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KMG - Q3 2014 KMG Chemicals Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentleman, and welcome to the third quarter 2014 KMG Chemicals earnings conference call. My name is Kim, and I will be your operator for today. (Operator instructions) As a reminder, this conference is being recorded for replay purposes.

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

Eric Glover - *KMG Chemicals Inc. - IR*

Thank you, Kim. Good morning, everyone, and welcome to the KMG Chemicals Inc. fiscal 2014 third quarter financial results conference call. I'm joined today by Chris 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 website, for the reasons we are presenting non-GAAP financial information and for the appropriate tables that reconcile these measure 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'll now turn the call over to Chris Fraser, Chairman and CEO. Please go ahead, Chris.

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

Thank you, Eric. Good morning and thank you, everyone, for joining us today. Our Q3 earnings release was issued this morning, and we plan to file our 10Q on Monday. I'll begin by providing an update on our business, and then I'll turn the call over to Mindy for review of the Q3 financials and our outlook for the fiscal 2014 year. After our comments, we'll open the call for questions.

An important element of creating value for KMG is to optimize our global electronic chemicals manufacturing operations. And I'm pleased to say the past 90 days, we've made important progress on the integration of UPC business and restructuring of our electronic chemicals operations.

As you recall, the global consolidation of our manufacturing operation involved the closure of our Fremont, California plant, and the cessation of manufacturing in Milan. As planned, we ceased production at the Fremont facility and expect a complete site decommissioning by July.

We continue to work closely with our customers on the necessary approvals and qualifications. And we successfully transition production from Fremont to our Pueblo, Colorado and Hollister, California facilities. While the sales volumes transitioned from Fremont is relatively small in comparison to our overall North American electronic chemicals operations, it is important to do it right and the integration and plant consolidation process has proceeded smoothly.

Meanwhile, we're also making good progress with the respect to the manufacturing realignment we're undertaking in Europe. We've begun the decommissioning of certain manufacturing equipment in Milan, and we've started to transition products previously manufactured in Milan to alternate sites in the UK and France. As in the US, we are working closely with our customers on the qualification of transition products to ensure reliable and high quality supply during this process.

Overall, the consolidation of our global operations remain on schedule as due to related restructuring benefits and commercial synergies that we originally projected. Excluding restructuring and integration expenses, our third quarter adjusted EBITDA was $7.6 million. Up from $6.3 million in the same period last year and up from $6 million in the second quarter of fiscal 2014.

The increase in adjusted EBITDA from last year's third quarter was due to the UPC acquisition. While the increase in adjusted EBITDA from the second quarter of fiscal 2014, was due primarily to operational efficiency achieved in our wood-treating chemical segment and lower SG&A.

Regarding our G&A expenses, I want to emphasize that one of our priorities is to operate in an efficient and cost effective manner. And we recognize our corporate overhead expense is excessive for a company of our size. The increase in G&A expense we've experienced this year is due primarily to our efforts to establish consistency around internal controls and financial reporting globally, including first year SOX implementation for the UPC businesses. We will continue to work diligently to optimize overhead expenses as we build our organization's global capabilities and streamline our business processes.

Turning to our earnings, we reported third quarter adjusted EPS to $0.20, down from $0.20 per share in last year's third quarter, but up from $0.20 per share in the second fiscal quarter of 2014. The sequential improvement in third quarter adjusted EPS reflects our continued efforts to optimize our supply chain within our wood-treating chemical business.

Additionally, we are pleased with the high level operating cash flow we generate in the third quarter which totaled over $14 million. While operating cash flow will fluctuate on a quarter-to-quarter basis due to changes in working capital, our core objective remains firmly on growing cash flow to drive long-term shareholder value.

Our third quarter electronic chemical sales improved sequentially in Europe and Asia, benefiting from opportunities due to our expanded global presence. Sales in North America which accounts for more than half of our total electronic chemical sales reflect, as we experience lower sales to a key customer. The [shot fall] of this customer is due to a technology upgrade that they are undertaking resulting in lower fab utilization and reduced wafer output.

Within our wood-treating chemical segment, third quarter sales decreased from last year's levels primarily due to lower Penta sale volume. But the decline was partially offset by increased Creosote sales. Penta shipments were particularly strong in last year's third quarter, and we're lowering the comparable period this year mainly due to limited timber availability and the absence of severe storms.

In addition, wood-treating chemicals segment revenue were diminished this quarter due to lower year-over-year pricing for hydrochloric acid which we sell as a byproduct of our Penta manufacturing process. While the year-over-year increase in our third quarter creosote sale is positive, this product faces challenging market dynamics as we've discussed on previous call. The railroad industry continues to offer cross tie dual [treated with borates], a trend which is the combined effect of reducing Creosote demand industry-wide and exerting downward pressure in Creosote prices.

These dynamics have presented challenges to our Creosote business. But we continue to position our Creosote supply chain to optimize operating costs, while also right sizing our distribution assets to better match market demand for Creosote. These actually led to improved third quarter wood-treating chemical segment EBITDA and EBITDA margin relative to the second quarter. Looking forward, we remain tensely focused on our objective in maximizing cash flow within this segment.

As I mentioned earlier, a key focus area is improving our organization's global capabilities to efficiency and cost effectively manage our global business and provide a platform and foundation for future growth. To that end, we have kicked off the global implementation of our new SAP ERP system at the end of April. And we expect to convert our US operations to our new ERP system in February of next year. Once SAP is implemented throughout our global operations, we will benefit from more efficient business processes, improved execution, enhanced day-to-day operational decision making and more streamlined integration of future acquisitions.

So now, I'd like to turn it over to Mindy. Mindy, please go ahead with financial review and our outlook.

Mindy Passmore - *KMG Chemicals Inc. - CFO*

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

KMG reported consolidated net sales of $84.4 million in the third quarter, up 41% on a year-over-year basis, reflecting the acquisition of the UPC business and Electronic Chemicals. Gross profit margin in the third quarter was 29.3%, up from 27.3% in last year's third quarter.

The acquired UPC business had higher growth margin as a percentage of sale due in part to our operations in Singapore which includes significant business in total chemicals management services. Third quarter distribution expenses were $12 million or 14.2% of sales, an increase from $6.4 million or 10.7% of sales in last year's third quarter.

The year over year increase is attributable to higher sales volume resulting from the UPC acquisition which includes our distribution operations in Singapore. I would note the distribution expense in our Singapore business represents 34% of Singapore sales due to the total chemicals management service component.

On a sequential basis, consolidated distribution expense decreased by approximately $900,000 due to lower electronic chemical shipments in North America, reduced supply chain costs in wood-treating chemicals and lower cost in Asia. The third quarter SG&A expense was $8.8 million, up from $5.6 million in the same period last year.

The majority of this increase was due to additional SG&A expenses from the UPC acquisition, higher audit and tax service fees and stock-based compensation. On a sequential basis, SG&A declined by approximately $1.1 million due primarily to lower personnel expenses and the absence of various one-time costs incurred in the second quarter.

Consolidated adjusted EBITDA in the third quarter was $7.6 million, up from $6.3 million in last year's third quarter. Third quarter fiscal 2014 adjusted EBITDA excludes $1.4 million of restructuring charges and integration expenses including $949,000 in non-cash accelerating depreciation expense related to the closure of the Fremont facility and the cessation of manufacturing in Milan, $112,000 in restructuring charges and $358,000 in integration expense.

On a GAAP basis, the third quarter net earnings was 11% per share compared to $0.25 per share in last year's third quarter. As Chris stated, adjusted EPS for the third quarter of fiscal 2014 was $0.20 excluding restructuring charges and integration expenses. The year-over-year decline in adjusted EPS reflected higher depreciation and amortization expense primarily due to the UPC acquisition and low profitability within our wood-treating chemical segment. The impact earnings of higher depreciation and amortization expense was approximately $0.08 per share in the third quarter.

Turning to our third quarter segment results including corporate allocation, electronic chemical sales were $61.5 million, up from $36.3 million last year. The year-over-year increase reflects the addition of the UPC business. Adjusted EBITDA in electronic chemical segment was $6.6 million or 10.6% of sales compare to adjusted EBITDA of $4.7 million or 13% of sales in last year's third quarter. Adjusted EBITDA margins declined from last year primarily due to lower margins in the acquired UPC business relative to our existing electronic chemicals business.

In our wood-treating chemical segment, sales were down -- I mean, sales were $22.9 million, down 2.9% from $23.5 million in the comparable quarter last year. The year-over-year decrease in wood-treating chemicals sales primarily reflected lower Penta volume and lower sales prices for hydrochloric acid partially offset by an increase in Creosote volume. Wood-treating chemicals EBITDA was $2.2 million or 9.7% of segment sales versus $2.7 million or 11.3% of segment sales in last year's third quarter.

Although segment EBITDA and EBITDA margin declined due to a less favorable products mix and lower Creosote prices, segment EBITDA and EBITDA margin improved from second quarter fiscal 2014 level as a result of our ongoing efforts to optimize supply chain cost and streamline operating expenses.

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 restructuring charge in the third quarter was $1.1 million. As stated on the footnote on the income statements, that amount included $949,000 in non-cash restructuring charges representing accelerated depreciation related to the closure of the Fremont facility and cessation of production in Milan.

Because of the pending closure of the Fremont facility and planned cessation of manufacturing in Milan, we've reevaluated the [useful lives of] fixed assets of these facility and have accelerated depreciation in accordance to GAAP for certain asset. For fiscal 2014, we estimate accelerated depreciation expense will total approximately $3 million including the $949,000 incurred in the third 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 expense, cumulative restructuring charges in fiscal 2014 and fiscal 2015 are forecast to total $7 million to $9 million. Starting in fiscal 2015, benefits to operating income resulting from the restructuring of $6 million to $8 million on an annualized basis are forecast. In addition, incremental capital expenditures of approximately $2 million are expected to be incurred to accomplish these plans.

We ended the third quarter in a strong financial position including cash and cash equivalents of $19.4 million, up from $15 million as of January 31, 2014.

During our third quarter, we generated $14.1 million in cash from operations after interest payment of $605,000 on our debt. We used our positive cash flow to further reduce our long term debt by $7 million as well as for capital expenditures in $1.8 million and dividend payments of $348,000. So far in fiscal 2014, we reduced the amount outstanding on our revolving credit facility by $13 million.

For the nine-month period ended April 30, 2014, we reported cash flow from operations of $25.9 million, up from $9.5 million during the comparable period of fiscal 2013. Our UPC business contributed significantly to our increased cash flow from operations. As I noted on our last conference call, the $20 million term long payable to Prudential that was formerly classified as long-term debt is now classified as current maturities of long-term debt. And this is now becomes due by the end of the calendar year. We continue to evaluate our options for replacing these notes and we're pleased to have several attractive options available.

Now, I'll review our financial outlook for the remainder of fiscal 2014. We project the consolidated net sales will increase sequentially from third quarter level with fiscal 2014 consolidated sales totaling approximately $350 million. We expect revenue to increase sequentially in our fourth quarter reflecting favorable seasonal trends in both our electronic chemicals and wood-treating chemicals businesses. We also anticipate further cost savings from our manufacturing consolidation initiative.

We estimate fiscal 2014 depreciation and amortization expense excluding accelerated depreciation will be less than $15 million. For the nine-month period ending April 30, 2014, we incur $10.4 million in depreciation expense as indicated in the cash flow statement attached in today's earnings release.

Now, let's take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator instructions) Your first question comes from the line of Rosemarie Morbelli from Gabelli & Co. Please proceed.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Thank you. Good morning, all.

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

Good morning, Rosemarie.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

I was wondering if you could give us a little more of a feel in terms of the issue from your major customer on the electronic side, and whether they are now over, and if you anticipate, therefore, some sequential pickup in that particular business with that particular customer?

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

Yes. Sure, happy to. So it is a major customer for us in North America. And they've been undergoing a technology upgrade as I said. And it has resulted in a lower output for them, and thus, resulting in lower demand of their chemicals from us as well as other suppliers to them. So if something -- as these technology upgrades go, sometimes they go very quickly and efficiently, sometimes they drag on.

So it's a global customer that is looking at their overall fabs and what production they produce in what regions of the world. So part of it is a realignment of technology for them around the globe. And so, we anticipate that they'll get through this technology upgrade. And sort out their global repositioning of production and that their volume will rebound. It's unclear when exactly that will be. But to say that our sales have been impacted year-over-year is accurate as well as from second quarter to quarter three specifically from that customer.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Could you give us a feel for how much your sales were affected? How much business you do with that customer or at least on what the short fall went?

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

Yes. Just from one quarter from quarter two to quarter three, it was close to $700,000.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. Which is really not that bigger number in the -- in the aggregate. So does that customer have a particularly high margin type of business [sort of]?

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

No, not particularly. I think it's in line with our overall margins.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. And just staying on the electronics, could you give us a feel for what is happening in the semiconductor market? Are you seeing any pickup? Are you making progress? Are your customers making progress manufacturing chips for mobile applications as supposed to TV and PCs?

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

Yes. So I think the industry is following the economy. And their overall trend is not as high as they would have expected at this point in time as the economy has not recovered as quickly as they had anticipated. But we're seeing some increases. It's spotty in some areas versus others, certain customers versus others. So we're not seeing a global improvement across the board. We're seeing some. But as I said, as some customers realign some of their production from one region to the other, we're seeing some shifts there.

Going forward, I think the industry is optimistic for the remainder of 2014 into 2015. The capital spend on equipment and fabs continue to be strong, and is projected to be strong into 2015. So we're optimistic about the future. With regards to mobility versus PCs and memory into various components, we continue to put an emphasis on trying to shift some of our supply to customers that are more focused on mobility to give us a lift from that higher growth segment.

So that's a continued focus for us around the globe. And we're utilizing our global presence to have discussions with those customers as well as try and gain some opportunities with them.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. Thanks. I'll get back on queue.

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

Thank you.

Operator

(Operator instructions) Your next question comes from the line of Rosemarie Morbelli, from Gabelli & Co. Please proceed.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. I guess it is my call. Just following up on that electronic industry, as your customers are realigning their fabs or productions, are you positioned in such a way that as they move out of the US, for example, into Asia, you can do business with them there or do they already actually have other -- I mean, other suppliers than you in those regions where they are adding capacity versus those where they are eliminating capacity?

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

Yes. So it depends, Rosemarie, where they go, right? So we've got the largest position in North America in this industry segment. And we have the largest position in Europe. So -- and we have a position in Asia, and this region acquisition gives us that global presence that others don't have.

So it depends where they go. And we're -- we have aligned our sales team to have global account management. So we're talking to the global customers on a high level to understand how they're shifting their production, and where it's moving, and to be in discussions with them, and to follow where their manufacturing is in. It depends by product as well as what region they go to.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. On the West Coast utility [poles] upgrade, can you give us an update on that? Is it actually happening or are they just talking about it and not doing anything?

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

No. There is some work being done there, not to the speed that I think everybody spoke about it. It had to do -- a lot of it had to do with wind and solar generation and the upgrading of the infrastructure. But we're continuing to see that. So we are following that closely. But on the overall pole demand, there's a larger pole demand in the Southeast as it relates to Penta. And that's been the overriding issue for Penta than the shortage of timber and the other uses for timber as well as the lack of storms and the related damage that those storms cause and the effect on pole.

So from a West standpoint, yes, we're seeing that. Not to the level that we had hoped. But we're still seeing that direction go in the right way. But overall, Penta sales were impacted primarily in the Southeast.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

All right. And then lastly, and then we'll talk later. Have you found -- you have built a new team. And so, have they found any new opportunities to improve results beyond what you are doing? And what do you think would be a good SG&A level for a company your size?

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

Yes. So I'm very pleased with the team that we've built. And very pleased with the progress we're making. So as we -- as I said earlier, as we build out the global capabilities, integrate UPC not only from manufacturing standpoint, but from an organizational capabilities and SOX compliance and financial reporting.

So we're spending a lot of effort as well as money on that to get us to that level. The implementation of the SAP ERP system is about giving everyone the tool that we need globally to provide that efficient cost effective organization in decision making and the platform for future growth. So yes, we're pleased with the team. I'm never pleased with the progress, because it's never fast enough. But I think we're making good progress. And we're -- I think we're going in the right direction. And we're continuing to find opportunities, and to take advantage of those.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

And the normalized or adequate SG&A level of your size?

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

I'm not sure. You're asking me what the appropriate level is?

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Well, in your comments, you said something to the effect that the SG&A was much too high for a company your size. So I am just wondering if you have a target, what would be a normal type of G&A for you to operate at this particular size?

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

Yes. So we have some internal targets that we're striving towards. And part of it is looking at each element of the organization, each function, each aspect and providing them with the right tools to be able to be efficient. So I'm not prepared to give you a number per say today. But to say that when I say it's excessive, I think a company our size should be spending much less. And I'm confident that we'll get to that optimal level with the team we have in place and the tools that we're going to give them and the capabilities we're going to build out to have the overhead be the appropriate level for a company our size with our strategy in lined of maximizing cash flow.

Rosemarie Morbelli - *Gabelli & Co - Analyst*

Okay. Thank you very much.

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

Thank you, Rosemarie.

Operator

Okay, ladies and gentlemen, this concludes our question and answer session. I will now turn the conference back over to Mr. Chris Fraser.

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

Thank you, everybody. And we appreciate your participation today, and your interest in KMG. And we look forward to speaking with you on our fourth quarter and fiscal 2014 year-end conference call. Thank you.

Operator

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