.

Now, I'd like to spend a few minutes on three key drivers that are contributing to our excellent financial results in 2023. First, while overall global industrial production is challenging, including in a number of industrial end-use markets that are already in recessionary tight demand conditions, our portfolio of business mix is providing great resilience.

Through the best-performing global industries in the second quarter were aerospace and auto OEM, we have established leading global positions in each of these end markets by facilitating our customer success through innovative and sustainably advantaged products and much relied upon services. We expect demand for our aerospace and auto OEM coatings products to remain robust as they are both still below 2019 demand levels. Two data points are international flights remain 10% below 2019 pre-pandemic levels, and over the past several years, lower automotive OEM global builds have resulted in an estimated supply deficit of about 40 million cars versus historical build rates.

The second key driver is that we continue to deliver strong earnings performance in Europe as we achieved consecutive quarterly earnings records despite lackluster regional industrial production activity and weak aggregate architectural demand. This has been accomplished by our team's strong execution of cost and margin management. When this region begins to recover to any degree, PPG will be well positioned for solid top line and additional bottom line growth.

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The third key driver is our strong positioning in Mexico where current economic conditions remain robust, including expansive near-shoring related growth, solid consumer wealth growth and an appreciating local currency. We expect the near-shoring benefits to continue for a number of years, first with capital investment, and then through increased regional employment.

PPG remains the clear leader in Mexico for architectural and automotive OEM, and we have actions underway to capture further growth in our other businesses, where we will leverage our core strengths, including the best-in-class PPG Comex concessionaire distribution network.

I'd also like to comment on our enterprise growth strategy. A key pillar of this strategy is to partner with our customers to deliver superior service and products with a focus on enhancing their productivity and sustainability. In the second quarter, we continued to make advancements and earn several new customer wins. I'm excited about the opportunities we have ahead of us to win more customer value-driven business and grow our organic sales.

Now, some quick updates about our important ESG initiatives. As we communicated in our 2022 ESG Report, we've introduced 2030 greenhouse gas emissions reduction targets that have now been validated according to climate science through the Science Based Targets initiative. We plan to reduce our Scope 1 and Scope 2 absolute greenhouse gas emissions by 50% by 2030 and our Scope 3 greenhouse gas emissions by 30% within the same timeframe.

Moving to our outlook. We expect global industrial production to remain at lower levels in the third quarter, including similar demand activity in Europe, some further slowing in the US and modest sequential improvement in China. We do expect certain pockets of industry activity to remain more resilient, including aerospace and automotive industries, where we are well positioned on a global basis. In addition, we expect economic activity in Mexico to remain solid.

In our architectural businesses, we expect demand conditions to be mixed by geography. In Europe, we anticipate demand will stabilize at current levels, resulting in year-over-year sales volume being much closer to the prior year. In the US, we anticipate DIY demand to remain at lower levels and PRO contractor residential repaint activity to begin to modestly decline sequentially with the backdrop of lower existing home sales.

Finally, in Mexico, we expect our PPG Comex business to continue to post solid organic growth. In the third quarter, we expect to realize additional benefits from moderating cost inputs. At the peak of our supply disruptions, we had more than 160 force majeures in our global supply chain. That is now about 10, which is in line with our historical norms. To date, we have not yet recognized the full financial benefit of our commodity supply chain normalizing. From a financial realization perspective, through the end of June, our input costs were still 20% higher than the pre-pandemic levels. As we further reduce our inventories, we will realize additional earnings benefit.

We continue to work on our previously announced restructuring initiatives and expect an incremental $15 million year-over-year earnings benefit in the third quarter. Additionally, we will benefit from the recent paint film acquisition that we made in the second quarter. This business is uniquely positioned in the premium end of this new emerging market and has good customer pull and future growth prospects. Annual sales of this business are about $100 million. Despite the challenging environment, we have raised our full year earnings guidance and expect third quarter aggregated segment margins will be higher on a year-over-year basis for the fourth consecutive quarter.

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Finally, I want to thank our team members around the world who support our customers, serve our communities, and continually look for ways to do better today than yesterday every day. It is their dedication and commitment to helping make our customers successful that gives me continued confidence in our future. As we mark PPG's 140th anniversary in August, I firmly believe that our best days still remain ahead of us. Thank you for your continued confidence in PPG.

This concludes our prepared remarks. And now, would you please open the line for questions?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Christopher Parkinson. Your line is now open.

Christopher Parkinson
Analyst, Mizuho Securities USA LLC

Q

Great. Thank you so much. Can we perhaps just dissect the outlook for Industrial Coatings segment margins a little bit just based on what you're seeing for price/cost for the second half of the year; end market mix, given the dichotomy of certain things moving in various directions per your 3Q outlook and your slide deck; comp accruals. Just anything else you think is worthwhile discussing as you progress back towards prior peak? Thank you so much.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Hey, Chris. Thanks. I'll let Vince answer the comp accruals, but I'll take segment margins and outlook for some of the businesses. Segment margins in Industrial were still on the recovery journey. So, we have continued to [Technical Difficulty] (00:13:51).

John A. Bruno
Vice President-Investor Relations, PPG Industries, Inc.

A

Carla, are we there? Hello?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Carla, can you please open up the secondary line?

Christopher Parkinson
Analyst, Mizuho Securities USA LLC

Q

Hey, guys, we can still hear you for what it's worth.

John A. Bruno
Vice President-Investor Relations, PPG Industries, Inc.

A

Thank you.

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Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Okay. Thanks, Chris. So, as I started to say, segment margins – okay. Good. Segment margins in Industrial certainly have more room to grow and we expect that to continue, both from the price/cost standpoint, but the other piece of recovery that is really not happened yet that will continue to improve the segment margins on Industrial are volume. Of course, right now, auto OEM is strong, but still below 2019. And then, we've got some pockets of weakness in industrial and certainly pockets of weakness in packaging. So, we will get segment margins as those volumes stabilize.

The other thing is the operational challenge that we mentioned at our May event have largely been in the Industrial segment. So, as we make progress on those initiatives, those two pieces will add to the improvements that will be realized from the continuing price versus cost recovery.

And then, end markets, to your question, for the Industrial segment, automotive has been very resilient, sometimes surprisingly so, despite everything that's happening in the world with interest rates and inflation and affordability. All of our major regions for automotive were up double digits for Q2. And we expect continued strong recovery as we move forward here. We'll be lapping a stronger Q3 for auto based on China, which had a strong Q3 last year. But overall, we'll continue to see good volume recovery in auto [Technical Difficulty] (00:16:17).

We expect that recovery to continue for years to come. So, powder is a mix – I'm sorry. [Technical Difficulty] (00:16:37-00:18:40).

Operator: Hi, everyone. Apologies. We have some issues with the phone lines. Bear with us a second whilst we gain reconnection with the speaker lines. Hi. We now have connection with our speaker lines. Please continue.

John A. Bruno
Vice President-Investor Relations, PPG Industries, Inc.

A

Apologies, everybody. We're trying to sort through these issues. We'll continue the call right now.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Okay. Chris, I'm back. The positive of technical difficulty is we've had a long time to think about your question. I already answered the segment margin piece.

And then, from a segment volume and sales and outlook standpoint, auto, we expect to continue to be strong, Q3 comp issue with China, but that will be – the whole auto build recovery will continue for beyond 2023 and into 2024. Industrial is very mixed. Certain segments are doing well. I'll point to powder, for example, where we were up solid double digits, which, as you know, from our May event is very important to our growth strategy. But sub-segments that are closer to the consumer, electronic materials, appliance and even [ph] co-ex (00:19:43) for construction are soft. But we do expect that to continue to be a mixed bag packaging. Packaging has been weak with both destocking, but also end customer demand given what's happened from an inflation standpoint. So, very much a mixed bag, but overall, the summary would be we are expecting Industrial segment margins to continue to improve.

John A. Bruno
Vice President-Investor Relations, PPG Industries, Inc.

A

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We'll move to the next question, Carla.

Operator: Your next question comes from the line of Ghansham Panjabi. Your line is now open.

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

Q

Okay. Hey, guys. Good morning. Can you hear me?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yes, Ghansham.

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

Q

Okay. I guess, just given all the moving parts on a macro basis, just kind of building on your last few comments, Tim, can you just give us a sense as to how your volume outlook for 2023 has changed since the last time you reported? And which of the businesses are seeing the greatest variability relative to your previous view? And then, separately, apart from packaging, are there still any businesses being impacted by inventory destocking in any material way?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

I'll answer your last question first and not really, Ghansham. Destocking is pretty much behind us. And even on the Industrial side, they don't carry a lot of inventory anyway. So, it's pretty much a just-in-time. And then, on our Performance side, most – any destocking that's occurred is largely behind us.

So, what we see outlook-wise across the company, the things that have changed a bit is the recovery in China slower than what we had anticipated. And we're expecting continued improvement in China industrial activity, albeit at a more measured pace going forward. So, sequentially improving, but not as much V-shaped as what we had previously projected.

Architectural Europe, I'd say the other one that was lower volume than what we expected in Q2. But a lot of that was driven, kind of, by one-off social and political events in France, which is one of our largest markets in Europe. So, we do believe architectural Europe, I would call it bouncing off the bottom. And we'll start lapping weak comps from last year.

And then, in the US, architecture – the DIY, not just US, around the world, continues to be soft. But overall, we still got more than half of our portfolio that's very resilient, and I would say, has positive outlooks. Auto was stronger than we anticipated. Refinish was stronger than we anticipated. Aero was stronger than we anticipated. PMC was stronger than we anticipated. And Mexico continues to just shoot lights out. So, a lot of positives there, but those are the ones that were a little different than what we had previously thought in our guide.

Operator: Your next question comes from the line of Josh Spector. Please go ahead.

Joshua Spector
Analyst, UBS Securities LLC

Q

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Yeah. Hi. Thanks for taking my question, and congrats on a solid second quarter here. I just wanted to ask some questions on your 3Q assumptions. So, specifically SG&A as a percent of sales and gross margin, I guess my math indicates that the midpoint of your guide to gross margins are maybe 40% or lower. You just printed about 41% in the second quarter and similarly in the first quarter. So, what would drive gross margins to go down, especially when you're expecting some raw material benefit? Can you just walk through some of the moving pieces in your assumptions there? Thanks.

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

A

Hey, Josh. This is Vince. On SG&A, let me take that one first. We did have a little bit of a higher SG&A in Q2 than the prior year. Really a couple of elements to that; we talked about higher performance-based incentive comp, including total shareholder return compensation. We did have, as we communicated in Q1, higher non-cash pension expense for the balance – for all of 2023 that falls in the SG&A bucket on a year-over-year basis, you could see that.

And just a reminder, a lot of our China business was shut down in Q2 of 2022. And some of this increased sales creates increased SG&A. So, those three elements pushed our SG&A cost up year-over-year. And the incentive comp item was a catch-up for both Q1 and Q2. So, again, that's the SG&A component.

On the gross profit percent, we did, as you pointed out, we're averaging about 41% year-to-date. Q3 typically is a lower volume quarter for us. We don't have as much operational pull-through as we would on a higher volume quarter, specifically in Europe. So, that's really the only delta I would point to. We do expect, as we said in our prepared remarks, higher or improved deflation capture. But again, the lower volumes are going to affect our manufacturing efficiency.

Operator: Your next question comes from the line of David Begleiter. Your line is now open.

David Begleiter
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you. Good morning. Tim and Vince, you mentioned the weakness – potential weakness in PRO. Where are the backlog today? And are you actually seeing that weakness yet to come to fruition?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. Hey, David. Thanks for the question. I would describe the weakness in PRO to be sequentially down a bit, but not a tremendous amount. A lot of that PRO work is commercial and maintenance that still remains pretty resilient. But we have seen some reduction in backlog. But honestly, the painters are still, in some cases, having difficulty getting labor. So there are cases where they're passing on jobs because of that. So, while we've seen DIY down fairly significantly, I would just say we're seeing just a bit of softness in the PRO backlogs.

Operator: Your next question comes from the line of Jeffrey Zekauskas. Your line is now open.

Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

Thanks very much. Two-part question. Can you talk about the state of the Chinese TiO2 industry in that there's enormous [Technical Difficulty] (00:27:24). Can you use that product in China and in other regions of China

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chloride-based material? And is it the case that tariffs are just too high to use it in the United States? And secondly, in your script, you say that 80% of your inventories are on FIFO. I thought most of your inventories in the United States were on LIFO. So, does that mean that the inventory adjustments that you really need to make are in the offshore markets and your inventory control is pretty good in the US and it's tougher abroad?

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

Hey, Jeff. This is Vince. We had a little break up on your question, but I think you asked about TiO2 oversupply in China. And we do – we are able to take Chinese TiO2 and are and have been for quite some time, utilizing that certainly in Europe, certainly in Latin America, South America, and obviously in Asia. And there are tariffs that make it less cost-effective today to do so in the US, but we are fully utilizing our capabilities to move that TiO2 to other markets or other regions of the world outside of Asia and capitalizing on those lower prices.

John A. Bruno
Vice President-Investor Relations, PPG Industries, Inc.
A

Jeff, this is John. I'll take the FIFO question. So, first start with the sales, we have our profile in the US. We're now about 35% sales in the US. And in the past five, six years, as we've made acquisitions in the US, the companies we've acquired have been on FIFO. So, we have not moved them to the LIFO accounting. So, over time, the percentage of inventory that we have on the FIFO method has just incrementally increased due to those factors.

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

To just add on there...

Operator: Your next question...

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

Sorry, Carla. Just...

Operator: Sorry. Continue.

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

Sorry, I apologize. Just to add on, my apologies. Just to add on, as John mentioned, we do have excess inventory, specifically in raw materials. If you look at our inventory historically, we've trimmed about 50% of the excess raw material inventory that we came into the year with in the first six months. So, we'll be working in the balance of the year to trim the other portion to get back to our historical level.

Operator: Your next question comes from the line of Stephen V. Byrne. Your line is now open.

Stephen Byrne
Analyst, Bank of America Merrill Lynch
Q

Yeah. Thank you. If I understood you correctly, Tim, you talked about raws and I believe it was in COGS still being 20% above pre-pandemic. And Vince, you just highlighted, you're still sitting on excess inventory of raws.

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My question would be, for raws purchased today, what would be the cost relative to pre-pandemic? And how long do you think that it will take for that to flow through COGS?

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

A

Yeah, Steve. I'll take the first stab at that and Tim will add some color here. So, what we're seeing today on invoice costs, as we said last quarter, invoice to invoice year-over-year, mid- to high single-digit and maybe in some cases low double-digit deflation on certain raw materials. I would remind everybody, these raw materials went up 20%, 30%, 40%. So, when you do it on a multiyear stack, we're still much higher, but we're seeing on a year-over-year basis on invoices mid- to high to low – high single to low double-digit declines that typically would flow through in 30 to 60 days or even 90 depending on the raw material. And again, that's extended right now.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. And bottom line, Steve, when you combine that with the additional $100 million or so of inventory that we've got to work through that we're sitting on now, you've got sequentially more raw material deflation combined with that additional inventory flow through. That's why, I'm so confident that our margin recovery journey will continue.

Operator: Your next question comes from John McNulty. Your line is now open.

John McNulty
Analyst, BMO Capital Markets Corp.

Q

Yeah. Thanks for taking my question. So, Tim, in your prepared remarks, you spoke to pricing continuing through the second half of the year. I guess, just because the comps are kind of pretty dramatic year-over-year, I guess, can you help us to think about whether you're going to see pricing sequentially from 2Q to 3Q and how we should be thinking about that?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. Most of what we're going to see, John, is a carryover impact. There'll be some targeted pricing that we do in Performance Coatings, but a lot of what you'll see going forward here for the remainder of 2023 will be carryover. And to your point, we are lapping some strong price quarters from last year. So, if you look at – we printed 8% for Q1, 6% for Q2. So, you'll probably see low single-digit pricing printed in Q3. Still a little early to tell in Q4. We're confident it'll be positive, but we'll see what happens and what other actions we might need to take.

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

A

And just to tag along here, we still expect that at price – the raw material delta to expand as we talked about in the prior question, which is we expect more – to realize more deflation as we pull down our inventories.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

The other thing – I mean, the pricing has been holding up very nicely. I'm proud of how our teams are executing to that regard. And so, our price story – someone earlier asked about what's different in our guide versus earlier, our price story is stronger than what our prior guides were.

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Operator: Your next question comes from the line of Vincent Andrews. Your line is now open.

Vincent Stephen Andrews
Analyst, Morgan Stanley & Co. LLC

Q

Thank you and good morning, everyone. Just a question on the wage inflation and [ph] you said it'll (00:34:10) remain elevated for the next few quarters. [ph] Is that as (00:34:12) you have to lap the flow-through of some wage increases from prior quarters, or is there more going in? And if you can size it a little bit, just to help us understand how much of a headwind that is versus the raw material benefits that you're getting?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. Vincent, we do have, no surprise, higher-than-normal wage inflation. I'd say in the mature markets average, you could call that about 3%, but higher than that on front-line workers like store workers, but 3% would be a good average. Emerging markets higher than that.

And then from a raw material inflation standpoint, we're still at that 20%-ish number versus pre-pandemic. And we're expecting Q3 to see mid- to high-single digits down. So, we expect the combination of those two to still keep us at elevated cost versus pre-pandemic, but improving sequentially as we move through the rest of the year.

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

A

And as we look at the trend lines, we're not seeing the trends change in terms of increase or decrease of wages. We provided our merit process or our wage increase process earlier in the year and we typically would do that once a year for most of our employees. So, that trend should hold for the balance of the year.

Operator: Your next question comes from the line of Duffy Fischer. Your line is now open.

Duffy Fischer
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Good morning, guys. Just a question around the EPS and the guide for Q3 and the implied for Q4. So, in Q1 and Q2, your year-over-year number was up $0.45 and $0.44. The guide midpoint for Q3 and then the implied for Q4 is up $0.24 and $0.19 year-on-year. With raw material deflation accelerating for you guys and price still up in the back half, as you're commenting, why would the year-over-year EPS improvement decline in the back half versus the first half?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Hey, Duffy. The biggest driver to that would just be the quarter-over-quarter price actions. Most of the larger price increases for us started to kick in like Q3 of last year. So, as we lap those and less new pricing, if you will, adding to the top, that's really the biggest difference.

Operator: Your next question comes from the line of Patrick Cunningham. Your line is now open.

Patrick Cunningham
Analyst, Citigroup Global Markets, Inc.

Q

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Hi. Good morning. Thanks for taking my question. So, increasing interest rates are clearly showing up in existing home sales and you cited softness in resi repaint. Now, I want to talk a little bit about non-resi. While it appears to be strong or maybe hanging in there, how should we think about the risk to commercial volumes in the back half and in 2024, given the higher interest rate environment and starting to see some deceleration in commercial construction and remodeling indices?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Well, I'd say in the short-term, that's not – frankly, for the rest of 2023, not something we're particularly concerned about, because there was such a backlog in those areas. If you think about the really bifurcation of painting activity that happened during COVID, you had a tremendous amount of resi painting happening, but you had virtually no commercial and maintenance painting happening. So, there's still a tremendous amount of pent-up demand in that space. Now, eventually, we'll see what happens with interest rates and macros in the longer term, but that's – we're just not seeing that right now being a major concern for us.

Operator: Your next question comes from the line of Michael Leithead. Your line is open.

Michael Leithead
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning, guys. Just one question for me on traffic solution. I think you expected sales to be up high-single digits in 2Q and they were down low-single digits. So, just can you talk through what drove the delta versus what you thought in April?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. So, part of it was comp related. We had a really strong Q2, Q3 last year in that business. Secondly, it's still a new business for us and we're still learning the market a bit. And this is an area where we did see some, I'd say, temporary shift in paint volumes as activities picked up. And so, we expect to get that back as we move forward through the rest of the year and certainly into next year. We have been focused very heavily on margin over volume in that business, and the team has done a great job there. And the last thing I'll say to that is, while the volumes did come in a bit lower than we expected for the quarter, this business is generating good cash for us, really good cash, and it will be a good contributor to the enterprise from that standpoint.

Operator: Your next question comes from the line of Frank Mitsch. Your line is now open.

Frank J. Mitsch
Analyst, Fermium Research LLC

Q

Good morning, and nice results. Obviously, you guys generated some strong cash flow in the first half of the year, begs the question on the use of cash. Debt paydown is part of it, but how do you think about buybacks versus M&A? I know, Tim, you've talked about right property, right price, right time. Is this the right time? Are you seeing the right price? Any thoughts there would be greatly appreciated.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. Thanks, Frank. Proud of the team, great second quarter and getting back to one of our strong legacies of just really strong cash generation. And as you noted, our number one priority was to pay down some debt. We

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said earlier this year, we would pay somewhere between $500 million and $600 million down. We paid about $200 million of that down so far this year. So, we've got a bit more of that to do.

But I'll tell you, we're going to have a really good cash year. We're going to have a really good cash year, which gives us a lot of optionality. Probably not time to talk about specific actions on the M&A side, but that clearly remains a priority for us. And we are seeing properties come across our desks there. But bottom line, we're going to have a really good cash generation year. We're going to pay down some more debt. And then, we're going to make decisions on how best to use that cash to deliver shareholder value based on what we see at the time.

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

And just to reiterate what we said in May in New York, we're not going to – after we pay down this debt, we're not going to let cash grow on the balance sheet.

Operator: Your next question comes from the line Aleksey Yefremov. Your line is now open.

Aleksey Yefremov
Analyst, KeyBanc Capital Markets, Inc.
Q

Thanks. Good morning, everyone. We've recently seen somewhat better data on new residential construction in the US. What do you see in your business in this market? Have your expectations here improved at all in the last three months? And then, separately, are you seeing any meaningful pickup in the US infrastructure spending?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

So, on the newbuilds, we are starting to see a little bit better activity there on new home construction. We've said in prior calls it's a fairly small part of our overall business, but it's not zero and we've had a couple of nice wins recently with some new homebuilders. So, bottom line, any walls, any additional walls that get painted in the US, Mexico, Europe, Australia is good for us. That's upside to us. So, that would be the first one. The second part of your question?

Aleksey Yefremov
Analyst, KeyBanc Capital Markets, Inc.
Q

Infrastructure.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

Infrastructure, I'll take it.

Aleksey Yefremov
Analyst, KeyBanc Capital Markets, Inc.
Q

It was about the US infrastructure.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

All right. Thank you, thank you. US infrastructure, we are starting to see, I would call it, upstream project activity and we're very active in the specification side of ensuring that our products are well specified, whether it's traffic

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or protective coatings or architectural coatings or industrial coatings. Typically, paint and coatings are late stage in those projects, sometimes last stage in those projects. So, this is more of a 2024 and beyond growth opportunity for us, but we're certainly seeing that upstream activity happening now. We're excited about it, and we're very active with it.

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

And if I could add, it's not a US comment, but it's a Mexico comment. We are seeing a significant amount of near-shoring occur in Mexico. Several hundreds of building permits for manufacturing facilities have been requested. Those will yield benefits for us, certainly in 2024 and 2025, as that manufacturing is put in place. And then, as Tim mentioned earlier, we have a full-fledged array of PPG businesses in Mexico to facilitate further painting once that industrial activity picks up as well as our strong Comex brand.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

Yeah. Just to put some metrics around that Mexico near-shoring, in Q1 of this year, there's about $48 billion of near-shoring investments in Mexico. That's 3x, 3 times Q1 of 2022. So, we are really seeing that pickup and we're involved in the specification side of that business as well.

Operator: Your next question comes from the line of Mike Harrison. Your line is now open.

Michael J. Harrison
Analyst, Seaport Research Partners
Q

Hi. Good morning. Wanted to ask about auto OEM and the price realization that you're seeing there. Is there more still to come on pricing in auto OEM? And are there any instances where you're starting to see some customer pushback related to raw material declines either in auto OEM or any other sub-segment?

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

Yeah, Mike, this is Vince. Let me start and then I'm sure Tim will add some color here. But it's taken us a while, as it typically does, during an inflation cycle to negotiate with our customers, get paid for the value we provide. So, we had a lag on the way up in terms of the inflation versus price to our OEM customers. We're in a steady-state environment now. We're not seeing any pushback. We're still trying to capture – as the volume grows, we're still trying to capture our margins back in that business. But we're not seeing any pushback at this point from the customers. And again, that's traditional lag effect that we would see in any inflation cycle.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

And to your broader question about other segments, I would say normal market dynamics, nothing significant, nothing material. There's been some intense competitive pressure just around the edges. But at the core, we haven't really seen anything that was unexpected or out of the normal.

Operator: Your next question comes from John Roberts. Your line is open.

John Roberts
Analyst, Credit Suisse Securities (USA) LLC
Q

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Thank you. Refinish organic sales were up mid-single digit. I don't know what pricing was up, but the Performance segment was up 6%. Refinish volumes globally flat and when you talk about it being better than expected, was price better than expected, or was volume better than expected?

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

Yeah. Hey, John. Volume was positive here in the US, which, of course, is our most – our largest and most critical market. And that was better than we expected. Volume in Europe, I would say, was worse than we expected. Volume down there a bit more than we thought. And then, volume in China, a little bit muted because of the slower recovery, but we see that sequentially improving as time goes on. But overall, a great quarter for that business, really bullish on particularly the US side, and we're watching closely what happens on the Europe side.

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

On the Europe side, we talked about a destock earlier in the call here, and we think in Q2, there was some destocking with certain refinish customers. We think that's concluded by the end of Q2. So again, as we get to the back half of the year, we would expect the demand and the volumes to be more in sync.

Operator: Your next question comes from the line of Michael Sison. Your line is now open.

Michael Sison
Analyst, Wells Fargo Securities LLC
Q

Hey, guys. Nice quarter. In terms of the half of your portfolio that's in decline or weak, do you think those markets are bottoming or potentially bottom here in the third quarter? And then, when I take a look at your volume outlook, third quarter seems to be down year-over-year again. And just wanted to get your thoughts on the fourth and how you see that sort of unfolding.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.
A

Yeah. So, I'll take a few of the markets that were lower volume than what we expected for Q2 and how we're thinking about them going forward. First one, architectural Europe was – that was clearly down more than we expected, but some of that isolated to France, as I mentioned earlier. I do expect that to start comping pretty close, maybe even a little upside from where we were at Q3 of last year. So, I've used the term bouncing off the bottom. I do believe that Europe architecture is bouncing off the bottom and maybe a little bit of upside there.

The China recovery, slower than we expected in Q2, no doubt. But the way we're thinking about that is that just stretches out the recovery, positive – any stimulus that the government does in the industrial space will be a real positive for PPG. And we do expect China to sequentially improve. So, those would be the two main ones I would point out as far as what we saw in Q2 and potentially improving in Q3 and beyond.

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

Yeah, Mike, and I think there is a comparable – year-over-year comparable issue as you look at volume. So, we do have improving volumes, as Tim mentioned, in China sequentially in Q3, but that was compared to a recovery from COVID shutdown last year Q3. So again, when you look at – you mentioned year-over-year volume challenges, that's – again, China is improving as we look Q2 to Q3, but it's against a tough comp.

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Operator: Your next question comes from the line of Kevin McCarthy. Your line is now open.

Kevin W. McCarthy
Analyst, Vertical Research Partners LLC

Q

Yes. Thank you. Good morning. Tim, a two-part question for you on auto OEM volumes. So, first, could you speak to the outlook for the back half of the year if some of the consultants are to be believed, it looks like there's quite divergent trends in Asia versus Europe, for example. So, curious to understand what you're baking in there?

And then, longer term, you referenced the supply deficit of 40 million units. Is the implication that, that is the amount that needs to be recovered over some period of time? How do you view the medium to longer-term outlook for global production?

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

A

Hey, Kevin, this is Vince. I'll start and I'll let Tim add here. But just a reminder, again, just the same question we had last – the last question. China had a recovery in Q3 last year in auto production. So, again, the numbers, when you look on a year-over-year basis, are a bit skewed. Go ahead, Tim.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah. So, Kevin, we're bullish on auto despite some of the kind of affordability and interest rate questions. And here's why; we continue to be positively surprised by performance in Europe, for example, where macros are worse than anywhere and yet the builds and sales remain resilient. The US SAAR, when everybody was predicting that would drop was – came in at a nice number of 15.8 million, which was a positive surprise, but still well below historical levels. We're starting to see – we're seeing really good numbers out of China, double-digit builds in China growth Q2. As Vince mentioned, we have a little weird comp situation here in Q3, but we do expect that to recover. So, we're bullish on auto. We are bullish on auto for both the short term and medium term.

Now, the 40 million is just straight math. You take the six-year average before COVID of annual builds and you take what happened during COVID and you come up with a 40 million deficit. I have no idea how long it's going to take to make up that deficit and how spread out that will be, but it's not going to be zero. That deficit will need to be made up, because in many countries, you still have population growth. In many countries, you still have cars per capita or cars per household being much lower than the developed world and you've still got aging fleets. In mature parts of the world, US, Europe, average car in a row is like 11 or 12-years old. So, the fundamentals say, at some point, some significant part of that 40 million deficit needs to be made up. It's a question of how stretched out that will be.

Operator: Your next question comes from the line of [ph] Aron Ceccarelli (00:54:11). Your line is now open.

Q

Hi, guys. Thanks for the question. I have one on the segment margins. So, your segment margins expanded 330 basis points in Q2, and they were expanded 370 in Q1. I understand we are past the peak in terms of pricing initiatives, but we'll start to see really the widening gap of raw materials going down. And some of the volumes

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you are talking in the weak markets are bottoming. So, what could prevent margins in Q2 and Q3 to expand – to accelerate in terms of expansion again?

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

A

Yeah. I mean, I think, we talked about this a little earlier in the call. We do expect, again, incremental deflation to flow through to our P&L. We're starting to lap some pricing. We do – especially in the industrial businesses, we do see volume as the biggest catalyst in back half of the year or in 2024 to help improve the margins as well, as Tim mentioned earlier, manufacturing – PPG manufacturing as a key element. And we laid that out in our May New York meeting. So, those would be the four key elements that I would point to that would impact our margins in the back half of the year.

Operator: Your next question comes from the line of Laurence Alexander. Your line is now open.

Laurence Alexander
Analyst, Jefferies LLC

Q

Good morning. Just a quick one. What's the net drag for earnings and margins from the destocking you're doing this year? Just trying to think about kind of how that translates into the bridge for next year?

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

A

An interesting question, Laurence. I'm doing the math in my head as we speak. But again, what we're seeing is, let's call it, mid to high single-digit deflation on our invoices. We're realizing mid-single-digit inflation through our P&L. So, I'm going to guess that, that's $0.05 to $0.10 a quarter, looking at John here to make sure my math is proper. But that would be the delay that's not coming through on a real-time basis into our P&L.

Operator: Your next question comes from the line of Arun Viswanathan. Your line is now open.

Arun Viswanathan
Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my question. Just wanted to understand kind of the volume outlook overall. It sounds like, obviously, aerospace and automotive OEM volumes have been trending positively and you expect that to continue. Now, you're calling out some weakness in packaging in some of the other markets. So, is there a path to maybe overall positive volumes by the first half of next year given some easier comps in some of these industrial businesses and maybe persistence of volume growth in auto and aerospace? How are you thinking about that kind of volume growth overall trends for the next couple of periods? Thanks.

Timothy M. Knavish
President, Chief Executive Officer & Director, PPG Industries, Inc.

A

Yeah, Arun, great question and one we talk about a lot. And I'll first qualify it by saying, it's still pretty early, given all the macro stuff that's happening around the world to really nail in our 2024 volume assumptions. But I will tell you that I'm optimistic based on a few things. We've talked a lot about auto and aerospace and Mexico and refinish and we fully expect those businesses to continue to perform. In addition to that, I've talked about a few businesses that we think are bouncing off the bottom and they're not small businesses for us. So, eventually, bouncing off the bottom will turn to positive.

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China; China, we have a really strong presence in China. China ramp-up and recovery has been slower than expected. But if you think about that for 2024, that's a positive, particularly with any government stimulus.

And the last one I would point out is Europe. And while Europe volume has been very muted for the first half of the year, we still printed all-time record earnings in Q1, all-time record earnings in Q2. So, the team has done a great job of positioning from both a margin and cost base standpoint. So, any incremental uptick in volume across any of those businesses in Europe will be a real positive for us. So, still a little early. We'll talk more about that in the next earnings call, but there are a lot of indicators that could point to positive volume for us for 2024.

Operator: There are no further questions at this time. I'll turn the call back over to John Bruno.

John A. Bruno

Vice President-Investor Relations, PPG Industries, Inc.

Thank you, Carla. This ends our second quarter earnings call. We appreciate everybody's interest and confidence in PPG. Have a good day.

Operator: This concludes today's conference call. You may now disconnect.

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