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KMG - Q2 2014 KMG Chemicals Earnings Conference Call

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CORPORATE PARTICIPANTS

Eric Glover *KMG Chemicals Inc. - IR Manager*

Christopher Fraser *KMG Chemicals Inc. - President, CEO*

Malinda Passmore *KMG Chemicals Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Rosemarie Morbelli *Gabelli & Co. - Analyst*

Jay Smith *Harris & Smith Inc. - President*

Jay Harris *Goldsmith & Harris - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the second-quarter 2014 KMG Chemicals earnings conference call. My name is [Denise], and I'll be the 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 Mr. Eric Glover, Investor Relations Manager. Please proceed.

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

Thank you, Denise. Good morning, everyone, and welcome to the KMG Chemicals Inc. fiscal 2014 second-quarter financial-results conference call. I'm joined today by Christopher Fraser, our Chairman and CEO, Mindy Passmore, our CFO, and Hank Mullen, our Director of Business Development. 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 press release, available on our Web site, for the reasons we are presenting non-GAP financial information and for the appropriate tables that reconcile these measure to our GAP 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 happen accurate and are subject to significant risks and uncertainties, included statements as to the future performance of the company. I'll now turn the call over to Christopher Fraser, Chairman and CEO. Please go ahead, Chris.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Thank you, Eric. Good morning and thank you, everyone, for joining us today. Our Q2 earnings release was issued this morning, and we plan to file our 10Q later today. I'll begin by providing an update on our business, and then I'll turn the call over to Mindy for review of the Q2 financials and our outlook for the fiscal 2014 year. After our comments, we'll open the call for questions.

The second quarter unfolded generally as we expected, as the business experienced the traditional seasonal slowdown. Having said that, we are pleased that our European and Asian electronic chemicals operations experienced only mild seasonality, which we believe is a positive indication that the semiconductor industry is poised for further improvement during calendar 2014.

Additionally, our electronic chemical business is benefiting from increased exposure to the automotive and mobility markets, both of which are showing more robust growth as compared to the traditional PC and server markets. From an operational perspective, we remain focused on the integration of the UPC business into our existing electronic-chemicals operations and began the process of consolidating our global manufacturing operations with the previously announced closure of our Freemont, California, plant and planned curtailment of our manufacturing operation in Milan.

As a result of these announced restructurings, we reported a GAP loss per share of $0.24 as a result of $4 million in restructuring charges for the manufacturing realignment. Excluding restructuring and integration expenses, we reported adjusted earnings per share of $0.12 versus $0.18 per share in last year's second quarter. The reduction in adjusted EPS was largely attributable to a $1.8 million year-over-year increase and depreciation and amortization expense resulting from the UPC acquisition. This increase in depreciation expense was equal to approximately $0.10 per diluted share. Cash flow in the second quarter was positive, as we reported adjusted EBITDA of $6 million, up from $5.6 million in the same period last year.

The strategic manufacturing realignment of our global electronic-chemicals manufacturing operations involves the transfer of production from our Milan, Italy, site, to alternate European facilities, and the optimization of our domestic operations by transferring from our Freemont, California, site to our larger facilities in the US The closure of the Freemont facility remains on schedule. As the Freemont site's production winds down, we're building the necessary capabilities to produce these products at other locations and successfully working with our customers on the necessary approvals and qualifications. Currently we anticipate that we will have fully transferred production from Freemont to other locations by the end of April. As we shift Freemont's production to our other US sites, we begin to realize the associated cost savings and operational synergies resulting from the optimization of our domestic manufacturing assets.

Meanwhile, we are pleased to have recently reached agreement with the Union and Works Council in Italy, enabling us to proceed with the planned stoppage of manufacturing operations in Milan and to commence the transfer of production to alternate facilities in France and the UK We've developed and begun implemented production-transition plan for those products out of Milan, and we have communicated these plans to our customers. We anticipate completing the restructuring of our European operations by the end of calendar 2015.

When the manufacturing alignment is completed, KMG will be strongly positioned to realize the maximum value for the high level of service and quality products we reliably provide to the semiconductor customers around the world. Consistent with our prior commentary, the projected restructuring benefits in our electronic-chemical business remain unchanged, as we anticipate generating $2 million to $3 million in restructuring-related synergies and commercial benefits in fiscal 2014 and $6 million to $8 million on an annualized basis in fiscal 2015. Mindy will provide further financial detail regarding the restructuring in her remarks.

Within our wood-treating chemical segment, second-quarter sales increased from last year due to higher creosote volume. However, as the share of the railroad ties treated with [borase] has increased, aggregate industry demand for creosote has declined, exerting downward pressure on creosote prices. As a result, our second-quarter wood-treating chemical segment margins declined from last year, even as our creosote volumes increased on a year-over-year basis.

Given these market dynamics, we are repositioning our creosote supply chain to lower operating costs. At the end of December, our contractual supply agreement with our European creosote supplier expired, and we were unable to reach agreement for a profitable relationship with them going forward. Since then, we have secured alternate sources of profitable creosote supply and have obtained creosote-supply commitments from other sources. We are also working with additional sources to further broaden our supply base. During this period, we've continued to meet our customer needs with an uninterrupted supply of creosote.

Our sales volume of Penta was lower in the second quarter compared to the same period in 2013 due to the absence this season of hurricanes, which typically stimulate the need for replacement utility poles in the Southeast. The outlook for our Penta business remains positive, especially in the Western region, as several utilities have increased their pole-replacement programs and demand for transmission poles is robust as solar plants and wind farms connect to the electric grid.

In the third quarter, we anticipate volumes in our wood-treating chemical segment will increase on a sequential basis due to seasonality. We do, however, anticipate that wood-treating chemical segment margins are likely to decline in the third quarter as we continue to reposition our business and reduce our creosote supply-chain costs and implement additional measures to maximize our cash flow.

In our electronic-chemicals business, global semiconductor industry production has picked up following the seasonal slowdown in our fiscal second quarter. As a result, we project electronic-chemical segment sales will increase moderately in our third quarter on a sequential basis.

Although fiscal 2014 will be a transition year from a financial standpoint, I'm confident we are laying the groundwork for substantially improved operational and financial performance in the years ahead. From the ongoing integration of the UPC business to the current restructuring of our electronic-chemicals operations, the actions we are taking now are vital to driving future earnings and cash-flow growth. We remain committed to our core strategy of managing our operations as smartly and efficiently as possible while identifying select acquisition opportunities that enable us to grow long-term shareholder value.

Finally, I'd like to take a moment to comment on the important organizational changes we have made recently. As KMG has grown, the scale and complexity of our operations have increased commensurately. Over the past six months, in particular over the past several months, we have strengthened our capabilities with key additions to KMG team. These individuals bring to KMG the talent and experience that will be instrumental to our success as we execute on our long-term growth strategy. I'll now turn the call over to Mindy for the financial review and outlook.

Malinda Passmore - *KMG Chemicals Inc. - CFO*

Thank you, Chris, and good morning, everyone. In my remarks, I will discuss adjusted or non-GAP numbers, as we believe non-GAP information can provide useful insight into the underlying operating performance of our business. The non-GAP numbers I reference are reconciled to the corresponding GAP numbers in today's earnings release.

KMG reported consolidated advanced sales of $84.3 million in the second quarter, up 48% on a year-over-year basis, reflecting the acquisition of the UPC business in electronic chemicals and growth in the wood-treating chemicals business. As expected, second-quarter sales were down from the $93.6 million reported in the first quarter of fiscal 2014, reflecting seasonality in our two operating segments. In addition, conditions within the rail-tie-treating market remained unfavorable.

Gross profit margin as a percentage of sales for the second quarter was 29.9%, up from 27.6% in last year's second quarter. The acquired UPC business had higher gross margin as a percentage of sales due in part to our operations in Singapore, which rely heavily on (inaudible). Second-quarter distribution expense of $12.9 million, or 15% of sales, increased from $5.9 million, or 10.4% of sales, in last year's second quarter. Distribution expense is significantly higher in our Singapore electronic-chemicals business.

Second-quarter SG&A expense was $9.9 million, up from $6.6 million in the prior period last year. More than half of this increase is due to additional SG&A expenses from the UPC acquisition, and we also incurred higher audit and tax service fees.

Consolidated EBITDA, which excluded $3.2 million in restructuring charges, $771,000.00 in non-cash accelerated-appreciation expense related to the closure of the Freemont facility, and secession of manufacturing in Milan, and $160,000.00 in integration expense, was $6 million. This compares favorably with $5.6 million in adjusted EBITDA in last year's second quarter.

Adjusted EPS for the second quarter of fiscal 2014 was down $0.12 -- I mean, sorry, it was $0.12 down from $0.18 last year. The year-to-year decline in adjusted EPS reflected significantly higher depreciation and amortization expense due to the UPC acquisition. On a year-over-year basis, depreciation and amortization expense increased by $1.8 million, or approximately $0.10 per diluted share.

On a GAP basis, the second-quarter net loss was $0.24 per share, compared to earnings of $0.14 per share in last year's second quarter. The second-quarter 2014 net loss was entirely due to restructuring.

Our effective tax rate in the quarter was negative-15.1%, primarily due to restructuring charges, for which we will not be able to realize a tax benefit. Due to the planned stoppage of manufacturing operations in Italy, management does not believe our Italian subsidiary will generate a sufficient taxable income in the future to utilize the net operating losses generated by the restructuring charges.

Turning to our segment results excluding corporate allocations, electronic-chemical sales were $61.4 million, up from $35.6 million last year. The year-over-year increase was driven by the addition of the UPC business.

Adjusted EBITDA in the electronic-chemicals segment was $6.4 million, or 10.5% of sales, compared to adjusted EBITDA of $3.9 million, or 11% of sales, in last year's second quarter. As the restructuring of our electronic-chemicals business progresses, operating profitability in this segment will improve due to increased asset utilization, the realization of supply-chain efficiencies, and ongoing cost rationalization.

In our wood-treating chemicals segment, sales were $22.8 million, an increase of 7.6% from $21.2 million in the comparable quarter last year. The year-over-year increase in wood-treating chemical sales reflected higher creosote volumes to customers that service the crosstie markets.

Wood-treating chemicals EBITDA was $1.2 million, or 5.3% of segment sales, versus $2.3 million, or 11% of segment sales, in last year's second quarter. The decline in segment EBITDA and EBITDA margin reflects a less-favorable product mix and lower creosote prices. In addition, we incurred approximately $330,000.00 of one-time expense in the second quarter of fiscal 2014 to rationalize a portion of our distribution costs as part of our continuing efforts to improve the long-term profitability of the creosote business.

I'll now provide additional detail and explanation regarding the restructuring charges we incurred this quarter. As indicated on this quarter's income statement, the total restructuring charge in the second quarter was $4 million. As stated in the footnote on the income statement, that amount included $771,000.00 in non-cash restructuring charges, representing accelerated depreciation related to the closure of the Freemont facility and secession of production in Milan.

Because of the pending closure of the Freemont facility and secession of manufacturing in Milan, we really reevaluated the useful [lives] and fixed assets of these facilities and have accelerated depreciation in accordance with GAP for certain assets. For fiscal 2014, we estimate accelerated depreciation charges will be approximately $3 million, including the $771,000.00 incurred in the second quarter. In addition, we anticipate approximately $1 million in accelerated depreciation will be incurred in fiscal 2015. These estimates for accelerated depreciation are labeled non-cash restructuring charges as seen in today's earnings release and are separate from depreciation and amortization expense as listed on the cash-flow statement.

Excluding non-cash accelerated depreciation charges, such as those we incurred in the second quarter, we continue to estimate fiscal 2014 restructuring charges of $4 million to $5 million, partially offset by an estimated $2 million to $3 million of restructuring-related synergies and commercial benefits. In addition, incremental capital expenditures of $2 million are expected to be incurred to accomplish these plans. In fiscal 2015, we project restructuring charges, excluding non-cash accelerated depreciation expense, will be $3 million to $4 million. As Chris noted, we project benefits to operating income resulting from the restructuring of $6 million to $8 million on an annualized basis in fiscal 2015.

We ended the second quarter in a strong financial position and have used our positive cash flow to further reduce our long-term debt. Over the first six months of fiscal 2014, we've reduced the amount outstanding on our revolving credit facility by $6 million, including a reduction of $4 million in the second quarter. During the second quarter, $20 million of prudential notes, formerly classified as long-term debt, are now classified as current maturities of long-term debt, since these notes become due by the end of the calendar year. We're beginning the process of replacing these notes by drawing on our revolving credit facility and/or adopting alternative financing arrangements. We believe that our revolving credit agreement capacity will be adequate to redraw the $20 million when the prudential notes become due.

Now I'll review our financial outlook for the remainder of fiscal 2014. As we have indicated, 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. We estimate fiscal 2014 depreciation and amortization expense, including accelerated depreciation, will be approximately $15 million -- I'm sorry, excluding accelerated depreciation will be approximately $15 million. For the six-month period ending January 31st, 2014, we incurred $7 million in depreciation and amortization expense, as indicated in the cash-flow statement attached to today's earnings release.

Now we'll take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Rosemarie Morbelli with Gabelli and Company. Please proceed.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Thank you. Good morning, all. Chris, could you -- or Mindy, could you give us a feel for what the revenue growth was in electronics year over year if you exclude UPC? Did it grow? Was it down versus last year?

Malinda Passmore - *KMG Chemicals Inc. - CFO*

Go ahead.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

It was essentially flat, Rosemarie.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

But you are talking about industry trends improving. If my memory serves me right, they are new [FABs]. They are other FABs expending capacity in the US Has none of that occurred in the second quarter? Is that in the future? Are those FABs kind of not utilized at the moment? Could you help me understand what is going on in that industry?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Yes. The second quarter is typically the -- from a seasonal basis, a lower level of sales, and we saw that occur in the second quarter. Our sales on our legacy business have seen some modest growth, but it's relatively small on a year-over-year basis, so it's essentially flat.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Right, because of seasonality. I mean, it's the same every year, right?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Correct.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And so, if I understood correctly, you are expecting the demand to pick up in the second half on a year-over-year basis, or is it just sequential pickup but still not above last year?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Well, we expect from a seasonal standpoint the quarter to pick up second half of the year, Q3 to pick up, but also last year in the third quarter was when we saw a drop-off, specifically from some of our major customers, and so we expect this year to see an increase on a quarter-to-quarter basis as a reflection of last year's drop-off. So we do expect an increase in sales not only from a sequential standpoint but on a quarter-over-quarter basis year to year.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

That is helpful. And could you bring us up to date on the Penta issues? Is there any change in the marketplace, given the controversy of the use of the chemical?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

No, we don't see any change. There's ongoing discussions, as we released in our press, relative to Penta and its use, and we're still very confident about the future of Penta and wood treating. So we haven't seen anything change since our last press release and discussions about that.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And one last question, if I may. As you are in the process of integrating UPC, looking at reworking your supply agreement on the creosote side, etcetera, have you put the potential of a third leg on the back burner until you are actually done with the current operation doing what you expect them to do?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

No. We are continuing to look for the third leg, albeit the ideal timing would be as we finish some of this integration that we're currently working on, but we don't necessarily control when those opportunities present themselves. So, we're continuing to keep that pipeline fresh and to look at the opportunities as they present themselves, and if the right opportunity does come along, we will pursue it to the extent we're able to. So, we're both on a third leg, as well as opportunities in our existing businesses. We're continuing to look at what those opportunities are.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Thank you. I'll get back on queue.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Thank you.

Operator

As a reminder, if you have a question, please press star one. Our next question comes from Jay Harris with Goldsmith & Harris. Please proceed.

Jay Harris - *Goldsmith & Harris - Analyst*

Sort of following up, do you have pro-forma numbers for electronics, including UPC? Was that business also sort of flattish year over year?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

The UPC numbers as compared to last year? Well, we didn't have the UPC --

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Jay Harris - *Goldsmith & Harris - Analyst*

I'm not talking about the UPC separately. I'm talking about on a pro-forma consolidated basis. You indicated, I think, in response to the earlier questions on this issue, that you may have grown a little market share. The industry, you said, was flat, but your business ex-UPC was up a little. I'm asking whether -- if you had the numbers going back, including UPC, for the first six months of this year versus the first six months of last year of whether the whole ball of wax was up flattish or up slightly, as you referred to the legacy business.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

So, in general, what we're seeing in the UPC business is we're seeing some strength with some key customers, and I would say that that is especially true in our European region. If I were to compare that going back to last year, if you're talking about specific volumes, yes, we are seeing increases in volumes in select customers.

Jay Harris - *Goldsmith & Harris - Analyst*

When this process is completed let's say by the end of 2015, looking at 2016, what's the likely corporate tax rate likely to look at -- look like? I'm sorry. Can't use English anymore.

Malinda Passmore - *KMG Chemicals Inc. - CFO*

We're looking at probably a 33%-to-35% drop in tax rate, and that's because of the lower tax rates in the international jurisdictions.

Jay Harris - *Goldsmith & Harris - Analyst*

Got it. And if you assume no change in your wood-treating business, after all the synergies are in, what would be the change in the level of your earnings?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Well, we've said that on an annualized basis the synergies we expect to achieve is $6 million to $8 million a year.

Jay Harris - *Goldsmith & Harris - Analyst*

And that includes this year's as well?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

That's on an annualized run rate of $6 million to $8 million.

Malinda Passmore - *KMG Chemicals Inc. - CFO*

Beginning in 2015.

Jay Harris - *Goldsmith & Harris - Analyst*

I'm sorry. Say that again, please?

Malinda Passmore - *KMG Chemicals Inc. - CFO*

Be for fiscal 2015 we --

Jay Harris - *Goldsmith & Harris - Analyst*

I've known that, but you've also indicated of some synergies of $2 million to $3 million in 2014. I don't know whether they're additive or not to 2015.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

No, they're not. So the $6 million to $8 million encompasses that $2 million to $3 that we're getting in 2014. The $6 million to $8 million is on an annualized basis when we've completed all of the restructuring.

Jay Harris - *Goldsmith & Harris - Analyst*

So what would be the basic earning power of the company in 2016 under these circumstances?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

I'm not sure. I mean, we're not giving guidance for 2016. We've given you --

Jay Harris - *Goldsmith & Harris - Analyst*

Well, I'm not asking for a change in revenues. I'm just asking basically, given the tax rate that you're inferring, assuming that your wood-processing business stays the same, what's this company capable of earning on a per-share basis? That's not guidance. That's just earning power. That doesn't mean that's what's going to be the case, because the market could change. A lot of things could change.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

I think it's safe to say that given the synergies that we see and given the base business that we're in, if you assume the businesses that we're in stay the same, it's pretty -- you can calculate what you think the earnings would be in 2016, given that tax rate and a $6 million-to-$8 million improvement on synergies. We're obviously pursuing other opportunities to improve our ongoing earnings, but, again, we're not giving any projections at this time for 2015 and '16.

Jay Harris - *Goldsmith & Harris - Analyst*

Well, all right, then. So help me on your -- if I had an adjusted operating income of X for this year, do I just add roughly $7 million to that and then impact that with a tax rate of 34%? Is that the way to do the calculation?

Malinda Passmore - *KMG Chemicals Inc. - CFO*

I think that would be a conservative way to do it.

Jay Harris - *Goldsmith & Harris - Analyst*

Well, it doesn't reflect any growth prospects in the business. Thank you very much.

Operator

We currently have a follow-up question from Rosemarie Morbelli. Please proceed.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Thanks. I was wondering, Chris, if you could give us a bit of feel for the new talents that you have brought in. We know all about Mindy, but what else were you looking for, and so what are you getting in terms of additional -- I can't think of the word in English -- well, talents? We'll use talents that other people have brought in, things that was not current before in part of KMG.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Well, we previously brought in a vice president of human resources. Chris Gonser joined the team several months ago. Chris brings a global experience level at larger companies and going to help us not only from an employee-relations standpoint but talent acquisition, as well as bringing the global HR standards to KMG. Additionally, we've recently hired a new comptroller, Marcelino Rodriguez. Marcelino was previously a CFO and has joined us as part of Mindy's team and brings a dimension of being a CFO of larger companies, as well as understanding all of the necessary requirements of comptrollership for a company of our size and growing. So he brings that dimension as well, so those are just two members, in addition to Mindy, that we've brought in the team and feel very comfortable and confident about the skill sets they bring and the capabilities they bring to us on a going-forward basis.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

So no new person in terms of marketing capabilities, which would possibly open adjacent markets for some of your products?

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

No. We in May brought in Andrew Lau as a head of our global electronic-chemicals business, and he continues to provide good leadership for that business globally, but outside of that, no. The existing team is made up from our recent acquisition, Air Products, OMG, and that team is very capable on electronic-chemical side, as well as our existing team on the wood-treating side.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Thank you.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

Welcome.

Operator

We have no further questions. I would now like to turn the call back over to management for closing remarks. Please proceed.

Christopher Fraser - *KMG Chemicals Inc. - President, CEO*

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

Operator

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