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KMG - Q1 2013 KMG Chemicals Earnings Conference Call

EVENT DATE/TIME: DECEMBER 07, 2012 / 3:00PM GMT



## CORPORATE PARTICIPANTS

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**Neal Butler** *KMG Chemicals Inc - President and CEO*

**John Sobchak** *KMG Chemicals Inc - CFO*

## CONFERENCE CALL PARTICIPANTS

**Rosemarie Morbelli** *Gabelli & Co. - Analyst*

**Richard O'Reilly** *Standard & Poor's - Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen. Welcome to the quarter-one 2013 KMG Chemicals earnings Conference Call. My name is Ian. I'll be your operator for today. At this time, all participants are in listen-only mode. We will conduct a question-and-answer session towards the end of the conference.

(Operator Instructions)

As a reminder, the call is being recorded for replay purposes. I would like to turn the call over to the following parties -- Mr. Neal Butler, President and CEO; Mr. John Sobchak, Chief Financial Officer; and Mr. Eric Glover, Investor Relations Manager. Please go ahead, gentlemen.

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

Thank you, Ian. Good morning, everyone, and welcome to the KMG Chemicals, Incorporated fiscal 2013 first-quarter financial results conference call. I'm joined today by Neal Butler, our President and CEO, and John Sobchak, our CFO. In a moment, we'll hear remarks from them followed by Q&A.

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 as to the future performance of the Company.

I will now turn the call over to Neal Butler, President and CEO. Please go ahead, Neal.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Thank you, Eric. Good morning, and again, welcome to KMG's fiscal 2013 first-quarter conference call. John Sobchak and I will take you through the financials, and provide an overview of each of our businesses. We will then discuss our expectations for the fiscal second quarter of 2013 and our outlook for the fiscal-2013 year. After our comments, we will be happy to answer your questions. Our earnings release was issued this morning, and we plan to file our 10-Q on Monday.

KMG's first-quarter results were highlighted by further improvements in our operating profitability, which helped drive diluted earnings per share of \$0.36, representing 16% year-over-year growth. First-quarter sales declined 8.7% from last year, primarily reflecting competitive pressures from alternative processes and materials in the rail tie treating market.



Although Electronic Chemical sales increased 2.9% year over year in the first quarter, sales growth was held in check by weakening global economic conditions, which limited demand for our high purity process chemicals, particularly in Europe. Despite this relatively challenging operating environment, we continue to enhance overall profitability to drive operating cash flow and generate solid growth in earnings per share.

Our continuing improvement program, which drives the optimization of the Company's overall efficiency, again benefited our profitability. Our first-quarter operating margins expanded by 110 basis points year over year to 10.9%. While our first-quarter sales fell short of our expectations, our earnings underscored the benefits of our consolidation strategy. With our strong balance sheet and solid cash flow, we remain well-positioned to pursue additional acquisitions or other strategic opportunities to enhance our market-leading positions.

I'll now turn the call over to John, who will discuss our financial results in greater detail.

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**John Sobchak** - *KMG Chemicals Inc - CFO*

Thank you, Neal, and good morning, everyone. Before I begin, I'd like to remind everyone that due to the sale of the Animal Health business this past March, this former segment is now classified as a discontinued operation. Prior-year information has been reclassified to conform to the current period presentation.

First-quarter net sales decreased 8.7% to \$65.3 million from \$71.5 million in the first quarter of fiscal 2012. Although net sales in our electronic chemicals segment rose \$1.1 million in the first quarter of 2013 over the prior year, that increase was offset by a \$7.5 million decline in net sales in our Wood Treating Chemicals segment.

Consolidated gross profit for the first quarter of 2013 was \$20.1 million, or 30.7% of sales. That compared favorably with gross profit of \$18.7 million, or 26.1% of sales in the first quarter of fiscal 2012. The year-over-year increase in gross profit margins reflect the benefits from the completion of the integration of the assets acquired from General Chemical, as well as a reduced percentage of lower margin creosote sales within our Wood Treating Chemicals segment.

Due primarily to higher freight costs, distribution expenses increased to \$7.1 million, or 10.8% of sales, from \$6.1 million, or 8.5% of sales in the year-ago period. SG&A expenses increased to \$5.9 million, or 9.1% of sales in the first quarter, versus \$5.6 million, or 7.8% of sales in last year's first quarter. The increase in SG&A expenses was for additional project costs, primarily involving consulting and other outside services.

Consolidated operating income was essentially flat at \$7.1 million, versus \$7 million in last year's first quarter. Diluted earnings per share grew 16% year over year to \$0.36 in the first quarter of fiscal 2013, compared to \$0.31 in the first quarter of fiscal 2012.

Electronic Chemical segment operating margins after corporate allocations were 12.8% in the first fiscal quarter, up from 6.9% in the same period last year. While Electronic Chemicals operating margins have experienced significant improvement over the past year, we anticipate margins may decline slightly in the second quarter from the first quarter of fiscal 2013, due to reduced volumes; however, when semiconductor production picks up in the second half of our fiscal year, as current market forecasts indicate, we anticipate that our Electronic Chemicals segment operating margins will rebound, aided by incremental efficiency gains from our continual improvement program.

Wood Treating Chemicals segment operating margins after corporate allocations were at 13.1% in the first fiscal quarter, down from 15.7% in the same period last year. The decline reflected lower creosote volumes, due to the competitive pressures that Neal mentioned previously. We anticipate improved sales volumes in the second half of the fiscal year.

We ended the first quarter with long-term debt of \$22 million, down \$2 million from the \$24 million reported at the end of fiscal 2012. Inventories at the close of the first quarter were \$46.1 million, up \$5.5 million from the fourth quarter of fiscal 2012. The increase in inventories was primarily due to the timing of shipments within our Wood Treating Chemical segment, and to a lesser extent, higher inventories in our Electronic Chemicals segment. Meanwhile, cash flow generation remains solid, with operating cash flow of \$6.3 million in the first quarter. Free cash flow, which we define as operating cash flow minus capital expenditures, was \$4.8 million in the first quarter.



And now I'll turn the call back to Neal.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Thank you, John. I'll now provide some additional commentary on our outlook for the fiscal second quarter and the fiscal-2013 year. We remain optimistic about our prospects for the current fiscal year. As noted, we expect to see fairly soft market demand in our second quarter. However, absent a major disruption to the global economy, we anticipate continued growth in our net earnings for fiscal 2013. In the near term, challenging economic conditions affecting our Electronic Chemicals business, and market pressures within our Wood Treating Chemical segment, will likely cause second-quarter diluted earnings per share to be essentially in line with, or maybe slightly below, last year's second quarter, with expected improvement in the third fiscal quarter.

Within our Electronic Chemical segment, we anticipate sales and production levels in the second quarter will decline from those in the first quarter, causing a decline in the segment's margins. However, market forecasts indicate semiconductor production levels will indeed pick up during the second half of fiscal 2013. This business should also benefit from increasing sales to customer fabs, which are ramping up production from recent capacity expansion initiatives. In addition to the margin benefits associated with higher production volumes, we expect to realize incremental margin benefits from our continued improvement program.

In our Wood Treating Chemicals segment, we anticipate that second-quarter sales will decline moderately relative to those in the first quarter of fiscal 2013. However, we anticipate that our second-half results will show improvement from our first-half levels. Overall, we expect the contribution of Wood Treating Chemicals to our bottom line to remain fairly steady on average through fiscal 2013 relative to fiscal 2012.

As always, we remain active in pursuing acquisition or other strategic opportunities that will enhance our market-leading positions in our Electronic Chemicals and Wood Treating Chemicals business. Our strong balance sheet and cash flow continue to provide us with a high level of financial flexibility to aggressively pursue our growth through consolidation strategy. We continue to have confidence in this strategic approach, which has enabled us to more than double shareholders' equity over the past five years.

I'll now turn the call over to the operator to poll for questions. Thank you.

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## QUESTIONS AND ANSWERS

**Operator**

Thank you.

(Operator Instructions)

We have a question for you straight away. It's from the line of Rosemarie Morbelli at Gabelli & Company. Please go ahead. Rosemarie, you're in the call.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Thank you. Not a problem. It is Gabelli. Good morning, all.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Good morning.



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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Neal, why do you expect the trend in creosote to improve in the second half? And before you get to that, in the first quarter, did you see an increase in the use of boron, which is diminishing the amount of creosote used, or is there another reason behind the decline?

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Well, let me tell you the borate question first. The impact of borates have manifest themselves over the last several quarters. So, if you look at the first quarter of this year, we didn't see any notable increase over prior quarter use of borate. It's already impacted us to some degree in terms of reduced creosote demand.

In reference to why we think we'll see an improvement in the second half, most of it's simply the forecasts that we're receiving from our customers and the railroads.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Okay. Are you going to benefit actually from Sandy on either the penta for telephone poles or creosote for railroad ties?

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**John Sobchak** - *KMG Chemicals Inc - CFO*

Rosemarie, we would anticipate to see some benefit in our utility pole business. And what we have seen is that inventories of utility poles have been drawn down across the country to respond to the crisis that hit the Northeast. The next step would be to replenish those inventories with increased treating activity. We've not seen that yet, and we do anticipate to see some tailwind from that effect in the second half of the year, though.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Okay, great, and if I may ask one question on Electronics Chemicals. How comfortable are you with the expectation of a better second half, because if my memory serves me right, this is what was expected in the second half of 2011, and of course, I am talking calendar.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Yes. At this point, Rosemarie, we're fairly comfortable with the forecast, and the forecast shows an increase. And if I recall the number correctly, the percentage increase was anticipated or forecast to be about 6% or 7% over 2012. And as it stands with the inventory drawdowns that we're seeing in semiconductors, and also in the associated products it goes into, we, and the sources that we utilize to assist with our forecasting, believe that that 6% to 7% number at this juncture looks very good.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

And are you also talking, Neal, about calendar, or are you talking about the second half of your fiscal year?

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

I'm referring to -- these numbers are all calendar.



**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Okay.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Which obviously, the end of our next quarter ends in February, so we pick up a piece of it.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Okay, thanks.

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**Operator**

Thank you. There's no further questions in the queue for you.

(Operator Instructions)

We've had a question come through. This one's from Richard O'Reilly at Standard & Poor's. Please go ahead, Richard.

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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Thank you. Good morning, gentlemen. I'm not that familiar with the Company. So, part of my questions is coming from that, but your margins for the two segments are after corporate allocations. Do you ever talk about, quantify, what those margins would be before the corporate overheads? I'm really thinking about the Electronics business.

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**John Sobchak** - *KMG Chemicals Inc - CFO*

Yes, and we'll have that overhead allocation in the 10-Q, which we'll be filing on Monday.

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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Okay. What was like the year ago, or the fourth-quarter margin before that? Do you have it offhand?

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**John Sobchak** - *KMG Chemicals Inc - CFO*

Yes. The corporate allocation for the Electronic Chemicals segment in the first quarter of 2013 was \$1.4 million.

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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Okay.

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**John Sobchak** - *KMG Chemicals Inc - CFO*

In the first quarter of 2011, it was \$1.1 million.



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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Okay.

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**John Sobchak** - *KMG Chemicals Inc - CFO*

The delta is due to the fact that we sold the Animal Health segment. So, there's been a bit of a reallocation of that overhead.

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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Okay, right. Second, my impression is there's a trend towards using concrete or composite ties in telephone poles. Is that true, or do you see that by your customers?

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**John Sobchak** - *KMG Chemicals Inc - CFO*

There are composite and concrete and steel utility poles have been around for a very long time in Europe where they don't have the forests that North America is blessed with, we see more of those materials. In North America, wood is still the most economical and most renewable resource we have. Treating the wood for utility poles extends the life of the pole to somewhere around 23 years on average. So, we've not seen an increase in the use of concrete or steel because of the economic advantage that treated wood has in the United States.

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**Neal Butler** - *KMG Chemicals Inc - President and CEO*

If you look in the rail tie industry, or rail tie demand, the composites, whether they're concrete or other composites -- plastic, rubbers and other things they've tried -- they typically have always maintained about a 10% share of that market, and that's historically been true.

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**Richard O'Reilly** - *Standard & Poor's - Analyst*

Okay, [fine]. My frame of reference is in the Amtrak in the Northeast corridor. They've made an effort of replacing them with concrete over the years, but I didn't know how prevalent that was. Okay. Thank you for your time, gentlemen. I appreciate it.

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**Operator**

Thank you, Richard. We have another question for you gentlemen. Again, from the line of Rosemarie. Please go ahead, Rosemarie. You're back in the call.

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**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Thank you. Just quickly. John, you said that SG&A increased there for consultants' fees related to project costs. Are you starting out on new projects? Could you elaborate a little bit on that?

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**John Sobchak** - *KMG Chemicals Inc - CFO*

Yes, Rosemarie. What I can tell you at this point is, the projects are not related to our existing operations. They are more aligned with what we consider business development and the fulfillment of our strategic objectives. Because of the nature of those costs, we can't provide too much more information at this point.



**Rosemarie Morbelli** - *Gabelli & Co. - Analyst*

Okay. Guess we'll have a [price freeze] at some point. Thank you very much.

**Operator**

Thank you. There's no further questions.

**Neal Butler** - *KMG Chemicals Inc - President and CEO*

Okay, thank you. To all of you, we appreciate your participation today and for your support of KMG. We look forward to speaking with you at our second-quarter conference call. And from the entire KMG team, we wish you a very Merry Christmas and happy holiday season. Thank you.

**Operator**

Thank you, ladies and gentlemen. That concludes your conference call. You may now disconnect. Thank you very much for joining us. Do enjoy the rest of your day today.

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