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KMG - Q2 2013 KMG Chemicals Earnings Conference Call

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Richard O'Reilly *- Analyst*

Daniel Rizzo *Sidoti & Co. - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2013 KMG Chemicals Earnings Conference Call. My name is Lisa, and I'll be your operator for today. At this time all participants are in listen only mode. Later, we will conduct a question and answer session.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Mr. Eric Glover, Investor Relations Manager. Please proceed, sir.

Eric Glover *- KMG Chemicals - Manager - IR*

Thank you, Lisa. Good morning, everyone, and welcome to the KMG Chemicals fiscal 2013 second 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.

Neal Butler *- KMG Chemicals - President, CEO*

Thank you, Eric. Good morning, and again, welcome to KMG's fiscal 2013 second 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 third quarter of 2013 and our outlook for the fiscal 2013 year. After our comments, we'll be happy to answer your questions. Our earnings release was issued this morning, and we plan to file a 10-Q on Tuesday.

The second quarter operating environment was unusually challenging, characterized by a yearend slowdown in semiconductor production and reduced customer demand within our wood treating chemicals segment. Generally speaking, it's unusual for us to experience sales weaknesses in both of our electronic chemicals and wood treating chemicals business within the same quarter, but that's what occurred in the fiscal second period.

Although we had anticipated and expected a short-term decline in global semiconductor manufacturing, the degree of slowdown and production and associated deleveraging of inventories was somewhat greater than what we had forecasted and communicated earlier. This was true in most geometries, including higher technology fabs.

Rail tie treating and pole treating also slowed during the quarter, and sales were adversely impacted by unplanned outages at customer plan sites, but demand has since seen significant signs of recovery. Given these conditions, coupled with the expected demand downturn, we responded quickly and effectively to challenging macroeconomic operating environment, reducing manufacturing expenses, where possible, and continuing to work within our supply chain partners to achieve greater efficiencies.

As a result, we better aligned our cost structure to the temporary reduction in revenues, minimizing the impact of earnings and cash flow. For example, in our electronic chemicals business, we implemented several continual improvement initiatives, including increased utilization of rail freight to reduce supply chain costs for finished goods. We also refined our storage and distribution strategy by relocating certain finished goods inventory to more advantageous geographic locations, minimizing the transport of consignment stock and transporting more inventory by rail to reduce shipping cost.

Within our wood treating chemicals business, we undertook several initiatives that will help maintain our margins and position us to take full advantage of expected volume demand increases in the near future. More specifically, some newly restructured supply contracts, and [recent] targeted pricing actions should begin to benefit our wood treating chemicals business starting in the current third fiscal quarter.

In summary, these actions and others like them undertaken in the second quarter were instrumental in enabling KMG to bolster gross margins and reduce operating costs during a particularly challenging period. We believe these optimization efforts will have a lasting positive impact on our business, especially as improving in market demand drives higher manufacturing and shipment volumes.

With our strong balance sheet and robust acquisition pipeline, we remain well positioned to pursue additional acquisitions or other strategic opportunities to enhance our market leading positions. We are pursuing potential acquisitions in our current businesses, as well as in the establishment of a new platform. By design, our acquisition process is deliberate and disciplined, ensuring that any acquisition we make will satisfy our rigorous strategic and financial criteria.

As we noted last quarter, we have a strong pipeline of opportunities. We are actively pursuing these and are optimistic about our near-term prospects. I'll now turn the call over to John, who will discuss our financial results in greater detail.

John Sobchak - *KMG Chemicals - CFO*

Well, 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 in March of 2012, this former segment is now classified as a discontinued operation. Prior year information has been reclassified to conform to the current series of presentations.

Second quarter sales declined 15%, year over year, to $57 million from $67 million in the same period a year ago. By business segment, electronic chemicals sales declined by 7.8%, year over year, to $35.6 million, and wood treating chemicals sales declined by 25.4% to $21.2 million. These quarter over quarter declines were primarily volume related, as pricing generally was maintained, and average gross margins increased.

Consolidated gross profit for the second quarter of 2013 was $15.7 million, or 27.6% of sales. That compared with gross profit of $17.1 million, or 25.6% of sales, in the second quarter of fiscal 2012. The year over year increase in gross profit margins reflected improved price in the electronic chemicals segment and a reduced percentage of creosote sales in our total revenue mix. As a distributor of creosote (technical difficulty) from $5.8 million, or 8.6% of sales in the year ago period.

Most of our distribution expense is attributable to the electronic chemicals segment, which was a greater percentage of total revenues in the second quarter of fiscal 2013, relative to the year earlier period.

SG&A expenses were $6.6 million, or 11.6% of sales, in the second quarter versus $6.5 million, or 9.6% of sales (technical difficulty) $683,000, primarily involving consulting and other services in advancement of our consolidation strategy. We anticipate these project costs will decline significantly in our fiscal third quarter.

Our consolidated operating income was $3.2 million, down from $4.9 million in last year's second quarter. The year over year decline in operating income was due to lower sales and the associated impact on profitability, as well as additional projects costs, as I mentioned previously.

Diluted earnings per share were $0.14 in the second fiscal quarter of 2013, down from $0.21 in last year's second quarter. Our effective tax rate for the quarter was 39.3%, which actually turned out to be a bit higher than we had earlier anticipated.

Electronic chemicals segment operating margins, after corporate allocations, improved by 30 basis points to 6.8% from 6.5% in the same period last year. The improvement in the electronic (technical difficulty).

We anticipate that segment margins will rebound in our fiscal third quarter, driven primarily by higher manufacturing volumes, but also by targeted pricing actions designed to recapture raw material cost increases. We also look to realize incremental gains in operating efficiency from our ongoing continual improvement program.

Wood treating chemicals segment operating margins, after corporate allocations, were 10.5% in the second fiscal quarter, down from 11.4% in the same period last year. The margin decline reflected lowered sales due to seasonal factors, unexpected shutdowns of customers' wood treating facilities, and competitive pressures from alternative processes and materials in the rail tie treating market.

We anticipate that segment margins will improve in the third fiscal quarter, as sales improve on a seasonal basis and customers' production facilities come back on line, in conjunction with targeted pricing actions that have been implemented. We also continue to work to build and strengthen alliances with strategic market participants.

Our balance sheet remains in excellent shape, with working capital of $52 million and long-term debt of only $22 million, as of January 31, 2013. We have $58 million of availability on our revolving credit facility and $5 million of cash, providing ample resources to help further our consolidation strategy.

Despite the challenging operating environment we experienced in the second quarter, we generated $3.2 million of cash from operating activities, bringing our fiscal year-to-date operating cash flow to $8.6 million. And now, I'll turn the call back to Neal.

Neal Butler - *KMG Chemicals - President, CEO*

Thank you, John. I'll now provide some additional commentary on our outlook for the fiscal third quarter and the fiscal 2013 year. Assuming no major disruptions to the global economy, we anticipate that both our electronic chemicals and wood treating chemicals businesses will strengthen in the second half of fiscal 2013, relative to the first half.

We are encouraged by the sales uptick we've seen in both of these segments in the first part of calendar 2013 and believe an improvement bodes well for our fiscal third quarter.

Regarding our electronic chemicals business, market research suggests global semiconductor production will increase between 4% to 6% on a year over year basis in calendar 2013, as the semiconductor industry rebounds from a disappointing finish to calendar 2012. Given our strong presence in both the US and European markets, we are well positioned to benefit from this projected increase. Already, we are starting to see a recovering demand for our wet process chemicals, driven by rising semiconductor production.

Additionally, we continue to benefit from growing market demand for our high-purity products. As semiconductor processing technology advances and production moves to even finer geometries, the purity requirements of the chemicals [used to edge] and clean silicon wafers continues to increase. KMG is at the forefront of this trend, supplying a range of ultra high pure chemicals that can meet the demanding purity levels required in the world's most advanced semiconductor fabs.

Within our wood treating chemicals business, we look for sales to improve in the third quarter, relative to the fiscal second quarter, as railroad cross ties production is expected to remain high, relative to average historic levels, and utility pole market replenishes inventories, which were depleted during Hurricane Sandy -- or, following Hurricane Sandy. We believe the demand environment for rail tie treating will improve, but anticipate sales will remain somewhat below the levels we saw in the third quarter of 2012.

In addition, as John mentioned earlier, we should begin to see benefit from targeted pricing actions, which have been implemented in this third quarter. Meanwhile, as mentioned, we continue to pursue acquisitions or other strategic opportunities that will enhance our leading positions in our electronic chemicals and wood treating chemicals businesses.

Additionally, as noted in previous calls, a strategic initiative is the establishment of a new platform prior to the end of fiscal 2014. We have nothing specific to announce on this front at present; however, we are assessing solid opportunities in key material additive sectors. While we cannot provide more specific details at this time, we continue to work diligently to identify, evaluate, and close on transactions that will enhance our earnings and cash flow and generate long-term value for KMG shareholders, in line with our growth strategies. And now, I'll turn the call over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Richard O'Reilly. Please proceed

Richard O'Reilly - - *Analyst*

Good morning, gentlemen. Thanks for taking my call. John, when you were talking about the gross margin, you kind of faded out a couple of times, and you were starting to talking about the distribution impact. And can you just repeat that? I think I know where you're going, but I just don't know how big those distribution, as parts of your two segments, are.

John Sobchak - *KMG Chemicals - CFO*

I had mentioned that distribution expenses had increased by a rate of $5.9 million from $5.8 million in the year ago period and most of our distribution expenses attributable to the electronic chemicals segment. That's because in the wood treating chemicals segment, generally, we're selling our product [FOB the plan case]. So, electronic chemicals, as it becomes a bigger portion of the total revenues, ends up increasing the distribution expense as a percentage of sales.

Richard O'Reilly - - *Analyst*

Oh, okay, versus the gross margin. Okay, okay.

John Sobchak - *KMG Chemicals - CFO*

Yes, I'm sorry. I should mention that other companies sometimes include a distribution expense in cost of goods sold. KMG does not; we separate it out as a separate operating expense item.

Richard O'Reilly - - *Analyst*

Fine. Okay, fine. So, we would see it in the growth -- we would see your numbers in the SG&A line versus the gross line. Okay, okay. But you -- do you think -- okay -- do you think the overall impact on the operating margin for the segment works out to be about the same?

John Sobchak - *KMG Chemicals - CFO*

Yes. There is -- in the electronic chemicals, just because of timing of the movement of some products, there can be a small shift in distribution expense from period to period. In general, the distribution expense has been holding, I think, very well. There's been upward pressure from the cost of freight, so trucking costs have increased. The offside -- the offset to that is that our operations teams has been very diligent and effective at driving greater efficiencies into our distribution channel.

Richard O'Reilly - - *Analyst*

Okay. If I can ask a second question on your expectations, longer term, for margins in the electronics business segment -- I know that that includes some unallocated -- the unallocated costs, so -- well, how do you see your margins in that longer term, because I think, in the last few quarters, the wood treatment is -- it's been higher. So, if anything, it -- the sexy business doesn't look like it has the sexy margins.

John Sobchak - *KMG Chemicals - CFO*

The electronic chemicals business actually has more fixed cost overhead, so the facilities are more expensive, and so, because of that, it's more volume sensitive. And we'll see operating leverage through higher volume throughput that will improve margins.

With the expansions that our customers have on their horizon in North America and some additional business that we expect to come our way through these organic growth opportunities, as well as just a recovery from what's been a downturn in the semiconductor production industry, we expect volumes to increase through the fiscal, and, as a result, margins will improve as well.

Richard O'Reilly - - *Analyst*

Okay. Do you ever talk about a long-term goal for margins for the business?

John Sobchak - *KMG Chemicals - CFO*

We have, and frankly, we've kind of exceeded our goal in I think it was the fourth fiscal quarter of 2012. So, there -- we've done well versus what our initial targets were for the business when we first got involved in it.

Richard O'Reilly - - *Analyst*

Right.

John Sobchak - *KMG Chemicals - CFO*

And now, what we're working on is setting new goals and new opportunities through expanded production and organic growth at those facilities.

Richard O'Reilly - - *Analyst*

If I can ask another question on the wood treating -- your customers for the utility pole. What were the nature of their problems, because I would have just thought they would have been wanting to, at least, be running full out?

John Sobchak - *KMG Chemicals - CFO*

Yes. I wish I had greater insight into this. One of the issues, of course, is that there's the ultimate customer of the utilities, and there's thousands of them across the United States. What we have been able to determine is that the inventory of utility poles that are treated and ready to be installed is at a low level. We don't think that there's that serious a concern about it right now, because, for the most part, we're out of the high storm season. We're out of the hurricane season. Most of the poles that we lost this year in the United States were in the Northeast part of the country, as a result of Sandy.

Unfortunately, that's kind of the home turf for our competing product, which is chromate copper arsenate, CCA. However, when it comes time to replace inventories across the country, and during Hurricane Sandy, in the aftermath, utility poles are brought in from all over the country.

Richard O'Reilly - - *Analyst*

Right.

John Sobchak - *KMG Chemicals - CFO*

And so, there are plenty of Penta poles that were installed in the Northeast. There is a Penta pole installed across from my mother's house in Queens, New York.

Richard O'Reilly - - *Analyst*

Probably where I'm in, in New Jersey, too.

John Sobchak - *KMG Chemicals - CFO*

Okay. It was good to see.

Richard O'Reilly - - *Analyst*

Okay.

John Sobchak - *KMG Chemicals - CFO*

So, we are -- we were, frankly, surprised by the downturn we saw around the holiday season in pole treating. We are seeding -- we are seeing now a pickup of that. And why that occurred -- it could be for a number of reasons. Sometimes it's as simple as weather prohibiting the harvesting of the wood for pole treating, because pole treaters don't need to let their wood dry out and cure as long as rail tie treaters do.

Neal Butler - *KMG Chemicals - President, CEO*

Yes, I think there's -- one of the things we did see was it's just what we believe to be a delay in the replenishment. Some of the -- as John said, some of our treaters actually shut down their systems and did maintenance during -- particularly, during the month of December, and part of that was driven by just the lack of available wood or the ability to get into the woods and harvest. And, as a consequence, they shut down and do their maintenance work. So that was a component of it.

But, to his point while ago, we see the replenishment coming back now, and we see the uptick in demand coming back.

Richard O'Reilly - - *Analyst*

Okay, good. Okay, thanks a lot. I took enough time. Thank you, gentlemen.

Neal Butler - *KMG Chemicals - President, CEO*

You're welcome.

John Sobchak - *KMG Chemicals - CFO*

Thank you.

Operator

Your next question comes from the line of Daniel Rizzo.

Daniel Rizzo - *Sidoti & Co. - Analyst*

Hi. Do you think additional pricing action is going to be necessary in the creosote business, or is it more of a wait and see?

John Sobchak - *KMG Chemicals - CFO*

In the creosote business, the issue has been primarily volume related. So, there's been tensions in the marketplace between the supply side of the equation and the demand side of the equation, due to, generally speaking, higher energy prices and what the industry is now coining as carbon inflation. But, for the most part, there's been some stability there. We've seen some erosion of prices in certain areas. As a whole, we've been able to maintain the profitability of the segments fairly well.

Daniel Rizzo - *Sidoti & Co. - Analyst*

Okay. Thank you, guys.

Neal Butler - *KMG Chemicals - President, CEO*

Yes, Dan, I think, just one -- just as a bit of a caveat, the impact in creosote has been a consequence of the demand environment issue. It has been a slowdown in just actual shipments in demand.

Daniel Rizzo - *Sidoti & Co. - Analyst*

So that would -- do we expect it to pick back up as the summer rolls in?

Neal Butler - *KMG Chemicals - President, CEO*

Yes.

John Sobchak - *KMG Chemicals - CFO*

There's one thing I would like to point out, and I'm glad you kind of bring some of this up, is the impact of borate dual treatments that we've been watching very closely over the last several quarters. We had anticipated that there would be some erosion in the demand for creosote, because of this process. We weren't expecting it to be as widely accepted as it has been, and while certain industry trade groups do not support the reduction of creosote usage per tie, that, in fact, is what is happening in the industry, and it caught us a bit by surprise.

At this point, we are looking at it as a structural change to the industry -- how wood is being treated, and we're working to reposition ourselves in the business, given the current market realities.

Daniel Rizzo - *Sidoti & Co. - Analyst*

Okay. All right. Thank you, guys.

Operator

There are no additional questions at this time. I would now like to turn the presentation back over to management.

Neal Butler - *KMG Chemicals - President, CEO*

To all of you, we sincerely appreciate your participation today. We thank you for your support of KMG. We look forward to speaking you in our third quarter conference call, and with that, I bid you all a goodbye. Thank you.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.
