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KMG - Q1 2014 KMG Chemicals Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the First Quarter 2014 KMG Chemicals Earnings Conference Call. My name is Denise, and I'll be your operator for today.

(Operator Instructions)

I would now like to turn the conference over to your host for today, Mr. Eric Glover, Manager of Investor Relations. Please proceed.

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

Thank you, Denise. Good morning, everyone, and welcome to the KMG Chemicals, Incorporated, fiscal 2014 first quarter financial results conference call. I'm joined today by Chris Fraser, our Chairman and CEO, and Hank Mullen, our Director of Business Development and Interim CFO. In a moment, we'll hear remarks from them, followed by Q&A.

During today's call, we will refer to financial measures not calculated according to generally accepted accounting principles. Please refer to today's earnings release available on our website for the reasons we are presenting non-GAAP financial information and for the appropriate tables that reconcile these measures to our GAAP results.

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

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

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Thank you, Eric. Good morning, and thank you, everyone, for joining us today for KMG's physical 2014 first quarter conference call.

Our earnings release was issued this morning, and we plan to file our 10-Q later today. I'll begin by providing an update on our businesses, and then I'll turn the call over to Hank for a review of the Q1 financials and our outlook for the second quarter and fiscal 2014 year. After our comments, we'll open the call for questions.

As I indicated on our last conference call, one of our top priorities in fiscal 2014 is the integration of the Ultra Pure Chemicals business KMG into our legacy electronic chemicals business. Thanks to the dedication of many of our team members around the globe, I can report that the integration is proceeding well, and we continue to focus intensely on this initiative to ensure a seamless transition for our numerous customers in the global semiconductor industry.

During the first quarter, we announced a manufacturing realignment of our global electronic chemicals business involving the consolidation of our manufacturing operations and optimization of our supply chain. While these decisions are always difficult, as it directly affects members of our worldwide team, we believe this restructuring is necessary to better align our production capabilities with global demand for our products.

We are transitioning production from our Fremont, California, site primarily to our larger facilities in the US, and we recently announced that we will shift production from our Milan, Italy, site to our other European facilities, while maintaining our customer services operations in Milan.

As previously disclosed, we've identified $4 million to $5 million of charges relating to this restructure in fiscal 2014, partially offset by a $2 million to $3 million of incremental benefits during the year from restructuring-related synergies and commercial benefits. In addition, we anticipate spending an incremental $2 million in capital expenditures primarily in fiscal 2014 to accomplish these plans.

One of our key growth initiatives in our electronic chemicals business is to more fully participate in the mobile semiconductor market, which is growing rapidly compared to the traditional PC and server markets. I'm pleased with the initial progress we're making in this area, where we are benefiting from our enhanced global presence and targeting marketing efforts. These initiatives, along with the recent UPC acquisition, have doubled our electronic chemicals revenue tied to the mobility market.

We are confident our share will grow further over time, not only because our customers are migrating their businesses towards mobility, but because we are actively pursuing various growth opportunities in this market with mobility-focused customers across North America, Europe, and Asia.

Overall, I'm pleased with the operational progress we are achieving on our electronic chemicals business. The integration of the UPC business is proceeding smoothly, and the long-term strategic value inherent in the transaction remains compelling.

As discussed on our most recent conference call, we expect that the restructuring we are now undertaking will generate annualized benefits of $6 million to $8 million for our electronic chemicals business, excluding one-time projected charges of $7 million and $9 million on a cumulative basis over fiscal 2014 and fiscal 2015.

Now turning to our wood-treated chemicals business, our first quarter sales increased 13% over last year, reflecting higher volumes to the rail tie treating market. However, segment operating profit margins declined from last year's first quarter due to a less favorable product mix and lower prices on creosote sales.

As we look forward, our creosote business faces a challenging and dynamic market environment, and we are responding by optimizing our supply chain and cost structure to best maximize our cash flow within this segment. While we continue to address the issues impacting our creosote business, we've identified several specific factors that may adversely affect the financial performance of wood-treated chemical segment.

First, although industry rail tie replacement rates have remained at relatively high levels, there remains an oversupply of creosote in the market. The current oversupply has largely resulted in the continued adoption of [foray treatments] that reduce creosote retention in treated rail ties. Second, we project that rail tie replacement activity may decline, and some railroads had recently stated plans to reduce tie insertion in calendar 2014. Given these market dynamics, we believe competitive activity in the creosote market will increase in calendar 2014, exerting downward pressure on creosote prices.

While creosote market continues to pose challenges, I would note that our wood-treating chemical segment also includes our Penta business, which stands to benefit from rising demand as western US utilities upgrade and replace their utility pole infrastructure. KMG is the sole manufacturer of Penta in North America, enabling us to fully capitalize on market demand for this specific industrial wood preservative.

Overall, the outlook for our Penta business remains very favorable, though sales can be somewhat uneven in any particular quarter depending on the timing of customer orders, along with the impacted severe weather events can have on demand. Nonetheless, the positive cash flow characteristics of this business continue to benefit the financial performance of our wood-treating chemical segment.

Now I'd like to update you on our CFO search. As we announced in October, John Sobchak, our longtime CFO, was departing KMG. And on behalf of KMG, I'd sincerely like to thank John for his many years of service to KMG and wish him the best in his future endeavors.

Over the past few months, we've been conducting an extensive search for a new CFO, and I'm pleased to say that we've made considerable progress. We've narrowed our short list down to a handful of exceptional candidates, and we expect to announce our next CFO soon.

Before I turn the call over to Hank, I would like to comment on the significant corporate overhead costs we incurred in the first quarter. The coincident timing of the close of the UP acquisition with our fiscal year-end filing caused our first quarter audit, tax and SOX testing fees to increase by approximately $1 million on a year-over-year business. The extent of this cost increase was not fully anticipated.

While our newly expanded size and global scale will require a higher level of corporate overhead expense, I want to emphasize that we remain resolute in our focus on managing costs and operations as efficiently as possible. Hank, please proceed with a review of the Q1 financials.

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Thank you, Chris, and good morning to everyone.

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

KMG achieved consolidated net sales of $93.6 million in the first quarter, up 43% on the year-over-year basis, reflecting the acquisition of the UPC business. Electronic chemical sales were $64.5 million, up from $39.5 million last year. While the year-over-year increase was largely driven by the addition of the UPC business, sales within our legacy electronic chemicals business improved on a sequential basis from the fourth quarter of fiscal 2014 due to an increase in global semiconductor production.

Adjusted operating profit in our electronic chemicals segment was $3.8 million, or 6% of sales, compared to operating profit of $5.1 million, or 12.8% of sales, in last year's first quarter. The decline in adjusted operating income and adjusted operating margin reflects depreciation and amortization expense of $3.2 million, compared to $1.6 million in last year's first fiscal quarter.

The increase is attributable to the acquired UPC assets. Going forward, we anticipate that the electronic chemicals segment quarterly depreciation and amortization expense will increase to approximately $3.5 million per quarter, reflecting a higher valuation of the physical assets acquired from UPC and increased amortization of intangible assets.

While D&A expense is non-cash in nature, and therefore does not reduce cash flow, the higher projected level of D&A expense will dampen reported operating profits. Wood-treating chemical sales were $29.1 million, an increase of 13.1% from $25.7 million in the comparable quarter last year. The year-over-year increase in wood-treating chemical sales reflected higher volumes to the rail tie treating market.

Wood-treating chemicals' operating profits was $2.5 million, or 8.6% of sales, versus $3.4 million, or 13.1% of sales, in last year's first quarter. The decline in segment operating profit and margin reflects a less favorable product mix and lower creosote prices. Consolidated adjusted EBITDA for the first quarter was $8 million, compared to $9.3 million last year.

Adjusted EBITDA in the first quarter of fiscal 2014 excludes $500,000 of UPC integration expense and $1.28 million of CEO transition expense, while adjusted EBITDA in last year's first quarter includes $577,000 of UPC acquisition expense. First quarter 2014 adjusted diluted earnings per share was $0.22, in line with our adjusted earnings per share guidance range of $0.22 to $0.25.

Now I'll review our outlook for the second quarter and fiscal 2014 year. While overall semiconductor industry production has slowly picked up following the industry correction that persisted into mid-calendar 2013, we anticipate a typical seasonal slowdown in our second quarter. In addition, the PC market remains a drag on overall semiconductor industry growth. As a result, we project second quarter electronic chemical sales will decrease slightly from the level we reported in the first quarter.

In our wood-treating chemicals business, the second quarter is often the seasonally softer period as colder weather can limit routine maintenance demand for poles and cross ties, and some customers may temporarily shut down their wood-treating facilities for maintenance.

At the same time, conditions within the creosote market remain challenging due to reduced demand and excess supply resulting from the adoption of borate treatment for cross ties. Consequently, we project second quarter sales in our wood-treating chemicals segment will decline on a sequential basis.

As we indicated in our October conference call, fiscal 2014 will be a transition year in terms of our overall financial performance, given projected charges related to the integration and restructuring of our electronic chemicals business.

At this time, we reiterate our prior guidance for fiscal 2014 consolidated net sales to exceed $350 million, benefiting from a full-year contribution from the acquired UPC business. While we had previously projected flat to modest GAAP net income growth in fiscal 2014 compared to fiscal 2013, we are now updating this guidance to account for an increased depreciation in amortization expense in our electronic chemicals business, as well as higher corporate overheads for outside services. We are also taking a more cautious view with respect to our creosote business in light of the current market environment.

Taking all these factors into consideration, we believe it's prudent to expect the fiscal 2014 GAAP net income will decline from last year's level. Although we are not providing fiscal 2014 GAAP EPS guidance, we anticipate higher projected DNA expense in our electronic chemicals business will negatively impact fiscal 2014 GAAP operating income by approximately $3 million more than we had estimated in our previous guidance.

Now let's take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Jay Harris with Goldsmith & Harris. Please proceed.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Good morning.

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Morning, Jay.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Is it reasonable to assume that when the restructuring is completed in electronics chemicals that you'll be sometime in 2015, that you'll be reporting operating margins of 12% or higher?

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

So our previous guidance in regard to that, Jay, was that the full-year benefits that we would experience after the transition was complete would be $6 million to $8 million. And that would be to operating income.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Well, all right. So did you -- I'm sorry. I may have missed it. Did you say how much revenues you'd expected this year in electronics?

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

No, we didn't break that out, Jay.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. So -- all right. That's about as close as I can get to a margin objective looking out a couple of years, right?

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Yes, I would think so.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. I have some -- if I might, I have some questions. There were some transition -- CEO transition expenses in the fourth quarter of $1.6 million, and I see in the first quarter there was additional of $1.3 million. Could you explain that?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Well, sure. Much of that was related to bringing on -- in first quarter of 2014 was bringing on Christopher Fraser as the -- as the CEO. In the first quarter, it was -- it had to do with Neal Butler's severance cost and associated fees -- and the associated search for the new CEO, as well.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. So the change cost the company a little less than $3 million. And then I wonder if you could -- what will be the interest expense in the second quarter?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

In the second quarter? It looks like it's going to be about -- a little less than $700,000.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. All right. And I presume it'll grow a little on a quarterly basis, as the year progresses, because of your capital investments?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

No, we're not projecting -- we're not projecting for it to grow. You know, as we're making these investments, Jay, a big reason we're making them is we're looking to get some synergies out of these investments, and we would expect that, based on the free cash flow that we're getting, we would be able to reduce...

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Slowly -- slowly reduce the debt levels, all right.

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And could you explain a little more detail, the items and operating expenses, how -- the reasons for their growth?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

So you're referring specifically to my comments on outside services?

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Well, if I'm -- bear with me for a second. I think I wrote something down.

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes, so there has been some growth there, Jay. And let me just talk about that in general. We have a significantly larger and more complex business that we've brought on a result of this acquisition. And there are a number of things that we need to complete in order to meet our obligations as a publicly traded company. And a lot of those have to do with our obligations for compliance under Sarbanes-Oxley and audit.

And one of the things that we failed to anticipate was the ramp-up in costs around those -- around those services. The net result of that in the -- in the first quarter was an overage that we had not anticipated of about $1 million.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And what caused -- what caused this recent run-up in these Sarbanes-Oxley compliance costs? So why didn't you have those costs last year or the year before?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

So a lot of that has to do with the increasing requirements we're seeing from the PCAOB. In addition, we -- you know, as part of the larger organization, we're looking to build out our documentation and our -- and our ability to continue to properly comply with those -- to do our internal testing.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And that'll run, what, $1 million a quarter this year? Or is it one-time...

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

No. No, we expect -- a lot of that, Jay, was related to the fiscal 2013 audit. So a lot of that hits in the first -- in the last quarter of the year or the first quarter in the -- of the following fiscal year. So we would expect that to moderate in the coming quarters.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. I guess my question was really referring to distribution expenses.

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Okay.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

The acquisition, I presume, added the bulk of the increase in distribution expenses?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes, it did. And distribution expenses were up $5.5 million.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Right.

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

And we would expect that to continue.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And the -- are there any savings in distribution expenses as you complete your reorganization of that business?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes, that's actually a really good question, Jay. The way we distribute products in the EC business in North America and Europe and in Singapore, in our acquired businesses, are somewhat different.

So in North America, we use a hub-and-spoke system. And we have through the years been able to optimize that system and bring down our distribution expenses. I think at one time, we were running at close to 20%, and I think in this quarter we were running at a much lower level.

In Europe, we run our own fleets, our own dedicated fleets, and we typically optimize -- we have an optimized distribution system throughout Europe to deliver our product to customers, but also to bring back returnable containers and bring back raw materials to the plant. You know, Europe is a much smaller size. We would expect some synergies as a result of our reorganization and supply chain savings through this reorganization in Europe.

In Asia, we have a much larger portion of our operating expense that's due to distribution. And Singapore, as you know, is a very small area. We would not expect a whole lot of savings in that part of the world. We believe that our distribution abilities in Asia are already fairly well optimized.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

In Europe and the US, is that all by truck?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

In Europe and the US, yes, it is. In Europe, it's by our dedicated fleet, and by -- in the US, we have a number of carriers we contract with.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And on -- and on selling and general administrative expenses, how much of that increase is completed and is at all due to the acquisition?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes, 1.5, and it is due to the acquisition.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. And obviously...

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

SG&A expenses.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

And obviously, the $1.3 million is in that $10.4 million?

Hank Mullen - *KMG Chemicals, Inc. - Director - Business Development, Interim CFO*

Yes.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Okay, thank you.

Operator

(Operator Instructions). We have no -- actually, we have a follow-up question from Jay. Please proceed.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

I hope I'm not the only one on the call. Talk a little about the way you're going to pursue your acquisition interests and how that may differ from what had been done before, if it does differ at all.

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Jay, this is Chris. The -- you know, as I've mentioned in our last call, our strategic direction remains unchanged. So our intent on growing the company through acquisition remains intact.

And so our discipline in approaching acquisition opportunities remains the same as it has been, looking at niche markets that we can go into, that provide us an opportunity to consolidate and bring value and create value in that industry.

Additionally, we continue to look at opportunities to build out our wood-treating business, as well as our electronic chemicals business, whether it be geographic- or market-specific.

So we continue to pursue those and look at those opportunities. Hank has been foundational in providing a good pipeline for us to look at. Having said that, as we've talked about, 2014 is a busy year from a transition standpoint. We've got a lot of things to do.

We've commented before about us implementing a new ERP system, building out our infrastructure to manage and optimize the company in the size and complexity it has now, so we're going to be prudent in any acquisitions we make to make sure it is -- we can add the value in that acquisition and it brings value to our shareholders. So we're not stopping from our direction or moving from our direction, but at the same time we're going to be prudent in our pursuit of those.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

When -- what would be the earliest that -- from an organizational point of view -- you would be prepared to make an acquisition? I'm sort of wondering whether the reorganization of electronics chemicals would slow it down or cause you to pause in terms of your acquisition strategy?

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Yes, it really is -- I won't say it will cause us to pause. We don't necessarily create the timing of acquisition opportunities. So we need to be prepared, as they present themselves, for us to react. But as I said, we are building out our systems, our capabilities, so, you know, we want to make sure we're prudent as we pursue those.

If realignment of our manufacturing both in North America and Europe is going to take time, as we've talked about, we -- the full benefits we realize will be in about 18 months to get us to a steady state. You talked about logistics and supply chain earlier. A lot of that distribution expenses is where we're looking to optimize that.

So, you know, the organization has capabilities now. What we're doing now is optimizing it. So if the right opportunity presents itself in electronic chemicals, we will pursue that.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Well, in terms of adding a new leg to the stool, are we at a point in the business cycle where the opportunities are declining simply because business is getting better?

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

I don't see that at all. We have a lot of things to look at right now.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

Okay.

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

And certainly there are a lot of opportunities coming out there in the market, things that are being sourced from both our contacts in investment banks, but also things that we've been able to pursue independently. So there's no dearth of opportunities out there right now.

Jay Harris - *Goldsmith & Harris Asset Management - Analyst*

All right. Thank you very much.

Operator

At this time, we have no further questions. I would now like to turn the call back to management. Please proceed.

Chris Fraser - *KMG Chemicals, Inc. - Chairman, CEO*

Well, we appreciate your participation today and your interest in KMG. We look forward to speaking with you on our second quarter conference call. Thanks, and goodbye.

Operator

This concludes today's conference. You may now disconnect. Have a great day.
