Rogers Corporation(Q3 2018 Earnings)

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Corporate Speakers:

- Jay Knoll; Rogers Corporation; SVP of Corporate Development, General Counsel & Corporate Secretary
- Bruce Hoechner; Rogers Corporation; President, CEO & Director
- Mike Ludwig; Rogers Corporation; SVP, CFO & Treasurer
- Bob Daigle; Rogers Corporation; SVP & CTO

Participants:

- Craig Ellis; B. Riley FBR, Inc.; Analyst
- Daniel Moore; CJS Securities, Inc.; Director of Research
- Sean Hannan; Needham & Company, LLC; Analyst

PRESENTATION

Operator^ Good day. My name is [Catherine], and I will be your conference operator today. At this time, I would like to welcome everyone to the Rogers Third Quarter 2018 Earnings Call.

(Operator Instructions)

I would now like to turn the call over to your host, Mr. Jay Knoll, General Counsel. Sir, you may begin your conference.

Jay Knoll^ Thank you, and good afternoon, everyone, and welcome to the Rogers Corporation Third Quarter 2018 Earnings Conference Call. The slides for today's call can be found on the Investors section of our website, along with the news release that was issued today.

Please turn to Slide 2. Before we begin, I would like to note that statements in this conference call that are not strictly historical are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and should be considered as subject to the many uncertainties that exist in Rogers' operations and environment.

These uncertainties include economic conditions, market demand and competitive factors. Such factors could cause actual results to differ materially from those in any forward-looking statement.

Also, the discussions during this conference call may include certain financial measures that were not prepared in accordance with Generally Accepted Accounting Principles. Reconciliation of those non-GAAP financial measures to the most directly comparable

GAAP financial measures can be found in the slide deck for today's call which is posted on the Investors section of our website.

Turning to Slide 3, with me today is Bruce Hoechner, President and CEO; Mike Ludwig, Senior Vice President and CFO; and Bob Daigle, Senior Vice President and CTO. I will now turn the call over to Bruce.

Bruce Hoechner^ Thanks, Jay. Good afternoon, everyone, and thank you for joining us on today's call. Please turn to Slide 4.

In Q3, Rogers achieved record revenues of $227 million, an increase of 10% compared to Q3 2017 and a sequential increase of 6% over Q2, including a $4 million negative currency impact. Sales were at the midpoint of our previously announced guidance.

Strong organic sales growth in our Elastomeric Material Solutions business and Power Electronic Solutions business were driven by demand in certain advanced mobility applications, primarily in EV/HEV.

Sales in our Advanced Connectivity Solutions business were below expectations, essentially flat for the quarter, due to weaker demand for applications in wireless 4G LTE as the market prepares for the approaching 5G rollout.

In addition, ACS saw lower demand for Advanced Driver Assistance Systems applications as European automakers work through new emission standards. I will speak to our individual business segment results in more detail, shortly.

While we did not meet our gross margin guidance for the quarter, disciplined SG&A control led to strong adjusted EPS, at $1.42. Our strategic investments to focus on the high-growth markets of advanced mobility and advanced connectivity in addition to our synergistic M&A strategy has resulted in significant top line growth opportunities for the corporation.

This high demand as well as increasing raw material costs has impacted our margin performance. As outlined in last quarter's call, we are addressing these challenges and have made progress during the quarter. Our multi-site qualification activities are essentially complete.

The site consolidation in Belgium has been concluded on time and within budget, and our pricing actions have mitigated raw material price increases. However, we continue to carry costs associated with maintaining underutilized capacity in anticipation of significantly increased demand in our core markets.

In addition, the strategic costs to support our operational excellence initiatives as well as site consolidation costs and product ramping costs will continue to impact gross margins into the first half of 2019.

We believe we have a disciplined plan in place to drive profitability improvement as we look to capitalize on substantial market growth opportunities. Please turn to Slide 5. We remain focused on our proven growth strategy which serves as the road map to our 2020 goals.

Our commitment to market-driven innovation is helping us advance our position in high-growth global markets. This is where we are investing to support today's applications and secure design wins in tomorrow's emerging opportunities.

Our recent acquisition of Griswold demonstrates our ongoing commitment to augmenting organic growth through top of the pyramid synergistic acquisitions. The Griswold integration is progressing according to plan as we look for opportunities to grow Griswold's product lines through geographic expansion and product innovation.

We are intensely focused on key operational excellence activities across all three of our businesses to drive margin improvements. In ACS, we are incurring costs associated with preserving capacity flexibility and adding new capacity capabilities.

In addition, we have essentially completed manufacturing network optimization activities. We expect ACS margins to improve towards their historical rates as the ADAS market rebounds in the first half of 2019 and 5G ramps in the second half of 2019.

Due to the explosive growth in PES, we are incurring additional costs in order to meet customer expectations. In addition, we are adding capacity, automating manufacturing and optimizing our footprint to achieve longer-term gross margin improvement. As we complete these projects in the coming quarters, we expect to see a sequential improvement in margins.

Initiatives to improve margins in the EMS business are primarily focused on optimizing the operations of our recent acquisitions. We expect these new businesses to achieve margins comparable to the legacy EMS business as we progress through 2019.

Turning to Slide 6. For Rogers, the growth outlook remains robust for advanced mobility applications. We continue to work closely with a broad range of customers to support current demand and develop products that will enable the performance of emerging technologies.

We are seeing substantial opportunities in areas that include the next generation of ADAS radar as well as advanced performance EV and HEV power systems.

In advanced connectivity applications, we have developed new platform products that have received an enthusiastic response from our customers. These products are aimed at significantly enhancing the performance of the highly demanding 5G infrastructure in both base stations and massive MIMO antenna systems.

Please turn to Slide 7. ACS delivered third quarter net sales of $72 million, which were relatively flat compared to the third quarter of 2017 and a decrease of 6% compared to the second quarter of 2018.

Lower-than-expected revenues were due to weaker demand for applications in 4G LTE and ADAS. Softness in wireless infrastructure was associated with sluggish demand for 4G LTE applications in anticipation of the transition to 5G.

We've seen a number of positive indicators regarding the 5G build-out. According to industry sources, leading smartphone manufacturers are now set to roll out 5G-enabled models in the first half of 2019.

In addition, there have been successful service provider field test results in both China and the US. Further, industry experts are predicting 2019 5G base station installations of roughly 100,000 to 200,000 units.

Rogers continues to achieve substantial design wins with significantly higher content than 4G LTE from all major telecom equipment OEMs. We are preparing for this major growth opportunity through ongoing capacity expansion projects, including our recent plant and equipment acquisition in Chandler, Arizona.

During the quarter, Rogers' ADAS-related material sales were negatively impacted by lower European car sales due to the worldwide harmonized light vehicle test procedure emissions protocol.

Industry experts believe this is a temporary situation as automakers work through the new standards. Supply chain inventory adjustments due to this lower auto production also impacted sales in the quarter. We expect to return to double-digit ADAS growth as these issues are resolved.

Please turn to Slide 8. In Q3, PES achieved net sales of $55 million, an increase of 19% over Q3 2017 and a 3% increase over the second quarter of 2018. We saw particular strength in EV/HEV applications, where we were up over 50% year-over-year and 20% sequentially.

Part of this strong EV/HEV growth was driven by record demand for our new-generation silicon nitride materials for wide band gap semiconductor packaging. We also saw a strong demand for ROLINX power interconnects in electric vehicle applications. Looking ahead, we anticipate continued robust growth in demand for our EV/HEV applications.

Turning to Slide 9. In Q3, EMS delivered all-time record net sales of $96 million. Organic sales revenues increased 8% over Q3 2017.

Including contributions from the Griswold business, revenues increased 17% over Q3 2017 and 21% sequentially. Net sales were driven by strong demand in automotive applications, particularly EV/HEV battery pads and battery pack sealing systems, in addition to seasonal strength in portable electronics.

Looking ahead, we expect to see the broad-based growth for EMS applications to continue, with particular strength in EV/HEV applications. Please turn to Slide 10.

The outlook in our key growth drivers of advanced mobility and advanced connectivity remain positive. As mentioned, we have seen a number of indicators pointing to a second half 2019 rollout of 5G.

In advanced mobility, we are seeing a significant increase in demand for EV/HEV applications as automakers continue their race to introduce more EV and HEV models, which gives us great optimism around demand. In ADAS, we expect to see continued penetration of our materials as automotive safety features become standard in mass market models.

Areas of concern are the macroeconomic impacts of trade policies and the uncertainty that it brings, overall, to the economies around the world.

Thus far, we have actively managed our exposure through multi-site manufacturing options and working closely with customers and suppliers. We will continue to monitor the situation and respond with agility to mitigate the potential impact on our business.

In summary, we remain committed to executing our strategy and achieving our 2020 goals. Our markets remain strong, and we are making good progress on our operational excellence imperatives in order to drive continued profitability improvement.

We are investing in additional capacity to ensure we take full advantage of the many opportunities we see ahead of us in our markets.

Now I'm pleased to introduce Mike Ludwig, who joined Rogers in mid-September as Chief Financial Officer. Mike brings a wealth of experience as a senior finance leader in global high-tech manufacturing companies, which fits well with Rogers' business profile and growth goals.

Mike is already bringing a fresh perspective to Rogers, and we're thrilled to have him here. Now I'll turn the call over to Mike to report on our Q3 results in greater detail. Mike?

Mike Ludwig^ Thank you, Bruce, and good afternoon, everyone. I'm excited to take on the CFO position for Rogers at such an exciting time for the Company. In my short tenure, I am impressed by both the quality of the people in the Rogers organization and the opportunities to both grow revenues and expand margin.

My experience with FormFactor aligns well with the opportunities at Rogers. In the slides ahead, I will review our third quarter results, followed by our fourth quarter guidance.

Turning to Slide 12, we will preview the financial results for Q3 2018. Third quarter revenues, as previously noted, were $226.9 million, slightly higher than the midpoint of our Q3 guidance range and 10% and 6% higher, respectively, compared to Q3 2017 and Q2 2018.

Gross margin, at 34.9%, was below our guidance of 37%, meaningfully below Q3 last year and slightly below our Q2 2018 gross margin. Bruce covered the gross margin challenges of each business in his prepared remarks, and I will add some additional commentary later in my presentation.

Good cost control of our SG&A expenses in the third quarter enabled us to deliver adjusted operating income in Q3 of $38.6 million, 17% of revenues, slightly lower than the $40 million of Q3 2017, but measurably above the $31.7 million of Q2.

EPS of $1.06 per fully diluted share for Q3 was within our guidance, and adjusted EPS of $1.42 per fully diluted share for Q3 was above the upper end of our guidance, $0.01 higher than Q3 2017 and $0.23 higher than our second quarter.

Please turn to Slide 13 for a review of our third quarter revenue, compared to Q3 2017 revenue. Our third quarter 2018 revenues increased $20.1 million, or 10%, versus the third quarter of 2017.

The increase was primarily due to higher demand for products in both our PES and EMS businesses, higher pricing at all business units to mitigate raw material price increases and $6.9 million from our Griswold acquisition completed in the third quarter. The adoption of the new revenue recognition accounting standard in 2018 negatively impacted revenue in Q3 by $1.9 million.

Revenues were favorably impacted by strong accelerating demand in EV and HEV applications in our PES business. Within our EMS business, we experienced nice growth year-over-year in all applications, with particular strength in automotive, specifically EV/HEV, and portable electronics.

These positives were partially offset by slightly lower revenues in our ACS business resulting from declines in 4G LTE as the market prepares to transition to 5G in 2019, and weaker ADAS applications demand due primarily to new auto emission standards in Europe and inventory rationalization in the auto supply chain.

Looking at Slide 14, our Q3 2018 revenues were $12.2 million, or 6%, higher than our second quarter revenues. Q3 revenues were negatively impacted by foreign currency compared to the second quarter, in the amount of $4.2 million, as the dollar strengthened in the third quarter compared to the euro and renminbi.

The demand environment we experienced in the third quarter of 2018 was consistent with our experience in the second quarter, with e-mobility and a seasonally strong portable electronics demand providing the sequential quarter revenue growth along with the additional revenues from our Griswold acquisition, while the anticipated transition to 5G, new auto emission standards in Europe and inventory rationalization in the auto supply chain served to constrain the revenue growth compared to Q2.

On Slides 15 and 16 we cover the third quarter 2018 gross margin compared to the gross margin in the third quarter of 2017 and the second quarter of 2018. Starting with Slide 15, our gross margin for Q3 was $79.1 million, or 34.9% of revenues, 480 basis points lower than our Q3 2017 gross margin.

The detriment to gross margin was caused in part by a less profitable mix of revenues, as the higher-profitability ACS revenues declined slightly while the lower-profitability PES revenues increased 19% over Q3 of 2017. The impact of less profitable mix is seen in the low conversion of incremental volume, including the incremental revenue from the Griswold acquisition, to gross margin.

In addition to the unfavorable revenue mix in the third quarter, the Company continues to invest to support our growth strategy and to consolidate manufacturing sites to achieve operational excellence and lower product costs.

These initiatives put pressure on our near-term gross margin result and our corresponding comparative results. We made strategic investments as we continue to carry underutilized capacity in our ACS business to meet the anticipated revenue growth from the 5G rollout in 2019.

The underutilized capacity costs accounted for approximately 75% of the strategic investment cost in the year-over-year comparison. These costs are primarily labor-related costs but also include facility- and equipment-related costs.

We also incurred additional strategic costs in our PES business to add capacity to address the significant growth occurring in EV/HEV demand and meet customer expectations. These costs include labor-, facility- and capital-related costs.

In addition, in Q3 2018 we purchased land and equipment from Isola in the amount of $43.4 million. While this purchase does not impact the third quarter gross margin, it demonstrates the Company's commitment to have capacity available for the anticipated ramp of 5G applications.

In Q3 2018 the Company incurred an increase of $5 million of costs associated with sub-optimal operational performance compared to Q3 2017, or approximately 200 basis points of gross margin.

Approximately half of these costs are expenditures related to the EMS infrastructure in place as a result of past acquisitions. The infrastructure and related costs will be optimized over the next two to three quarters, consistent with Bruce's earlier comment.

The remaining 50% of the costs are a combination of yield impacts associated with ramping new and existing products in PES, freight charges to expedite raw materials and customer products in all businesses and other production-related costs. Increasing raw material costs have been neutralized by price increases we have implemented.

Slide 16 compares our Q3 2018 gross margin to our second quarter gross margin. Q3 gross margin is 80 basis points lower than our second quarter gross margin of 35.7%. Much like our year-over-year comparison, the business unit revenue mix was unfavorable in Q3 compared to Q2, with ACS representing a lower percent of the total revenues in the third quarter.

The Company's strategic investments to support its growth strategy were primarily made from Q4 2017 through Q2 of 2018 and continued to be carried by the Company through Q3 of 2018.

Therefore, you will not see any incremental spending for strategic investments impacting gross margin in the Q3 versus Q2 comparison. Similarly, much of the Q3 2018 performance variances highlighted in our last slide, $5 million, were also performance variances in Q2 2018.

Therefore, on a sequential quarterly comparison, the expenses in the performance category on this slide are relatively small. Lower ACS volumes in Q3 compared to Q2 drove the majority of the negative $1.5 million performance variance detailed in the bridge.

The strategic costs to support our growth and operational excellence initiative as well as the performance-identified costs related to site consolidations, product ramps in PES and incremental infrastructure costs associated with the EMS acquisitions will continue to impact our gross margins in Q4 and into the first half of 2019.

We anticipate increasing yields in PES, reducing the manufacturing site consolidations cost and optimizing certain infrastructure costs in EMS incrementally in 2019, with corresponding incremental improvements in gross margin.

We expect to achieve more meaningful margin expansion when the underutilized capacity in our ACS business is leveraged with the rollout of 5G applications beginning in 2019.

Slide 17 details the changes in adjusted EPS for Q3 2018 of $1.42 per fully diluted share compared to adjusted EPS for Q3 2017 of $1.41 per fully diluted share. The first two columns represent the difference in gross margin, which we discussed previously.

SG&A expenses for Q3 2018 were $1.6 million less than Q3 2017 expenses. The majority of the savings were performance-related savings, partially offset by spending for outside services and spending in Griswold. R&D spending in Q3 was slightly higher compared to Q3 2017, supporting new product initiatives.

As a result of the gross margin and operating expenses dynamics, the adjusted operating profit for Q3 2018 was $38.6 million, or 17% of revenues, compared to $40 million, or 19.4% of revenues, for the third quarter of 2017.

Below the adjusted operating profit line, the Company incurred $0.5 million of losses on its copper derivative contracts and $1.1 million of losses on its foreign currency hedging contracts in Q3 2018 compared to gains of $0.6 million and $0.8 million, respectively, on copper and foreign currency contracts in Q3 2017.

Lastly, our effective tax rate for Q3 2018 was 31%, compared to 38% in Q3 2017. The decrease in the effective tax rate was due primarily to a lower US tax rate resulting from US tax reform.

Slide 18 details the changes in adjusted EPS for Q3 2018 of $1.42 per fully diluted share compared to adjusted EPS for Q2 2018 of $1.19 per fully diluted share. The first two columns represent the difference in gross margin, which we discussed previously.

SG&A expenses for Q3 2018 were $3 million less than Q2 2018 expenses. The majority of the savings was due to good cost control and some favorable seasonality of expenses, mitigated by the increase from Griswold expenses.

R&D spending in Q3 was also lower compared to Q2 2018, due to the timing of discrete engineering project expenses in Q2. As a result, the adjusted operating profit for Q3 was $38.6 million, or 17% of revenues, compared to $31.7 million, or 14.8% of revenues, in the second quarter of 2018.

Below the adjusted operating profit line, foreign currency hedging contracts incurred $0.9 million more losses in Q3 compared to Q2, and interest expense was higher in Q3 due to increased borrowings to fund the Griswold acquisition. Lastly, our effective tax rate for Q3 2018 was 31%, compared to 33% in Q2 2018.

On Slide 19, I believe between Bruce and I we have sufficiently covered the revenue profiles of each of the business segments, as well as the strategic and growth initiatives driving profitability for each of our segments.

Turning to Slide 20, we ended the second (sic) [third] quarter with a cash position of $149.6 million, a decrease of $31.6 million from December 31st, 2017.

In the first nine months of 2018, the Company spent $78.6 million on the Griswold acquisition, net of cash; $43.4 million on the Isola asset acquisition; and $36.6 million on capital expenditures. The Company also spent $25.3 million in pension and other post-retirement benefit contributions, primarily in anticipation of the termination of certain plans.

To fund these expenditures, the Company borrowed an additional $102.5 million on its revolving credit facility and generated $33.4 million from operating activity, net of the pension and other post-retirement benefit contributions and an increase in working capital.

Year-to-date, working capital consumed $44 million, adjusted for the revenue recognition methodology. The use of cash from the increase in working capital is primarily due to an inventory increase of $25.6 million, mostly driven by plant consolidation initiatives and managing long lead time raw materials, and an increase in accounts receivable of $14 million due to the timing of shipments in the quarter.

Year-to-date, our effective tax rate is 25.8%, compared to 34.6% last year. The lower effective tax rate is due to a lower US tax rate resulting from US tax reform, changes in pretax income mix across jurisdictions and the net impact of releases and accruals of uncertain tax positions.

Taking a look at our Q4 2018 guidance, on Slide 21, revenues are estimated to be in the range of $215 million to $225 million, slightly down from our Q3 revenues at the midpoint as we expect lower seasonal revenues from portable electronics from our EMS business.

We are guiding gross margin at 35% to 36% for Q4, consistent with the incremental improvement we mentioned in our gross margin comment.

We guide GAAP EPS for Q4 in the range of $0.84 to $0.99 per fully diluted share. On an adjusted basis, we guide fully diluted earnings in the range of $1.20 to $1.35 per diluted share.

Guidance for capital spending for the year is in the range of $45 million to $50 million, which does not include the Isola asset purchase of $43.4 million. The effective tax rate for the full year is expected to be 26% to 28%, and 30% to 31% for Q4. I will now turn the call back over to Bruce.

Bruce Hoechner^ Thanks, Mike. This concludes our prepared remarks. We'll now open the line for Q&A.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Craig Ellis, FBR.

Craig Ellis^ Bruce, clearly within EMS we have some very strong automotive growth, but in Advanced Connectivity there is some inventory and just regulatory and other issues. So regarding the particular strength in EMS, is that reflective of new customer programs? Or what drives such significant growth here in the third quarter?

Bruce Hoechner^ So EMS, certainly the handheld electronics and so forth, Q3 is a high quarter for the build, in anticipation of the holidays, so we've been very successful in getting some new programs there earlier in the year, and now that's paying off.

The other thing, though, that we saw was in the EV/HEV side, battery pads and containment materials for the battery packs themselves, we've made very high inroads there in terms of new programs, as well, and with the penetration of EVs, which we've seen growth in September up 61% year-over-year on EVs and HEVs. So that's driving some of the growth that we're seeing in EMS.

Craig Ellis^ And on that latter point, Bruce, is there a particular geography? Or is that multi-geography in nature?

Bruce Hoechner^ It's multi. We've seen it in Europe, North America and in Asia.

Craig Ellis^ Regarding the (inaudible) comments that there's some inventory buildup that's out there, how significant do you sense that is? When does it get worked off? And, related to that, Bob, what are the trends that you're seeing with respect to radar adoption and radar intensity in advanced vehicles as we move ahead?

Bruce Hoechner^ As I mentioned in my prepared remarks, what we're seeing is that with the European testing and the delay there, that European sales are down primarily in the higher-end automobiles where we have higher content. So the automobiles that are more premium/luxury would have a higher number of radar sensors.

So we're getting impacted there. And then, correspondingly what we're seeing is that the inventories that are being held by their suppliers into the automotive OEMs are being pulled down in anticipation of those lower sales.

Now, our understanding is that the European car manufacturers will work through these new standards and return to normal sales. Our view is this will happen most likely as we move into 2019. And so we would anticipate returning to double-digit growth in our ADAS business.

Bob Daigle^ I think in terms of the market dynamics we're continuing to see increased penetration, and it's not just the number of vehicle platforms that are adopting these Advanced Driver Assistance Systems, but also the number of sensors, the average number of sensors continues to increase.

We think that's going to get reinforced a bit also by the new European NCAP requirements where you need to pick up a motorcycle from 100 meters back. So the technical requirements to meet those distances is also, we think, very favorable in terms of driving average number of sensors.

I think if you look at the road maps most of the Tier 1's have in place, there's more effort going into what's referred to as high-definition radar, which again generally means more content opportunity for us as people go towards what effectively would be higher-definition radar in future systems.

So all in all, very positive. It continues to be a penetration story. And as Bruce mentioned, we haven't seen anything beyond the fact that automotive production, specifically with a couple of the German automakers were down fairly substantially during part of the quarter because they're scrambling to get all the vehicles certified with the new emission standards.

Craig Ellis^ Mike, appreciating that you've been on the job less than a full quarter, I wanted to get your conviction that the gross margin in the third quarter really is a bottom. We had expected gross margin to move up.

There are some things going on, obviously, it moved down. But what gives you conviction that the fourth quarter can actually rise sequentially? And, from where we are now, how would you [bin] out the different drivers that we need to get back to that 40% target level?

Mike Ludwig^ I think the real question is, as well, we guided to 37%; we came in at 35%. What drove that? And, how do we recover from there, going forward?

So let me address that. I think the majority of the miss in Q3 versus our guidance is still due to the revenue mix, with ACS revenues being down and PES revenues being up. ACS, as you know, is the highest margin business, so I think that was the fairly significant contributor to the miss in Q3.

But secondly, we anticipated making more progress on the $5 million performance and other costs in Q3 that were outlined on Slide 15. So first of all, in EMS, which we said accounted for 50% of that $5 million performance bucket, there have been three acquisitions that we're in the process of, one, consolidating sites and, two, optimizing their operational infrastructure.

The consolidation and optimization processes, they're proceeding at a more deliberate fashion maybe than what we had anticipated, to accommodate the increased customer demand and to ensure that we maintain the value that we acquired in the business.

And in PES, we have introduced new product that has been well received in the market, and we're having some difficulties with the product ramp. And I think some of those are fairly predictable. But mainly yield is costing us some money to address to ensure that we are really meeting the customer expectation.

So I think those were the big challenges with respect to Q3. Going forward, our commentary related to incremental improvements over the next two to three quarters to address that $5 million performance bucket.

And I think it's contemplated in our margin guidance, where we see gross margin incrementally improving to capture the majority of the 200 basis points of performance opportunity.

So I feel like, based on what I've seen, I think we have good plans in place. I think the Company has actually made some really good strides over the last couple of quarters to address operational efficiency challenges, but I think we need to be measured in how we do that.

So I'm pretty comfortable that we will increment this. And so you can see at the midpoint we're going from 35% to 35.5%. Those types of increments seem, I think, realistic to me, and I think those are ones that we are committed to make.

And that incremental improvement does not contemplate the real positive margin impact from ACS from the 5G ramp, which will be additive and bring us, I'd say, will bring us towards that 40% contemplated in the 2020 financial model. So that's my take after six or seven weeks on the job.

Bruce Hoechner^ I think the other thing to point out, we said that we were going to make progress in our last call on pricing, on multi-site qualification and completing that, concluding the site consolidation in Belgium.

So all of that was completed, and we feel very good about that. So the other thing is our online equipment performance is good. So the maintenance issues that we had earlier in the year have improved, as well as quality.

So on the operational front where we've said that we were driving operational improvements, we've made them, and some of the impacts that happened in the quarter in Q3 were related to the items that Mike pointed out.

And as Mike also said, we've got plans in place and we're working through it. So we remain very optimistic as we move through the next couple of quarters on righting that and moving towards that 40% goal.

Mike Ludwig^ I think the point there, Greg, is that we don't believe we're going to make 200 basis points or 300 basis point changes in a particular quarter. These things are going to take time, we want to be methodical about it. We don't want to destroy value. So I think looking at some smaller increments, like 50 basis points, I think is much more realistic.

Operator^ Daniel Moore, CJS Securities.

Daniel Moore^ Within ACS, the 5G, obviously, we've not seen a pickup yet. We had expected it to be '19. You referenced the second half of '19 a couple of times in the prepared remarks.

What kind of data points can you point to, to talk about your confidence in seeing that ramp sometime in the back half of 2019?

Bruce Hoechner^ So when we look at indicators that are important to us, certainly the design activity that we see with these major OEMs is fast and furious. And of course we've been designed in. So we see what's going on across that spectrum.

We also have seen the chipset makers for handsets accelerating their output and introduction. And I think as I said in the remarks, the handheld folks are looking to provide the market in the first half of 2019 with 5G-capable smartphones.

The other thing we're waiting to see is the Chinese frequency assignments that have been targeted to be assigned towards the end of this year and then the licensing in the first half of 2019.

So that will be a big indicator as to when we will really see this thing start rolling. But the indications, particularly from the OEMs that we talk with almost every day, are that this is coming, and most likely second half of the year.

Bob Daigle^ The other thing I might add, is again I think part of it is if you look at the trend of announcements and basically triangulating around what you're hearing from both the equipment providers and the service providers, we continue to see signs of pull-ins versus push-out.

So people are talking about things sooner rather than later. And that's giving us a lot more conviction, frankly, about the volume coming and making sure that even though we're absorbing a little bit more expense in the near time that we're ready to support that.

Daniel Moore^ And then, maybe update us on the Isola acquisition? How much incremental capacity that brings, how much runway that will provide you? And when we think about 5G starting to ramp and ACS starting to ramp, what is the incremental margin profile look like into the back half of next year and 2020?

Bruce Hoechner^ With regard to capacity, we've got two approaches here. We've been having ongoing investments in the ACS infrastructure to make sure that we continue to build our capabilities at the existing facilities, and that's been on our road map.

What we've done with the Isola asset acquisition is to provide ourselves with capabilities both in lamination presses as well as treaters that take us out probably two to three years with the road map that's already in place for some of our other capacity additions in the existing ACS facility. So we feel very good about that.

We've learned quite a bit. Rogers over the last eight to 10 years has been a leader in the high-frequency circuit materials used in cellular systems; so 2G, 3G, 4G.

And one of the things that we've identified is that when this inflection point comes, when this transition comes, you know it's coming within a certain period, whether it's six, nine months, something like that, but not exactly when and not exactly how steep the curve is on the uptake.

So our strategic decision on the acquisition of the Isola assets was to ensure that we have the capacity in place so we don't disappoint our customers as we move forward over the next one to two to three years. So I think the road map is very clear. We feel very good about that acquisition.

Over the next six to nine months we will be converting that equipment in that facility to be able to produce our materials. It's not a very difficult conversion because this is similar equipment to what we have in our facilities, but we will have trials and so forth and make sure that those equipment can produce our products for us.

Mike Ludwig^ I think when we look at margins as it relates for the 5G, again I think we're still looking through and understanding what the impact is of the Isola plant on all margins, and whatnot. But certainly, we think that, what I'd call, the incremental margin, the contribution margin, not necessarily gross margin, of that business is going to be well north of 50%.

I don't think I want to get pinned down right now to an exact number, but I think it's going to be pretty significant, again taking us towards our 40% gross margin target, and I think that's going to be a big piece of it.

So I think north of 50% is probably what I'd be willing to say now. We may have more to say on that later.

Operator^ (Operator Instructions) Sean Hannan, Needham.

Sean Hannan^ I want to see if I can make sure that I have an appropriate understanding of is, when I look at the guidance, as I map the gap for where your earnings are looking to be versus where the Street previously was, trying to get a better understanding around how impactful is automotive as a headwind in there, versus what you would have otherwise seen?

And, to what degree would you say the softness in 4G demand during this middle transition time has actually deteriorated further than you had previously thought? Or is it just holding steady in its softness and somewhat consistent with where you've been thinking?

The focal point of my question is around ACS, primarily automotive. Any other color around 4G? If I'm missing the boat on something else, if you could lay that out, that would be helpful.

Mike Ludwig^ So certainly when you look at it from a gross margin standpoint, the fact that whether it's ADAS or whether it's 4G LTE, those are obviously markets within the ACS business. That's very profitable business.

So to the extent that those create headwinds, they certainly are going to create headwinds from a gross margin perspective. And I would have to believe that that represents a pretty significant part of the challenge with respect to getting back to maybe what a Street consensus might look like for the fourth quarter.

Bruce Hoechner^ On the market side, I think the 4G LTE is less than we expected, certainly in Q3, and we're carrying that through into Q4. So that's an impact.

And the ADAS situation, I think we've covered that that should turn around as the testing gets completed and qualification gets completed by the car manufacturers. So we're not expecting that to be through in Q4 -- most likely Q1 where we'll see that recover.

So we've looked at this for Q4, going from Q3 to Q4 in the ACS business as pretty much going sideways at this point, until we see the ADAS recovering and certainly as 5G starts tuning up.

Sean Hannan^ So basically our disconnect sounds like it's all tied to ACS. Incremental softening within 4G, but that's transitory. The magnitude doesn't sound like it's all that material, but it is incremental. And the surprise out of left field as a topic really was automotive, and that seems to be, arguably, the bigger contributor because we hadn't previously been thinking about that too much.

Even though we knew the standards were coming, how that actually played through in getting cars appropriate for the showroom I think was a little bit more of an industry surprise than we expected. Fair?

Mike Ludwig^ I think that's probably a good summarization. That's probably the biggest piece, let's put it that way. We talked about some of this performance challenges with respect to how that impacted the Q3 actual gross margin versus the guidance.

And my guess is that there's probably some of that in that discrepancy between maybe what the Street is thinking versus maybe some of the guidance that we provided, again because I think we're being a little more deliberate in terms of how we work through those problems to ensure that we keep the value of the acquisitions. But again, I think we're very, very committed to working those over the next couple of quarters.

Sean Hannan^ Over to EMS for a moment, I realize that you've addressed some around this topic already, but the strength that we had in the quarter -- trying to get a little bit of a better understanding in terms of the sustainability around some of these revenues and what risks could emerge that would otherwise undermine that?

Because it's such a sharp performance. There may be some assumptions on our part in terms of how to extrapolate out from here. I just want to make sure that we have the right perspective on that.

Bruce Hoechner^ So Sean, the view on EMS, automotive, particularly the EV/HEV side, we predict will continue to have strength.

So year-on-year we were up in that sector up 30%, and that's consistent with what we're seeing in terms of the actual purchase of EV and HEV automobiles, and it also mimics a bit of what we've seen over in the PES business in terms of EV/HEV applications there. So we think that's real and that's sustainable.

As I mentioned, Q3 is a higher quarter generally for the portable electronics in anticipation of the holidays, and the build for the holidays. I think the other area that we are cautious in looking at is the general industrial side.

We've seen continued pretty good strength there. We had about 4%, 5% growth year-on-year in that, and it was flat quarter-to-quarter from Q2 to Q3. But we're keeping a strong eye on that in terms of where the economies are heading.

So overall, though, we see ACS being relatively steady here across their different sectors, with the HEV/EV side showing that growth.

Sean Hannan^ To follow up on the general industrial, as you monitor that carefully, the catalyst in monitoring that carefully, is that anything that is tea leaves that you've seen or observed or heard within your own business? Or is it just, effectively, monitoring headlines that are going to hit whatever newswire or service that you may take a look at?

Bruce Hoechner^ When I step back, when I look at the corporation and what we've done over the last five years, or so, in terms of diversification of the portfolio, we've really focused on these higher-growth markets of advanced mobility, advanced connectivity. It's, like, over 50% of our sales. So I feel very good.

We've made a very clear strategic decision to invest in those areas, and those areas are paying off in terms of growth. Now, we'll see 5G towards the end of next year, but the other ones in EV/HEV and ADAS, they're there for us, with just that issue in the European side on ADAS.

The typical cyclical nature of economies, the general industrial is where we'll see it first. So that's the one that we're watching very carefully, a little bit reflecting what you're seeing in the headlines and so forth.

So that's the area of, I would say, concern. It's about 25% to 30% of the corporation. So that's just the one area that, with what people say around being top of the cycle at this point, that's what we're watching.

Sean Hannan^ So it’s a matter of diligence from the executive team over there at Rogers versus we've got some squishy points and we need to keep our eyes on it?

Bruce Hoechner^ It actually has maintained itself over the last couple of quarters, but like we said, we're watching it.

Operator^ And there are no further questions at this time.

Bruce Hoechner^ Great. Thank you, everyone, for joining us on today's call and have a great afternoon and evening.

Operator^ Ladies and gentlemen, this concludes today's conference call. You may now disconnect.