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KMG - Q4 2013 KMG Chemicals Earnings Conference Call

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CORPORATE PARTICIPANTS

Eric Glover *KMG Chemicals - Manager - IR*

Chris Fraser *KMG Chemicals - President, CEO*

John Sobchak *KMG Chemicals - CFO*

CONFERENCE CALL PARTICIPANTS

Jay Harris *Goldsmith & Harris - Analyst*

Daniel Rizzo *Sidoti & Company - Analyst*

Richard O'Riley *Revere Associates - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Fourth Quarter 2013 KMG Chemicals Earnings Conference Call. My name is Dominique, and I'll be your operator for today.

At this time, all participants are in a listen-only mode. Later we will conduct a question and answer session.

(Operator Instructions)

I would now like to turn the conference over to Mr. Eric Glover, Investor Relations Manager. Please proceed.

Eric Glover - *KMG Chemicals - Manager - IR*

Thank you, Dominique. Good morning, everyone, and welcome to the KMG Chemicals, Inc., fiscal 2013 fourth quarter financial results conference call. I'm joined today by Chris Fraser, 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 Chris Fraser, President and CEO. Please go ahead, Chris.

Chris Fraser - *KMG Chemicals - President, CEO*

Thank you, Eric. Good morning, everyone. It's a pleasure to be speaking with you today. I hope to meet many of you in person in the upcoming years. It's an exciting time for KMG, and I'm truly honored to have the opportunity to lead KMG's next phase of growth.

Over the past four months, I've had the opportunity to visit many of our customers, suppliers, and employees across the globe. Our conversations have been instructive, providing me invaluable insight into KMG's operations, our challenges, and our future growth opportunities. I come away from these meetings with an even stronger optimism about KMG's potential, and I look forward to sharing with you our progress in the years ahead.

For those of you who may not be familiar with my background, I've been a member of KMG's board of directors since 2008, and was elected chairman of the board this past December. I come to KMG with more than 30 years of experience in the chemicals industry where, as CEO of two companies, I focused on driving top-line growth both organically and through acquisitions, optimizing business performance, and maximizing cash flow.

I bring that same focus and energy to KMG, which has grown impressively over the past several years. Our most recent acquisition that we completed in June fundamentally increased the scale and complexity of our global operations, doubling the number of our employees as well as the number of countries that we operate in.

I'm currently in the process of reviewing all aspects of our business to ensure that our information system, organizational structure, market positioning, and business level strategy are appropriate not only for where are today, but where we intend to be in five years and beyond. KMG is fortunate to have dedicated employees to help drive our company forward, and I'm excited to be part of that team.

As I reflect on this past year, I want to be clear. Our fiscal 2013 financial results did not meet our expectations. And thus, our focus on execution and operational efficiency will intensify to ensure that we achieve our full growth potential. KMG's core strategy is sound. We will manage our operations as smartly and efficiently as possible, while pursuing select acquisitions that enhance shareholder value.

Along those lines, one of our key initiatives in fiscal 2014 is the implementation of a new enterprise resource planning, or ERP, system. As a global supplier with operations in three continents, and as a strategic partner of many top semiconductor manufacturers, we recognize that access to integrated real time information across our entire business is essential.

I'm confident that once the ERP system is in place, it will be a vital tool to better manage our global operations, streamline our internal processes, and enhance our decision-making capabilities.

Before we review the fourth quarter and full year financial results, I'd like to offer my assessment of KMG's business and provide some information around our restructuring plan for our global electronic chemicals business.

Our wood-treating chemicals business, which constitutes about 30% of our total revenue, has experienced uneven performance over the past year, as many Class I railroads specified reduced creosote retention in wood railroad ties. In response, we have continued to optimize our cash flow within the business, while promoting the value and proven efficacy of a full charge of creosote in railroad ties.

Meanwhile, our Penta business remains a strong performer, benefitting from growing market demand for utility poles, particularly from western US utilities which are in the midst of a multi-year upgrade of their distribution infrastructure.

Looking ahead, while results in our wood-treating chemical business will continue to experience its usual quarter-to-quarter fluctuations due to seasonal trends, financial performance should be less variable in fiscal 2014, as many Class I railroads have already shifted toward borate treatment for railroad ties.

However, we acknowledge that additional railroads may adopt borate treatments going forward. Our focus remains firmly on maximizing cash flow from our wood-treating chemicals business, which remains an important contributor to our overall financial performance.

Recently, we provided an update on the treatment of Penta, which is under review as a Persistent Organic Pollutant, or POP, in the Stockholm Convention. As we commented earlier this week, we disagree with the POP committee's recent recommendation that Penta be moved to the next stage of the POPs listing process, as the available scientific data is insufficient to conclude that Penta meets the listing requirements for POP.

Because the United States has not ratified the Stockholm Convention, these developments concerning Penta have no immediate direct regulatory impact on KMG. I also want to emphasize that Penta remains a registered pesticide with the EPA, and will continue to be used as an effective treatment for wood utility poles and cross arms.

Now, turning to our electronic chemicals business, which now represents approximately 70% of our revenue following our recent acquisitions, KMG is the largest and only global supplier of high purity process chemicals to the semiconductor industry, and our manufacturing and distribution assets are second to none.

As the semiconductor manufacturing industry continues to consolidate, semiconductor manufacturers are looking for supplier partners with global scale, unfailing reliability, and the capability to meet increasingly stringent requirements for chemical purity.

With our recent acquisition, KMG fits that profile perfectly, and consequently is a Tier 1 or strategic partner to many of the world's largest and most technologically sophisticated semiconductor manufacturers. Our relationship with these strategic customers will afford us organic growth opportunities, and we will continue to work closely with them to ensure that our products meet their evolving needs given the rapid technological change in the semiconductor industry.

One of our key growth initiatives is the positioning of our electronic chemicals business to more fully participate in the mobile semiconductor space, where growth is outpacing the traditional PC and server markets. KMG's high purity process chemicals are ideally suited for leading edge mobile semiconductor manufacturing, and we see a meaningful opportunity to increase our presence in this segment going forward.

Our top priority in fiscal 2014 is the integration of OM Group's Ultra Purity Chemicals operations into our global electronic chemicals business. This plan, developed by a cross-functional team consisting of long-term employees and those that joined us with the acquisition, our restructuring plan involves the consolidation of manufacturing operations and optimization of our electronic chemical supply chains.

As we recently indicated, our first step in this effort is to move production from our Fremont, California, site primarily to our larger US manufacturing facilities in Hollister, California, and Pueblo, Colorado. Given the relatively small size and limited production of the Fremont site, we determined it is more efficient for us to produce and distribute these products from alternate manufacturing locations.

We anticipate that production from our Fremont site will wind down in the next four to five months, with decommissioning and other shutdown steps largely being completed by fiscal year-end.

We are also reviewing other opportunities to reconfigure our global electronics chemicals operations, which include six manufacturing and distribution sites across Europe and Asia. In light of current industry production capacity for high purity process chemicals, we intend to optimize our global manufacturing footprint to better match market demand.

Due to the estimated 18 month timeline for the restructuring of our global electronic chemicals operation, as well as its associated costs, we anticipate only modest net income growth in our fiscal 2014 year. Beyond 2014, however, we expect that the financial benefits arising from this restructuring will ramp up during fiscal 2015 and become fully realized in our fiscal 2016 year.

John Sobchak, our CFO, will provide more specific financial guidance regarding our planned restructuring program and outlook for 2014.

While we remain keenly focused on optimizing our current businesses, we also continue to evaluate a wide range of potential acquisition opportunities, including those that would complement our existing businesses as well as those that would establish a new growth platform. Although our acquisition pipeline remains robust, we remain diligent and patient in our approach to acquisitions, only pursuing those that meet our financial and strategic criteria.

In closing, I'm honored to have the opportunity to lead KMG. We have exciting growth opportunities in front of us, and I'm confident that we can execute our plans and realize our full earnings potential.

I will now turn the call over to John to review our fourth quarter and fiscal 2013 financials.

John Sobchak - *KMG Chemicals - CFO*

Thank you, Chris, and good morning, everyone. As shown in today's earnings release, KMG is publishing non-GAAP financial data as well as the appropriate reconciliation to GAAP, to more comprehensively present and summarize the company's overall financial performance.

As we incur quarterly expenses related to the integration of our recent acquisition, we intend to continue to provide the investment community with similar non-GAAP financial data and the appropriate reconciliation to GAAP. In our commentary we distinguish non-GAAP financial data from GAAP results by our use of the term "adjusted" which excludes various non-operating or non-recurring expenses.

As previously disclosed on October 14th, we filed for an extension for our 10-K filing to provide sufficient time to comprehensively complete the audit of our fiscal 2013 results, which includes the acquisition of OM Group's UPC business. That acquisition closed two months before the end of our fiscal year, and added seven facilities in three new countries, operated on four separate accounting systems, using four different functional currencies.

And I want to take this opportunity to thank our newest colleagues that are running our financial operations in England, France, and Singapore, for their exceptional effort over the last four months, and also especially our controllers and accounting staff in Houston for a job well done.

Now, let's move to our results. Fourth fiscal quarter net sales were $81.1 million, up 19.9% from last year's fourth quarter's levels of $67.6 million. Fourth quarter sales improved primarily due to the recent acquisition of OM Group's UPC business, but also benefitted from growth within our wood-treating chemicals business.

Electronic chemical sales were $54.3 million in the fourth quarter, up 26% year-over-year. It is through the contribution from the UPC acquisition fourth quarter electronic chemical sales increased sequentially by 5.4% relative to the third fiscal quarter of 2013. That was aided by rising global semiconductor production.

Fourth quarter wood-treating chemical sales were $26.8 million, up 10% year-over-year. The gain in wood-treating chemical sales is due to increased shipments into the rail tie treating market.

Consolidated adjusted operating profit in the fourth quarter was $5.3 million or 6.5% of sales, compared to $6.7 million or 9.9% of sales in last year's fourth quarter. Adjusted operating profit excludes acquisition and integration expenses of approximately $1.2 million incurred during the fourth quarter, and approximately $1.5 million of CEO transition expenses.

Including these expenses, GAAP operating profits in the quarter was $2.5 million or 3.1% of sales. The decline in operating profit margins from 9.9% in last year's fourth quarter to an adjusted level of 6.5% in the fourth quarter of fiscal 2013 was primarily due to a less favorable product mix and our higher operating expense structure in the UPC business relative to our current electronic chemicals business.

We have found that distribution expense as a percent of sales historically has been significantly higher for a newly acquired electronic chemicals business as compared to our existing electronic chemicals business. As a result, this is typically an area that we have focused significant attention for synergy capture and have seen much success in the past.

Fourth quarter GAAP diluted earnings per share was six cents, and adjusted diluted earnings per share was 28 cents, versus GAAP diluted earnings per share of $0.33 in last year's fourth quarter.

In addition to the acquisition, integration, and CEO transition expenses previously discussed, earnings per share was adversely impacted by an increase to tax expense of $682,000 associated with the requirement to capitalize for tax purposes all of the previously incurred transaction expenses associated with the UPC acquisition.

Turning to our fiscal 2013 full year results, net sales decreased 3.4% to $263.3 million from $272.7 million in fiscal 2012. The sales decline reflected lower sales in our wood-treating chemicals business which was partially offset by improved sales in our electronic chemical segment, due to the addition of the UPC business, which closed on May 31st.

Fiscal 2013 adjusted profit -- operating profit, which excludes acquisition and integration and CEO transition expenses, was $21.3 million or 8.1% of sales, down from $25.4 million or 9.3% of sales in fiscal 2012. The decline in adjusted operating profit was due to reduced profitability in our wood-treating chemicals segment.

For the 2013 year, wood-treating chemicals segment operating profit was $10.5 million, down from $15.6 million in fiscal 2012. Although industry demand for wooden railroad ties remains solid, our wood-treating chemicals business faced difficult marketing conditions as many Class I railroads specified reduced creosote use in rail ties, decreasing our volume-sensitive market. Additionally, we experienced a less favorable product mix in this segment.

Electronic chemicals segment adjusted operating profits for the fiscal 2013 year was $14.6 million or 8.8% of sales, up from $13.4 million or 8.4% of sales in the prior year. Adjusted operating profit excludes approximately $577,000 in integration expenses related to the UPC acquisition. Electronic chemicals GAAP operating profit of $14 million increased by approximately $600,000 or 4.5% from fiscal 2012, primarily due to the UPC acquisition.

Adjusted diluted earnings per share was $1.11 in fiscal 2013, and that was down from $1.20 in fiscal 2012. Adjusted diluted earnings per share excludes approximately $3.5 million in acquisition, integration, and CEO transition expenses, or $0.30 per diluted share. On a GAAP basis, fiscal 2013 diluted EPS was $0.81.

I'd like to now provide more detail on our outlook for the first fiscal quarter in fiscal 2014 year. As Chris discussed, we're examining options to reconfigure our electronic chemicals manufacturing operation, to improve operating efficiencies and optimize our global manufacturing footprint.

As we integrate the UPC business into our operations, we anticipate fiscal 2014 will be a transition year in terms of our overall financial performance. More specifically, we project consolidated fiscal 2014 net sales will exceed $350 million, rising significantly from fiscal 2013, primarily due to the addition of sales from the UPC business which should generate approximately $95 million in annual sales.

However, we anticipate flat to modest net income growth on a GAAP basis, as we incur costs to reconfigure our global electronic chemicals manufacturing operations which, as previously announced, includes the shifting of production from our Fremont, California, site primarily to our larger facilities in the United States.

As we move forward with our manufacturing realignment plan in fiscal 2014, we project one-time charges of $4.5 million for the year, partially offset by incremental benefits of $2 million to $3 million during the year from restructuring related benefits.

I would like to note here that the projected costs and benefits of this restructuring program include the Fremont site closure as well as our expectation that additional manufacturing realignment initiatives will be implemented.

Once completed in fiscal 2015, this restructuring is expected to generate annualized benefits of $6 to $8 million per year for our electronic chemical segment, excluding one-time projected restructuring charges of $7 million to $9 million on a cumulative basis over fiscal 2014 and fiscal 2015. In addition, we intend to spend an incremental $2 million of capital expenditures, primarily in fiscal 2014, to accomplish these plans.

Now, looking specifically at our first quarter, we anticipate sales within our electronic chemicals business will rise sequentially, given a full quarter's worth of contribution from the recently acquired UPC business. Electronic chemicals segment first quarter operating profits are expected to increase from the prior quarter, benefiting from a full three months of UPC revenue.

Within our wood-treating chemicals business, first quarter operating profits should be consistent with those reported in our fourth fiscal quarter, aided by a favorable seasonal trend. However, increased overhead charges related to the expansion of our business, such as for additional accounting, tax, and administrative services, will likely cause consolidated first quarter earnings to fall below fourth quarter earnings as adjusted.

Overall, we project first quarter GAAP diluted earnings per share, including restructuring and other unusual charges, will be $0.13 to $0.16. Adjusted non-GAAP fiscal first quarter diluted earnings per share, which excludes restructuring integration charges, as well as CEO transition-related expenses, are projected to be $0.22 to $0.25.

For the fiscal 2014 year, we anticipate global semiconductor industry production will increase moderately over fiscal 2013, with production progressively improving over the course of this year. While laptop and desktop chip markets remain sluggish, mobile computing and markets for other chip applications are experiencing growth.

In our wood-treating chemicals business, we expect continued steady market demand for wood railroad ties and improving demand for utility poles as western US based utilities upgrade their distribution infrastructure. And now, we'll take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And please stand by for your first question. And your first question comes from the line of Jay Harris of Goldsmith & Harris.

Jay Harris - *Goldsmith & Harris - Analyst*

Good morning. Thanks for taking my question. Could you go back in to the quarter, and how much of the $54.3 million of electronic chemical revenues were acquired?

John Sobchak - *KMG Chemicals - CFO*

Good morning, Jay. And the -- I'm sorry. Give me a second, please. Approximately $16 million of the $54 million in fourth quarter revenues in electronic chemical segment was acquired with the UPC acquisition.

Jay Harris - *Goldsmith & Harris - Analyst*

So that would be $38 million from -- I'm sorry. I can't do the math. Thirty-eight million from pre-acquisition assets, compared to $43 million in fiscal 2012.

John Sobchak - *KMG Chemicals - CFO*

Yeah, it's about $38.3 million in the fourth quarter of '13. And you're right, about $43.1 in the fourth quarter of '12.

Jay Harris - *Goldsmith & Harris - Analyst*

All right. And how -- what do you ascribe that decline to?

John Sobchak - *KMG Chemicals - CFO*

Primarily the weakness in the laptop/desktop/server markets. We have been heavily weighted towards those markets in terms of the customers we serve.

And as Chris has noted on previous disclosures, one of our strategic initiatives is to expand our exposure to the mobile computing market and other applications. And frankly, this recent acquisition of the UPC business does do that. In fact, they have greater exposure outside of the desktop/laptop/server market.

Jay Harris - *Goldsmith & Harris - Analyst*

And what -- what did the UPC business do over the trailing 12 month period versus their prior year?

John Sobchak - *KMG Chemicals - CFO*

Over the trailing 12-month period.

Jay Harris - *Goldsmith & Harris - Analyst*

In other words, how -- what was the change in the performance of the business you've just acquired?

John Sobchak - *KMG Chemicals - CFO*

Well, you know, there's been a slowdown in Europe. And off the top of my head, Jay, they have experienced a slowdown during the last 12 months. They have been on a bit of an upturn. We have published three years of historical performance for that acquisition in our most recent 8-K filing that I could refer you to.

Jay Harris - *Goldsmith & Harris - Analyst*

Well, I was hoping you could give me the numbers so I didn't have to do a search. So -- and, so, what do you expect to happen in terms of top-line of the UPC business in your next fiscal year, and the one we're in now, and in the pre-acquisition business?

John Sobchak - *KMG Chemicals - CFO*

Jay, we're in the process of scrambling the omelet. These two businesses have virtually a 90% overlap in products and a very high overlap in customers. So we will not be discerning between these two businesses as separate entities going forward.

You know, as referenced in our discussion about Fremont, we'll be moving that manufacturing to our existing facilities, and we anticipate accomplishing similar manufacturing realignments . . .

Jay Harris - *Goldsmith & Harris - Analyst*

Well, I'm not talking about cost structures and realignments. I'm talking about revenues. Um, in other words, is -- do you expect the business that you've acquired to be growing in this fiscal year versus what that business did in the last fiscal year -- your last fiscal year? And what do you expect to happen in the -- that portion of your electronics business which you've owned all along?

John Sobchak - *KMG Chemicals - CFO*

The UPC business is expected to generate about $95 million of sales --

Jay Harris - *Goldsmith & Harris - Analyst*

And is that up, or flat, or down?

John Sobchak - *KMG Chemicals - CFO*

-- in 2014. That's up moderate -- that's up modestly for the last 12 months. Long-term, the UPC business has greater exposure into Asia, of course. Approximately 40% of the revenues are located in Singapore, which is growing at a 7% long-term growth rate. We expect a benefit from that growth.

Their exposure in Europe has a lower growth rate associated with it. You know, most recently there's been a bit of a decline in Europe. But, you know, going forward we're expecting to see somewhere around a three% growth rate there.

Jay Harris - *Goldsmith & Harris - Analyst*

And the pre-acquisition revenues -- did you mean to imply that they would be up somewhat in fiscal 2014 versus '13?

John Sobchak - *KMG Chemicals - CFO*

Yes.

Jay Harris - *Goldsmith & Harris - Analyst*

Okay. Thank you.

Operator

(Operator Instructions). And your next question comes from the line of Daniel Rizzo of Sidoti & Company.

Daniel Rizzo - *Sidoti & Company - Analyst*

Hi, guys. I saw the release about Penta coming from Europe and it being potentially hazardous. Is this a business that you're considering getting out of at any point? Or is it something you think that -- this is not going to be an ongoing problem, or a problem that could potentially spread?

John Sobchak - *KMG Chemicals - CFO*

Hey, Dan. You know, in the 12 to 13 years I've been here, this is kind of a normal course of action situation. It's -- Penta and creosote are registered pesticides in the United States and elsewhere in the world. They are constantly under a regulatory scrutiny. We're very confident in how we produce and manage those products.

This is -- and this -- the Stockholm Convention is something that we're giving a lot of attention to, of course, and we have a plan to address it. But it's not totally unexpected. A lot of these decisions are often politically motivated.

But in the end, Penta has a very high economic value to the market it serves, and it's a very low volume that is, you know, being produced. And we don't believe that this is going to be something that's going to be very high on the list of concerns for the Stockholm Convention.

Daniel Rizzo - *Sidoti & Company - Analyst*

Okay, and then can you just remind us -- I know you don't break it out (inaudible) but how much of the wood-treatment business is creosote versus Penta?

John Sobchak - *KMG Chemicals - CFO*

Yeah, Penta is about 25% to 30% of wood-treating chemicals revenue.

Daniel Rizzo - *Sidoti & Company - Analyst*

Okay. All right. Thank you, guys.

John Sobchak - *KMG Chemicals - CFO*

Okay.

Operator

(Operator Instructions). And your next question comes from the line of Richard O'Riley of Revere Associates.

Richard O'Riley - *Revere Associates - Analyst*

Hi. Good morning, gentlemen. When we look at the margins for the two segments, for the two businesses, and I think that includes distribution costs, for several -- for a number of quarters, at least, the electronic segment margin has been running below the wood-treatment. And I think that includes the distribution costs.

Do you ever see the electronic segment be -- having a higher margin than the wood-treatment? And the wood-treatment can be volatile quarter-to-quarter, as you noted. But what's your outlook on that?

John Sobchak - *KMG Chemicals - CFO*

Yes, it -- when I first joined with KMG the wood-treating margins were not as favorable as they currently are. I think that if you look at the economic value that the electronic chemicals products bring to the markets they serve, and if you look at the operating efficiencies that we've been introducing into the business through our consolidation program, you know, I think there's a very good opportunity to expand the operating margins in that business.

Just to give you an example, you know, we had, in the past, previously disclosed that when we first entered the electronic chemicals business, distribution expense as a percentage of sales was a little over 20%. You know, we've gotten that down to about 15%.

And, you know, there's other efficiencies that can be gained on the manufacturing side as well, through, you know, a strategic realignment of manufacturing with the customer base.

Richard O'Riley - *Revere Associates - Analyst*

Okay. Do you see the electronics get into the double digit -- sustainable on the double digit margin percentage?

John Sobchak - *KMG Chemicals - CFO*

Yes. In the long term, absolutely, and that's our objective.

Richard O'Riley - *Revere Associates - Analyst*

Okay, fine. Okay. Great. Thank you, guys.

Operator

You have a follow-up question from the line of Jay Harris of Goldsmith & Harris.

Jay Harris - *Goldsmith & Harris - Analyst*

John, I was looking up your 10-K's, and have you filed that 10-K yet that has the historical data on the UPC acquisition?

John Sobchak - *KMG Chemicals - CFO*

Oh, it -- that'd be an 8-K, Jay.

Jay Harris - *Goldsmith & Harris - Analyst*

Sorry. Have you filed it yet?

John Sobchak - *KMG Chemicals - CFO*

Oh, yes, yes. That was filed in August.

Jay Harris - *Goldsmith & Harris - Analyst*

Oh, all right. I've --

John Sobchak - *KMG Chemicals - CFO*

You know, so to be clear, that would be a -- it was three years' audited results of the UPC business as owned under OM Group.

Jay Harris - *Goldsmith & Harris - Analyst*

Well, I don't see -- August 16th, I guess. Right?

John Sobchak - *KMG Chemicals - CFO*

Yes. It'd be listed as an 8-K/A, actually.

Jay Harris - *Goldsmith & Harris - Analyst*

All right. I have found it. Thank you.

John Sobchak - *KMG Chemicals - CFO*

Okay.

Operator

This ends today's question and answer session. I would like to hand the call back over to Mr. Chris Fraser, President and CEO, for closing remarks.

Chris Fraser - *KMG Chemicals - President, CEO*

Thank you. We appreciate your participation today and your interest in KMG. I look forward to speaking with you on our first quarter conference call. Thank you.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect, and have a wonderful day.
