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KMG - Q3 2013 KMG Chemicals Earnings Conference Call

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## CORPORATE PARTICIPANTS

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**Neal Butler** *KMG Chemicals Inc. - President, CEO*

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## CONFERENCE CALL PARTICIPANTS

**Rosemarie Morbelli** *Gabelli & Company, Inc. - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the Quarter Three KMG Chemicals Earnings Conference Call. My name is [Julianne], and 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, this call is being recorded for replay purposes. I would now like to turn the call over to Mr. Eric Glover, Investor Relations Manager.

Please proceed, sir.

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

Thank you, Julianne.

Good morning, everyone, and welcome to the KMG Chemicals Inc.'s Fiscal 2013 Third 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, CEO*

Thank you, Eric.

Good morning, and welcome to KMG's Fiscal 2013 Third Quarter Conference Call. John Sobchak and I will take you through the financials and provide an overview of each of our businesses.

We'll then discuss our expectations for the fiscal fourth quarter of 2013. After our comments, we'll be happy to answer your questions. Our earnings release was issued this morning and we plan to file our 10-Q later today.

Before turning to our third quarter financial results, I'd like to start by saying how pleased we are to welcome OM Group's accomplished team to KMG. As you recall, on April 29, we announced our intention to acquire OMG's Ultra Pure Chemicals business. I'm very pleased to report that we accomplished that acquisition on June 1st.

This purchase marks KMG's third acquisition in the Electronic Chemicals market since we bought Air Products' high-purity process chemicals business in 2008.

The addition of OMG's Ultra Pure Chemicals business, which generated calendar 2012 sales of $93.8 million, substantially advances KMG's consolidation strategy in the Electronic Chemicals market, as KMG is now the world's leading supplier of high-purity process chemicals to the global semiconductor industry.

While the product portfolio acquired matches extremely well with our existing product offering, the acquisition did provide certain interesting new product extensions, expand our customer and geographic base, and increased our technical and production capabilities.

Our electronic Chemicals business now spans three continents, with advanced facilities in North America, Europe, and Asia. We're able to provide semiconductor manufacturers worldwide with the broadest portfolio of high-purity process chemicals business in the industry.

As semiconductor manufacturing technology gains complexity and requires ever higher levels of chemical purity KMG is ideally positioned in this market.

We're a vertically integrated manufacturer, dedicated to meeting the stringent requirements set by semiconductor and other technology customers who require the coherent manufacturing, analytical, and packaging capabilities of a single global supplier.

The addition of OMG's Ultra Pure Chemicals business offers us several compelling strategic advantages and opportunities for growth; first, Europe remains an important market for KMG, and OMG's European operations were a main driver behind our motivation to acquire this business.

For example, OMG's European assets will expand our product portfolio in Europe, giving us new opportunities and capability to supply key chemicals such as ammonium hydroxide, ammonium fluoride, sulfuric acid, hydrochloric acid, and nitric acid.

Second, OMG's four European facilities, including one site in U.K. and three in France, will enable us to better serve customers not only in Europe but also in Israel and Asia.

Third, OMG's French production capabilities and facilities provide us the ability to provide additional capacity and backup to some of our critical operations in North America.

Finally, OMG maintains a strong presence in Singapore, serving major semiconductor customers on the island nation from its two distribution centers. Although we had previously sold a limited amount of material into Asia, our new physical presence in Singapore significantly increases our exposure to this fast-growing market for semiconductor manufacturing.

We're now beginning the integration process and assessing the opportunities to enhance logistical efficiencies and optimize the supply chain. This will be an ongoing process, involving input from both KMG and former OMG team members.

While it remains early to discuss details related to potential synergies, we are confident that the combination of KMG's and OMG's Electronic Chemicals businesses offers attractive opportunities to realize operating efficiencies and cost savings. We have formed international integration teams who are specifically reviewing synergy opportunities and developing associated plans.

Turning to our third quarter financial results. We reported diluted earnings per share of $0.25. This was somewhat ahead of our expectations for the period. While the operating environment remained challenging, we're slowly rebounding demand. We're encouraged to see sales volume strengthen in both our Electronic Chemicals and Wood Treating Chemicals businesses, particularly in the latter 2 months of the quarter.

The demand trend improvement we experienced raises our confidence that KMG's businesses are on a recovery track, with further sales volumes improvement in both of our business segments anticipated in the fiscal fourth quarter.

I'll now turn the call over to John for a more detailed review of our third quarter results and further information on our recently completed acquisition.

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

Thank you, Neal.

And good morning, everyone. The third quarter sales declined 10% year-over-year to $59.9 million from $66.6 million in the same period a year ago.

By business segment, Electronic Chemicals sales declined by 7.8% year-over-year to $36.3 million, and Wood Treating Chemicals sales declined by 13.4% to $23.5 million. These quarter-over-quarter declines were primarily volume-related, reflecting reduced customer demand in each of our business segments.

Consolidated gross profit for the third quarter of 2013 was $16.3 million or 27.3% of sales; that compared with gross profit of $20.6 million or 30.9% of sales in the third quarter of fiscal 2012.

The year-over-year decrease in gross profit margins reflected lower sales and throughput volumes in both our Electronic Chemicals and Wood Treating Chemicals businesses.

Distribution expenses decreased to $6.4 million or 10.7% of sales from $7.4 million or 11.1% of sales in the year-ago period. The reduction in distribution expense was attributable to reduced Electronic Chemicals volume shift as well as a reduction in inventory adjustments and other related costs.

SG&A expenses were $5.6 million or 9.3% of sales in the third quarter; versus $6.3 million or 9.5% of sales in last year's third quarter. While SG&A expenses fell slightly as a percentage of total revenue on a year-over-year basis, SG&A dollars declined approximately $1 million from the $6.6 million reported in the second fiscal quarter of 2013. The sequential decrease in SG&A dollars reflected a reduction in acquisition transaction expenses.

Most of the spending on due diligence, financing, and transaction costs related to our most recent acquisition occurred in the first half of the fiscal year. We estimate there will be about $400,000 in transaction-related costs during Q4 as well as transition and integration-related spending, which will total to something over $1 million in the fourth quarter.

This transaction was more complex than normal because it included seven facilities that spanned across four countries, increasing our due diligence and transaction costs relative to our previous acquisitions in the segment.

Consolidated operating income was $4.4 million, down from $6.9 million in last year's third quarter. The year-over-year decline in operating income was due to lower sales volumes and the associated impact on profitability.

Diluted earnings per share were $0.25 in the third fiscal quarter of 2013, down from $0.34 in last year's third quarter. Our overall tax rate for the quarter, at 26.2%, was lower than we had anticipated due to certain discrete adjustments. We expect a more normalized tax rate of approximately 36% for our fourth fiscal quarter.

Electronic Chemicals' segment operating margins after corporate allocations declined by 170 basis points to 8.2% from 9.9% in the same period last year, due primarily to lower manufacturing volumes which reduced operating leverage.

However, Electronic Chemicals' segment operating margins improved by 138 basis points from the fiscal second quarter of 2013, driven primarily by sequential improvement in manufacturing volumes, as well as the benefits from implemented cost saving measures.

Wood Treating Chemicals' segment operating margins after corporate allocations were 10.8% in the third fiscal quarter, down from 14.5% in the same period last year. The margin decline was attributable to lower sales volumes due to competitive pressures from alternative processes and materials in the rail tie treating market.

Relative to the second quarter of fiscal 2013 however, Wood Treating Chemicals' segment operating margins improved by 34 basis points benefiting from strengthening market fundamentals and the resumption of production at certain customers' wood treating facilities.

Now before I hand the call back to Neal for his comments on our fourth quarter outlook, I'd like to provide some additional detail regarding KMG's acquisition of OMG's Ultra Pure Chemicals business. Since the acquisition closed on June 1, OMG results will be incorporated to KMG's financial statements from that point forward.

As a result, our fourth fiscal quarter, which ends July 31, 2013, will include KMG's standalone results for the month of May, plus combined KMG financial results including the acquisition for the months of June and July.

The purchase price for OMG's Ultra Pure Chemicals business was $63.3 million in cash, which included approximately $17.3 million for working capital and $46 million for the long-lived assets.

Based on its historical performance, as well as our experience in the industry, we estimate that the business would require an average of $14 million in working capital to operate.

Prior to closing, working capital in the acquired business expanded by $3.3 million, primarily due to the acceleration of payments for certain accounts payable and an increase in inventory.

The closing price was adjusted by that amount according to the purchase agreement, but we anticipate that working capital increase reverting back to cash for KMG in fairly short order.

We funded the acquisition by borrowing on the revolving loan under our amended credit facility. That facility was amended in April to increase the maximum borrowing capacity to $110 million and to include an accordion feature that allows for an expansion of up to $135 million in capacity.

Currently, the amount borrowed on the revolving loan is $67 million. Advances under the revolving loan bear interest at a varying rate of LIBOR plus a margin based on our funded debt-to-EBITDA ratio. Currently, we're paying an interest rate of about 1.7% on our revolver borrowings.

In addition to the $67 million balance on the revolver, we have $20 million in non-amortizing seven-year notes that mature in December 2014.

As Neal noted earlier, OMG's Ultra Pure Chemicals business recorded revenues of $93.8 million in calendar 2012. Of this amount, approximately 45% was generated in Europe and approximately 45% in Asia, with the remainder generated in the US.

Over the past 3 years, the business produced average annual EBITDA of approximately $9.8 million. That 3 months average EBITDA was reduced by the downturn the home market experienced in 2012, and what we estimate was about $1 million of annual spending to develop product expansion that are just beginning to generate sales. We will file an 8-K containing audited financial information on the acquired business by mid-August.

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

**Neal Butler** - *KMG Chemicals Inc. - President, CEO*

Thank you, John.

I would like to provide some commentary on our outlook for the fiscal fourth quarter. Within both our Electronic Chemicals and Wood Treating Chemicals businesses, we anticipate we will see further improvement in the fourth quarter relative to the third quarter of fiscal 2013.

As I mentioned earlier, we're encouraged by the sales uptick we've seen in both of these segments and anticipate those trends will continue into our fourth quarter.

Global semiconductor production is slowly but steadily increasing as the inventory correction that started in the second half of the calendar 2012, appears to be nearing its end.

With our strong market presence in North America and our newly enhanced positions in Europe and Asia, we are particularly well-positioned to benefit from a more favorable operating environment.

Within our Wood Treating Chemicals business, we expect sales to improve in the fourth quarter relative to the fiscal third quarter as railroad crosstie production is expected to remain high relative to average historic levels and demand within the utility pole market has indications of improving further. As a result, operating profits are expected to improve as compared to the level reported in our third fiscal quarter of 2013.

We expect our fourth fiscal quarter diluted EPS to be slightly improved over the $0.25 per diluted share we reported in the third quarter of fiscal 2013, after taking into consideration over $1 million of closing and integration costs anticipated to be recognized in the fourth fiscal quarter.

While we work diligently to integrate OMG's businesses into KMG's Electronic Chemicals segment, we continue to pursue acquisitions or other strategic opportunities that will enhance our leading position in our Electronic Chemicals and Wood Treating Chemicals businesses.

We had previously targeted fiscal 2014 for the acquisition of a new platform segment. That timing was based on our acquisition pipeline of our two existing business segments.

There were several promising new platform opportunities that we were diligently pursuing during fiscal 2013, which did not work out for a variety of reasons. In the meantime, we've discovered more potentially attractive opportunities within our two existing segments.

For both of these reasons, the timing for the need to add a new platform to meet our long-term growth objectives is now extended to calendar 2015. As always, we evaluate potential acquisitions judiciously to ensure that any transaction we close will enhance our earnings and cash flow and generate long-term value for KMG shareholders in line with our growth objectives.

In closing, we're excited to merge OMG's talented team with ours. In the last 2 weeks, I personally met with most of the former OMG team members and have visited the sites in Singapore, and the UK and France. These modern facilities, coupled with our experienced and skilled teams, significantly enhance our position in all global semiconductor markets.

We see significant strategic value and opportunities for growth from this transaction, and we're optimistic about our future as KMG provides global leadership in high-purity process chemicals markets.

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

## QUESTIONS AND ANSWERS

**Operator**

Thank you. (Operator Instructions)

Your first question comes from the line of Rosemarie Morbelli, Gabelli & Company. Please proceed.

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**Rosemarie Morbelli** - *Gabelli & Company, Inc. - Analyst*

Good morning, all.

When we look at the Electronics business, after combining several acquisitions last year, the margin hit about 14.2% -- no, sorry, I'm looking at the wrong data here, it is wood. Electronics hit about -- reached about 12.8% in the first quarter of this year. And obviously, at the onset -- or maybe not obviously -- the new acquisition is going to lower your overall margin.

So if you put together the work that you have done previously -- and I am assuming that the 12.8% is kind of close to the maximum that you can achieve on your existing Electronic Chemicals business -- what do you think of a period of 1 year the Ultra Pure business from OM Group can do to your margin? Are we going to be lower than the 12.8%? Can it be higher? Could you give us a better feel as to what the impact, again after 1 year, considering that the integration is done at that particular point?

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

Rosemarie, your good assessment about our margins -- we think that 12.8% was, after corporate allocations, was a good margin for the business. The, call it 50% of the business that's in the western hemisphere, we think could achieve those kind of margins with the OMG transaction after completing our integration process.

The, call it $45 million of business that's centered in Singapore, is actually primarily a distribution business. There's no significant manufacturing business in Singapore at the present. That business is mostly what we call total chemical management.

It's supplying, through our warehouse facilities, the fabricating -- the semiconductor fabs in Singapore with materials that's both from KMG and also from other manufacturers. And it comes with a slightly lower margin, as a result, also. So we would expect that the margins will be somewhat diluted by that -- 20% or so of revenues.

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**Rosemarie Morbelli** - *Gabelli & Company, Inc. - Analyst*

When you say slightly lower, I mean, isn't it -- I mean, the distribution business doesn't have much of a margin. So are we looking at that particular piece of the business having, I mean, not slightly dilutive but a major drag with the margins about half of what your other businesses are? Or am I too sanguine when it comes to that?

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

I think you might be looking at it a bit pessimistically. There's actually a fair amount of technical support that goes along with that business.

Although it doesn't have much in the way of manufacturing capabilities in Singapore, there's actually extensive testing capabilities at that facility, and so there's a fair amount of tech service that adds value to the business there.

That's the kind of business where we would expect more towards the upper single-digit numbers for operating margins versus the margins we would expect to see in the rest of the businesses.

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**Rosemarie Morbelli** - *Gabelli & Company, Inc. - Analyst*

Okay. And if I may ask one last question on that subject. How long do you think it will take you to figure out how much synergies, how many plants do you need? I am presuming that you don't need three plants in France plus yours.

And -- if you have one, and I think you do. And so once you have figured out what the potential synergies are, how long before you can actually -- we see them affecting the bottom line?

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

Yes. So we actually spent a fair amount of time preparing for this analysis prior to closing the acquisition, although because we are toe-to-toe competitors, we didn't have access to plenty of the information to be able to -- or the people to be able to begin the analysis.

We think the analysis of optimizing our manufacturing plant for Europe is going to take four to six months, and implementation of the plan would take closer to a year. But certainly through -- by the completion of fiscal 2014, we would expect to have most of that behind us.

Rosemarie, though, I do want to say we have this continual improvement program that's been very effective for KMG, and what we've seen is that it continues to bear fruit after the major milestones are completed for integration projects.

So we're hoping to be able to continue to reap benefits from our continual improvement program throughout the organization for the next 24 months.

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**Neal Butler** - *KMG Chemicals Inc. - President, CEO*

And Rosemarie, if I may expand just a little bit, one of the things that we've done during the process of just basically developing function capabilities in terms of the consolidation and integration being a key element of that, we have a pretty robust process going forward now.

We, in essence, have 15 different integration teams. These 15 integration teams are populated by KMG and OMG personnel. And one of the things that they're targeted with was assessing synergy opportunities and then developing associated plans and timelines to implement those.

So the entire organization is focused on not only integrating the business but ensuring that we maintain current levels of business, and there's continuity in the business that we're doing today, but also specifically looking at these integration opportunities, and I'll say that's a pretty robust process.

I know that I've met several times just with several of the team members in Singapore and in Europe over the last couple of weeks, and they're very involved in developing some pretty comprehensive synergy plans right now. So it's a key focus for us.

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**Rosemarie Morbelli** - *Gabelli & Company, Inc. - Analyst*

Neal, could you share with us a range of potential synergies that you are seeing? Obviously, we would not hold you to it, but could you give us at the low end and at the high end what you think can be accomplished?

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**Neal Butler** - *KMG Chemicals Inc. - President, CEO*

Rosemarie, it's way too early to do that. I mean, it would just be a shot in the dark, and I really think it would be unfair to do that because we're not just to the point where we can provide that kind of view forward on the actual synergy numbers.

Suffice it to say that we're very convinced, our synergies we've identified some initially -- we've identified some synergies as a team -- coming up with synergies as well. But the quantification of that right now is just it's very difficult to try to communicate what we think that is today.

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**Rosemarie Morbelli** - *Gabelli & Company, Inc. - Analyst*

Okay. I appreciate it. Thank you.

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**Operator**

Thank you.

Sir, you have no questions at this time.

(Operator Instructions).

We have no questions at this time.

(Operator Instructions).

We have no further questions. I would now like to turn the call over to Neal Butler for closing remarks.

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**Neal Butler** - *KMG Chemicals Inc. - President, CEO*

Well, we sincerely appreciate your participation today and also for your support of KMG. We look very forward to speaking to you in our fourth quarter conference call, and we'll share obviously more details about the OMG-KMG integration at that time.

So with that, I thank all of you.

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**Operator**

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.

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