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KMG - Q1 2018 KMG Chemicals Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the KMG First Quarter 2018 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to hand the floor over the Eric Glover, Investor Relations Manager. Please go ahead, sir.

Eric Glover - *KMG Chemicals, Inc. - IR Manager*

Thank you, Karen. Good afternoon, and welcome to the KMG First Quarter Fiscal 2018 Financial Results Conference Call. I'm joined today by Chris Fraser, our Chairman and CEO; and Marcelino Rodriguez, our CFO. In a moment, we'll hear remarks from them followed by a Q&A.

During today's call, we'll discuss financial measures not calculated according to Generally Accepted Accounting Principles. Please refer to today's earnings release available on our website for the reasons we are presenting non-GAAP financial information and for the appropriate tables that reconcile these measures to our GAAP results.

Before we begin, I'd like to remind everyone that the information on this conference call includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to significant risks and uncertainties, including statements regarding the future performance of the company.

I'll now turn the call over to Chris Fraser, Chairman and CEO. Please go ahead, Chris.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Thank you, Eric. Good afternoon, and thank you, everyone, for joining us today.

Our Q1 earnings release was issued today after the market closed, and our 10-Q will be filed this evening. After my remarks, Marcelino will review the financials and then we'll take your questions.

KMG accomplished a great deal both operationally and financially in the first quarter, and I'm proud of the progress we continue to make as an organization. Not only did we achieve record financial results with strong cash generation but we also reduced our debt leverage substantially through the completion of a successful common stock offering, and we entered into a swap agreement to reduce our interest rate exposure on a portion of our floating rate debt. As Marcelino will discuss, the reduction of our debt will lower our interest expense going forward, and we anticipate additional interest expense savings from the upcoming repricing of our term loan.

As we discussed on our fourth quarter call in October, KMG is experiencing solid fundamentals and favorable trends in each of our businesses that are helping to drive continued growth in sales and EBITDA as well as margin improvement. These positive dynamics were evident in our first quarter as KMG delivered another quarter of strong financial performance, highlighted by robust organic growth in our existing businesses as well as significant contribution from both Sealweld and Flowchem, our 2 most recent acquisitions.

Net sales grew 45% from the prior year to a record $110.7 million, representing the first quarter in KMG's history that quarterly sales exceeded $100 million. First quarter adjusted EPS of $0.83 also reached a record, increasing 73% from last year's first quarter and making our 13th consecutive quarter a double-digit year-over-year growth in adjusted EPS.

Our 2 reporting segments, Electronic Chemicals and Performance Materials each generated record financial results, leading to record consolidated adjusted EBITDA of $27.5 million, our 15th consecutive quarter of double-digit year-over-year growth in adjusted EBITDA.

I'm pleased that with the strategic acquisition we made over the past several years, KMG is now well diversified with a more balanced portfolio of businesses. First quarter sales in our Performance Materials segment more than tripled from the same period last year to a record of $36.9 million, driven by the contribution from Flowchem and Sealweld as well as strong product volume growth in both industrial lubricants and wood treating chemicals.

In our wood treating chemicals business, we experienced positive results from good volume growth partially offset by an increase in raw material costs compared to the prior year period. Product volume benefited from favorable seasonal trends and the replacement of hurricane-damaged utility poles. Overall, our wood treating chemicals business remains a solid and dependable source of cash flow.

Our pipeline performance business serving the global pipeline and energy market continued to perform strongly, benefiting from positive industry dynamics and trends that favor our unique products, capabilities and solutions. Increased oil and gas production, especially in the U.S. and higher maintenance spending within the energy sector continue to drive growth in our industrial lubricants business which supplies essential products and services that enable optimal valve performance and provide important safety benefits in both the pipeline and oilfield markets.

Flowchem contributed significantly to both sales and EBITDA in our Performance Materials segment, serving the numerous pipeline operations in North America and throughout the world. Flowchem directly benefited from increased oil production in the U.S. This higher level of production is straining existing throughput and takeaway capacity, particularly in the Permian basin and Bakken formation.

We remain excited about the opportunity that Flowchem's leading drag-reducing agent technology and products address on a global basis. Rising oil production in capacity-constrained regions, aging pipeline infrastructure and the construction of new pipelines are important trends that will drive further usage and market penetration of DRAs both domestically and internationally. We continue to make good progress integrating Flowchem's business into KMG, and we're transitioning key administrative functions into our overall corporate functions.

Turning now to our electronic chemical segment, which supplies high-purity process chemicals to semiconductor manufacturers worldwide, 2017 will be a record for the global semiconductor industry with global silicon wafer area shipment reaching a new all-time high. The key drivers behind this very strong market growth include the proliferation of semiconductors and the technology and products we use and rely on every day and continued growth in faster growing end markets and applications, including automotive, Internet of Things, cloud computing, advanced memory and artificial intelligence.

Furthermore, dynamic and powerful growth trends the semiconductor industry is experiencing now is what's being called the information explosion. The continued massive surge in data generation is leading directly to increased semiconductor production, including chips with greater processing power, increased memory and more robust storage capabilities to record, process and exchange this information so it is accessible anytime and anywhere.

In our position as a leading supplier of high-purity process chemicals to semiconductor manufacturers globally, KMG's benefiting from the rise in big data, and the increased volume opportunity provides for our electronic chemicals business. In this environment, we continue to work closely with our customers to reliably supply them with necessary purity, quality and volume that they require to support their future production needs.

Our first quarter electronic chemical sales grew 10% from the same period last year and 3% sequentially, driven by broad-based demand throughout the global semiconductor manufacturing sector. Product volume grew year-over-year and sequentially in all of our geographic regions.

One of KMG's key competitive strengths is our ability to reliably provide the highest purity and highest quality products to our global customers, ensuring that our products meet their evolving needs for purity and quality. As semiconductor device architects become more highly integrated and complex with more interconnected layers, the silicon wafers in which the semiconductors are manufactured require additional processing steps. These additional manufacturing process steps drive increasing demand for high-purity process chemicals. Supported by our investments in product quality and purity and in our supply chain, KMG remains well positioned to meet this growing demand for our semiconductor customers today and in the future.

While we focus on supplying ultra-high purity chemistry using our customers' most advanced processes to produce high-end logic and memory devices, our electronic chemicals segment also addresses high-volume opportunities such as the production of microcontrollers, sensors and analog ICs. As markets like the Internet of Things and automotive continue to experience some growth, we're benefiting from our customers' continued high levels of production of these type of devices for a variety of end markets and applications.

In summary, I'm pleased with our performance and continued progress in the first quarter. With favorable tailwinds in each of our businesses, our fiscal 2018 year is off to a solid start, and I'm excited about our opportunities for further growth this year and beyond.

We'll review and update our full year 2018 financial outlook at our customary time when we report our second quarter results.

I'll now turn the call over to Marcelino for a review of the financials.

Marcelino Rodriguez - *KMG Chemicals, Inc. - CFO & VP*

Thank you, Chris, and good afternoon, everyone.

In my remarks, I will reference adjusted or non-GAAP numbers as we believe non-GAAP information can provide useful insight into the underlying operating performance of our business. The non-GAAP numbers I reference are reconciled to their corresponding GAAP numbers in today's earnings release.

As shown in today's earnings release, we have specified amortization of intangible assets as a separate line item in our operating expenses due to the significant amount of amortization expense related to intangible assets we now incur largely due to the acquisition of Flowchem. Going forward, we intend to continue to exclude the portion of amortization expense directly attributable to Flowchem and related tax effects from our calculation of adjusted earnings per share.

Our financial performance in the first quarter was driven by: one, productive -- I'm sorry, product volume growth across all geographic regions in our chemicals segment; two, strong organic growth in our industrial lubricants business as well as our wood treating chemicals business; three, significant contributions from Sealweld and Flowchem; and four, enhanced operating leverage and improved operational efficiency throughout our global operations.

Overall, first quarter adjusted diluted earnings per share reached a record $0.83 compared to $0.48 in the same period last year. First quarter consolidated adjusted EBITDA margins were 24.9% compared to the 16.5% in the first quarter of last year. As you look at our segment results, you'll see a change in our corporate allocations due to the acquisitions we've made.

Electronic Chemicals segment adjusted EBITDA margins expanded to a record 19%, an increase of 222 basis points from Q1 2017. The increase was primarily due to product volume growth, operating efficiencies and a more favorable customer and product mix.

Performance Materials segment adjusted EBITDA margins increased to 42.3% in the first quarter from 41.2% in Q1 2017, reflecting the contribution from Flowchem and improved product volume in our industrial lubricants business, partially offset by higher raw material costs in our wood treating chemicals business.

We are pleased with the growth in our first quarter operating cash flow, which totaled $20.5 million, an 88% improvement over the $10.9 million in last year's first quarter. Q1 2018 operating cash flow benefit -- benefited from the acquisitions of Sealweld and Flowchem, other non-cash adjustments in this period and improvements in working capital.

We significantly reduced our debt in the first quarter using the approximately $176 million in proceeds from the follow-on offering plus an additional $2 million of cash generated from operations.

As of October 31, 2017, long-term debt was $352.9 million compared to $526.3million at the end of our fiscal 2017 year.

Our current net to EBITDA leverage ratio using the midpoint of our projected fiscal 2018 EBITDA guidance is now approximately 3x, better than our target goal leverage that we outlined in April when we announced a definitive agreement to acquire Flowchem.

Because we completed a successful common stock offering that reduced our leverage substantially and we've generated strong growth in EBITDA, I am pleased to report that credit rating agencies have upgraded the credit rating on our long-term debt. At our new lower level of leverage, our current credit agreement allows for an automatic 25 basis points reduction in spread. We believe that we can achieve additional interest rate savings based on our continued strong financial performance, a benefit from recent rating agency upgrades, the reduction in our leverage and current conditions in the debt market.

Capital expenditures were $5.8 million in the first quarter, which included investments in technology, supply chain and the expansion of our manufacturing facility in Singapore. We continue to anticipate total CapEx of $29 million in fiscal 2018, which includes a portion of our planned capital investment in Singapore.

Now turning to our income statement. Gross profit margin improved 320 basis points year-over-year to 420 -- I'm sorry, to 42% due to improved margins in our Performance Materials segment, higher sales volume in the electronic chemicals segment and manufacturing efficiencies.

SG&A expense increased by approximately $2 million from last year's first quarter, reflecting annual salary and wage adjustments, an increase of $200,000 in stock-based compensation expense and the additions of Sealweld and Flowchem. We anticipate stock-based compensation expense will be higher in fiscal 2018 compared to the prior year due to our continued strong financial performance and higher stock price.

Depreciation and amortization expense in the first quarter totaled $7.1 million compared to $3.6 million in the same period last year. D&A increased in Q1 2018 largely due to the acquisitions of Sealweld and Flowchem.

Having nearly completed the purchase price accounting related to the acquisition of Flowchem, we now anticipate total depreciation and amortization expense for fiscal 2018 year will be approximately $30 million to $31 million. Of this amount, we estimate amortization of intangible assets will be approximately $16 million.

In the first quarter, we entered into a swap agreement to hedge a portion of our floating rate debt against potential increases in interest rates. Because this swap is mark-to-market each quarter for financial reporting purposes, we recorded a fair value gain of $849,000 in the first quarter. We have excluded this gain, which was equivalent to $0.04 per diluted share from the calculation of our adjusted EBITDA and adjusted earnings per share.

Our effective tax rate in the quarter was 31% compared to 34.3% in the prior year period. The decrease was due to improved earnings in our international operations stock compensation tax benefits.

We continue to anticipate an effective tax rate of 32% to 33% for the fiscal 2018 year assuming no changes to the current U.S. tax code.

Karen, now let's open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Mike Sison with KeyBanc.

Michael Joseph Sison - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

In terms of Flowchem, can you maybe talk about some of the areas of growth that you saw in the quarter? And what do you think about the sustainability of that type of growth as the rest of the year unfolds?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes. Thanks, Mike. So what we saw was our biggest growth in volume came through our domestic portion of our business. And that had to do with, as I mentioned in my prior discussion, the fact that there's been increased oil production, specifically in the Permian and some in the Bakken, and it's straining the capacity -- throughput capacity as well as the takeaway capacity. So what we're seeing is as the volume goes up in those areas, they're increasing their volume of DRAs. But in addition, as they look to take more away in an existing infrastructure, the use of DRAs are providing real benefits. So we saw a year-over-year increase in our quarter. Even though we didn't own Flowchem, going back to their prior records, we saw a nice volume uptick overall but more specifically in the domestic market. And as we project out the remainder of our year, as we move into our second quarter, this is a -- from a seasonal standpoint, this is a higher-production, higher-sales quarter for us on DRAs as the winter months come to bear. Obviously, there's increase in viscosity and therefore a greater usage of DRAs during the winter months around the globe. So we expect an increase sequentially on volume, but also we believe that year-over-year growth that we saw in our first quarter will continue into the remaining quarters of the year. And it gets to the overall benefits of DRAs, when we bought this business, we were very excited about not only the benefits that the products bring, but also as we saw more and more pipelines adopting the use of them and getting the benefits of them not only domestically but internationally. So we're feeling good about the projections going forward and think this positive volume trend will continue the rest of our year.

Michael Joseph Sison - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay, great. And then in the electronic chemicals, your EBITDA margins improved a little over 200 basis points. Was that primarily from volume growth during the quarter? And if you think about that level of profitability as you head into 2Q, 3Q, 4Q, if volumes remain strong, is that a more reasonable level of profitability to expect out of electronic materials going forward?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes. So part of the margin improvement had to do with the fact that we -- as we move more volume and through our existing facilities, obviously, we'd get an uptick in margin because of the throughput. It was a very strong quarter for us. Seasonally, it's always a very strong quarter. We expect, as we move through the year, there'll be some seasonal impact. Usually, our second quarter is a slightly lower quarter from a seasonal standpoint, but -- so having said that, we'll probably see a slightly lower margin in the upcoming quarters but expect that to rebound as we continue to see volume increases. We -- when we went into 2018, I commented our fiscal year '18 versus '17 that we thought we'd see a 5% to 6% volume growth. We're off to a 10% start already. But overall, we think our 5% to 6% volume growth will continue projections, and you can see that obviously, we're not going to -- we don't believe we'll continue with a 10% pace. But having said that, the industry is running very strong. As the technology moves and -- to advanced nodes, we're seeing nice pickup in demand there. But in addition, it's just overall demand for semiconductor chips globally, and the applications continue to grow. And so we're benefiting from that, we think that'll continue. But going back to your original question, I think the margin we saw in the first quarter is a reasonable margin to assume for the remainder of the year, but each quarter will be slightly different obviously from various product trends, customer mixes that we have from quarter-to-quarter. But we feel good about the margin we got, and we do continue to think that it's a good surrogate for the remainder of the year.

Michael Joseph Sison - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

All right. And last question, when you think about the opportunity to expand in Asia and maybe look for some acquisitions, how does the pipeline look? And ideally, where would you like to strike as you head into 2018 with the balance sheet in better shape?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes, a good question, Mike. So we've -- clearly, as we said, strategically, we'd like to grow our presence in Asia. Our investment that we're making in Singapore is going to give us some of those capabilities. Our ability to serve the Singapore market will be clearly enhanced, but we also think there's some opportunities outside of it. I mean if you look at Taiwan, it's the largest semiconductor production area in the world, so that's a natural area for us to go into. We think our business model and our products apply very well there, so that would be a natural area to go into. It's been -- this is not new. We've been at this for several years, and we continue to stay at it. We're -- the thing that we do here is as much as I want to grow in Asia and our balance sheet is in much better shape now, we remain disciplined in not only the acquisition price that we pay but the assets that we buy. So we continue to stay at it, and we'll remain disciplined. But clearly, a line of focus for us is Asia. And specifically Taiwan will be a key market, and then as an offshoot from that moving into China, as their demand will continue to grow in the China region over the coming years.

Operator

(Operator Instructions) Our next question comes from the line of Mike Harrison with Seaport.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Just real quickly, in terms of the hurricane impact, clearly, you mentioned some benefits in the wood treatment business. Can you talk about maybe the magnitude of what benefit you saw there? And then talk also about the hurricane impact on the DRA business as well as the valve lubricant business?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes. So yes, let's start with wood treating. So we did see some impact. It was not very significant but enough for me to comment on. And we saw it obviously in the Texas area as well as in the Southeast and the benefits of additional volume in a year-over-year basis. So not a major impact but enough that it did push our sales up a bit. We also saw some increase in sales with the fires out West. A lot of poles were destroyed during that, and as we speak today, unfortunately, that is continuing. And we'll -- we will see some additional sales as those poles are replaced. And then as you look out to Puerto Rico, I mean, you've seen the devastation out there. That's just beginning to rebuild and the number of poles are significant that we acquired out in Puerto Rico. So we expect some continuation of that higher volume as we go into a relatively normal, seasonally slow period in the winter months as a lot of treating and maintenance of utility lines gets reduced during the winter months, but we do think year-over-year we'll see some benefit from that. As far as Flowchem goes, the team there did a great job of keeping our customers and product during that. Our plant continued to operate, and we were able to continue to make shipments to our customers albeit it was not as smooth as we'd like. I mean, not only from drivers getting stranded and unable to get to our site to be able to make the truck delivery, but also the inbound of raw materials and various products we need to make our products. So production actually slowed down for a period of time during the following week, but we were able to get our inventory built back up and get our deliveries made. So it didn't really have a material impact on our quarter. If you look at maybe from 1 week to the next, it did have an impact but had smoothed itself out over the quarter. In industrial lubricants, we really didn't see any impact at all. Where you had our -- we have facilities in Houston and they were impacted. The building we have in Houston for Sealweld, specifically, was significantly impacted with a lot of water damage. But again, the team there did a great job of keeping things running, getting on the repairs quickly and didn't miss a beat. So again, it speaks to the quality of the people we have and the dedication they have -- that we have inside the organization to keep us running.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Okay. So it sounds like it was kind of neutral, the -- to me, even a little bit positive as I think about the Performance Materials segment overall and the impact of the hurricanes.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes, I would say that's right.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Okay. In terms of the combination of Flowchem, Sealweld and Val-Tex, are you seeing any early wins in terms of the customer appreciation for bringing those businesses together? (inaudible) more holistic pipeline optimization-driven business?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes. So what we're seeing now, Mike, is the awareness that's occurring. Our customers' pipeline operators are beginning to look at us as a total solution provider, so they're having discussions with us. Our DRA customers are saying, "I'd like to talk to your lubricants guys and the contact points we have there and vice versa." So I can't point to any specific sales that have been through that, but the awareness is going on, and the introductions are happening and the connectivity is occurring. So I mean, that's going to happen over time. And our whole desire and strategy there was to be seen as this holistic supplier and solution provider and have the dialogue begin to take place so that as they consider either alternative DRA suppliers or alternative lubricant suppliers that they see us from that standpoint and we'll begin to see some crossover sales there. So it's good interaction between the teams. They've been exchanging information about where we have various sales contacts, where there might be some opportunities, not only domestically but internationally as we think about the Middle East and other regions that each one of the businesses might have had higher concentration. So we're seeing some good dialogue internally and that's relating to some good dialogue with our customers. So we're pleased with the progress there and excited about the future opportunities.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

And on electronic chemicals, you talked a little bit about the advances in semiconductor complexity and higher end logic and 3D NAND. As I think about the competitive environment, how many players out there are able to supply high-purity process chemicals at the purity levels that you need for the highest stats chips? Is it really just you guys and BASF and Honeywell? Or are we getting into echelons where it's even harder for a couple of those other players to play?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes. So it depends on the region and it depends on the product line. So certain product lines, we have different competitors that we do in other product lines. Solvents versus acids and bases and depending on the region. So there are -- I mean, I don't want to ever be dismissive of our competition. We have some good quality competitors that serve the customers well, and that keeps us sharp and keeps us thinking forward about how we can improve things and reliability of the supply chain all the time. So we do have good competitors in every region and in each of our product lines. And the thing that we focus on internally is being in close contact with our customers to understand what their needs and the direction they're going in so that when they move to a new technology or their demand grows we're best in tune with that, so we can be the one there to satisfy their needs. And as they think about new technologies 2 years out, they're talking to us about what their demands are and we're willing to make those investments, whether it's infiltration or distillation or packaging or whatever is required to meet those higher and higher demands. So again, we've got quite a bit of competitors out there in every area, and we pride ourselves in pacing ourselves against and ahead of them and being there for our customers when they need us.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And last question for me. I know this typically isn't the time when you adjust guidance or update guidance. I was just wondering if you can give us a sense of Q1 relative to your external -- or sorry, internal expectations. Did it come in ahead of what you were expecting in your initial guidance on the sales and the (inaudible)?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Yes, it's a good question, Mike. So as you said, we will be updating here in a couple of months when we announce our Q2. But having said that, speaking about Q1, it exceeded our expectations. The volume growth in EC was stronger than we had thought as we went into 2018, and the continued strength in industrial lubricants outpaced our expectations. Flowchem was pretty much what we had anticipated. So some of these trends that I talked about in each one of our businesses continue, and we're watching closely to see if they will continue in the quarters going out. But so far, we're pleased with where we are on all of our businesses. And like I said, both in EC and industrial lubricants, they outpaced our expectation as we looked at our year and tried to think about it from one quarter to the next. And as you know, these businesses, there's no magic line between one quarter to the next. We draw that from a reporting standpoint, but some of these trends can move and ebb and flow from one quarter to the next. So I think by the time we finish up Q2, we'll have a really good visibility on how we think the rest of the year will play out for us.

Operator

And that concludes our question-and-answer session for today. I would like to turn the floor back over to Chris Fraser for any closing comments.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman*

Thank you, everybody, for joining us today, and we appreciate your interest in KMG. Look forward to talking to you again at the -- when we announce our Q2 results. Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.
