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CCC - Q3 2013 Calgon Carbon Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Brandy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Calgon Carbon Corporation's Third Quarter 2013 Results Conference Call. (Operator Instructions).

Thank you. Ms. Gail Gerono, you may begin your conference.

Gail Gerono - *Calgon Carbon Corporation - VP IR and Communications*

Thanks very much. Good morning, and thank you for joining us.

Our speakers today are Randy Dearth, Calgon Carbon's CEO; Bob O'Brien, our Chief Operating Officer; and Steve Schott, our CFO.

The presentations will follow our standard format -- opening remarks from Randy, review of the third quarter financials by Steve, and an operations report from Bob, then Q&A.

Today's presentations will be brief. There will be an in-depth discussion during our Webcast on Thursday, November 7 in conjunction with our 2013 analyst day. The Webcast will begin at 10 o'clock a.m. Eastern Standard Time. You can access the link to the Webcast on the For Investors section of our Website, www.calgoncarbon.com.

Before we begin the formal presentations, I would like to remind you that the Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Today's presentations or perhaps some of the comments that Calgon Carbon's executives make during the Q&A may contain statements that are forward-looking. Forward-looking statements typically contain words such as expect, believes, estimate, anticipate, or similar words indicating that future outcomes are uncertain.

Statements looking forward in time, including statements regarding future growth and profitability, price increases, cost savings, product lines, enhanced competitive posture, and acquisitions, are included in the Company's most recent annual report pursuant to the safe harbor provision of the Private Securities Litigation Reform Act of 1995. They involve known and unknown risks and uncertainties that may cause the Company's actual results in future periods to be materially different from any future performance suggested during this Webcast. Further, the Company operates in an industry sector where securities values may be volatile and may be influenced by economic and other factors beyond the Company's control.



Some of the factors that could affect future performance of the Company are changes in or delays in the implementation of regulations that cause a market for our products, acquisitions, higher energy and raw material costs, costs of imports and related tariffs, labor relations, capital and environmental requirements, changes in foreign currency, exchange rates, borrowing restrictions, validity of patents and other intellectual property, and pension costs.

In the context of the forward-looking information provided in this call and Webcast, please, refer to the discussions, risks, and other information detailed in as well as the other information contained in the Company's most recent annual report.

Randy Dearth - *Calgon Carbon Corporation - CEO*

Welcome, everybody.

As Gail said, today, we will be focusing on our third quarter earnings, so we will limit our remarks to that subject. We look forward to seeing many of you later this week here in Phoenix, where we'll have the opportunity to discuss a range of topics in connection with value creation at Calgon Carbon.

With that said, let's talk about Q3. Calgon Carbon had another very solid quarter, and I'm pleased with our performance. As with the first two quarters of 2013, our cost improvement and price increase programs contributed to our success. Since initiating our restructuring initiatives that began about a year ago, we have significantly improved the financial profile of the Company. Later in the call, I'll provide some insight regarding those initiatives.

But, first, Steve will discuss the financials, followed by Bob with comments on operations.

Steve Schott - *Calgon Carbon Corporation - CFO*

Good morning, everyone.

Total sales for the third quarter of 2013 were \$139.4 million versus \$135.5 million in the third quarter of 2012, an increase of \$3.9 million, or 2.9%. Currency translation had a negative impact of \$3.8 million on the Activated Carbon and Service sales for the third quarter of 2013 due to the weaker yen.

Regarding our segments, sales in the Activated Carbon and Service segment increased \$8.1 million, or 7%, for the third quarter of 2013, compared to 2012's third quarter. The increase was primarily due to higher demand for activated carbon products and services in the environmental water treatment, food, and specialty carbon markets. Sales in our environmental air flue gas sub-segment were equal year over year. Currency translation had a negative impact of \$3.8 million on sales for the third quarter of 2013; again, due to the weaker yen.

Equipment sales declined \$4.8 million, or 26.3%, for the third quarter of 2013 compared to 2012's third quarter. This was due to lower revenue for balanced water treatment systems, which declined by \$4.3 million.

Sales for the Consumer segment increased approximately \$600,000, or 28.3%, for the third quarter of 2013 compared to 2012's third quarter. The higher sales were due to increased demand for activated carbon cloth.

Consolidated gross profit, before depreciation and amortization, as a percent of net sales was 33.3% in the third quarter of 2013, compared to 27.3% in the third quarter of 2012, an increase of 6 percentage points. The increase was in the Activated Carbon and Service segment due to improved plant performance and ongoing cost improvement initiatives. The 2012 quarter and year-to-date periods included \$2.5 million of costs related to the Pearl River facility, as well as a \$1.7-million write-off of obsolete inventory.



Depreciation and amortization expense was \$7.3 million in the third quarter of 2013, compared to \$6.8 million in the third quarter of 2012. The increase was due to increased depreciation related to the Company's new Gila Bend, Arizona facility that was placed into service in the second quarter of 2013, as well as for capital improvements at the Company's Pearl River facility that were completed in 2012.

Selling, administrative, and research expenses were \$21 million during the third quarter of 2013 versus \$25.8 million in 2012, a decrease of \$4.8 million, or 18.6%. The decrease was due to lower employee-related expenses due in part to the Company's cost reduction initiatives. Selling, administrative, and research expenses for the third quarter of 2012 included \$3.4 million of employee-related charges. Excluding the impact of these 2012 charges, selling, administrative, and research expenses as a percentage of sales improved to 15.1% in 2013 compared to 16.5% for the third quarter of 2012.

The third quarter of 2012 also included \$8 million of restructuring charges, which were all within the Activated Carbon and Service segment. The third quarter of 2013 included \$266,000 of expense related primarily to the settlement of an ongoing environmental dispute at our Big Sandy plant. Randy will address this later in the call.

The income tax rate for the third quarter of 2013 was 31.5% and reflects benefits from favorable return to accrual adjustments, as well as a release of certain uncertain tax position liabilities. The Company's full year 2013 tax rate is estimated to be between 34% and 35%.

In summary, our net income for the third quarter was \$11.9 million, or \$0.22 per diluted share, versus a net loss of \$4.5 million, or \$0.08 per diluted share, in 2012.

Turning again to the Company's business segments, the Activated Carbon and Service segment recognized \$25 million in operating income before depreciation and amortization and restructuring in the third quarter of 2013, compared to \$9.9 million in the third quarter of 2012. The increase was due to our 2013 price increase and benefits from our cost improvement programs. As I mentioned earlier, the 2012 period had several charges in the Carbon and Service segment that did not recur in 2013.

The Equipment segment recognized \$600,000 in operating loss before depreciation and amortization in the third quarter of 2013, compared to \$700,000 of operating income in the third quarter of 2012. The decline was primarily due to lower volume for ballast water treatment systems. Backlog for the Equipment segment was \$22 million as of September 30, 2013.

The Consumer segment recognized \$800,000 in operating income before depreciation and amortization in the third quarter of 2013, compared to \$500,000 in the third quarter of 2012.

Regarding our balance sheet, cash increased during the first nine months of 2013, and, at September 30, we have approximately \$30 million of cash. Receivables were \$105 million for the third quarter of 2013, which was \$3.3 million higher than yearend 2012, reflecting strong September sales.

Inventories were \$107.8 million for the third quarter of 2013, which are only \$600,000 higher than yearend 2012, despite our decision to increase our higher-quality coal raw material inventory that has increased by \$6.2 million since yearend.

As of September 30, 2013, the Company had total debt outstanding of \$48.6 million, which represents a decrease of approximately \$15 million from yearend, and that relates primarily to repayments for borrowings at Calgon Carbon Japan and those under our US revolving credit facility.

Cash flow from operations was \$21.3 million for the third quarter of 2013, compared to operating cash flow of \$18.6 million in 2012, an increase of \$2.7 million.

Capital expenditures totaled approximately \$6 million for the third quarter of 2013, and our estimated spending on capital for the full year 2013 is currently \$30 million to \$35 million.

Gail Gerono - *Calgon Carbon Corporation - VP IR and Communications*

Thanks, Steve. Bob's up next.

Bob O'Brien - *Calgon Carbon Corporation - COO*

Once again, our carbon manufacturing facilities trended well during this quarter, and we continue to realize benefits from the upgrades that we made at our Pearl River, Mississippi plant last year. Both of our activated carbon production facilities ran at full capacity in the third quarter.

With respect to our price increase on activated carbon and reactive products, as I reported on last quarter's call, we expect to realize our \$10-million target for 2013.

Next, I'll touch on emerging markets. I will cover this topic in more depth on Thursday's Webcast.

Let's begin with disinfection byproducts. In prior calls, we were in negotiations for a ten-year contract with the city of Glendale, Arizona to provide reactivation services for carbon used to treat the city's drinking water. This contract has now been signed, and the terms are identical to the contracts with Phoenix and Scottsdale. The reactivation of the carbon is being performed at our Gila Bend facility. The value of the contract will depend on the amount of spent activated carbon that is reactivated annually, which is expected to be 1.3 million pounds.

Calgon Carbon supplied the initial, virgin carbon to Glendale, and we have been reactivating their carbon under a former agreement since 2008. In fact, they were our first potable water custom reactivation customer in the United States.

In the third quarter of 2013, we were also awarded two contracts for equipment valued at \$1.5 million and three customers who are using granular activated carbon to be in compliance with the disinfection byproduct rules converted to custom reactivation.

Next, mercury removal from electric-generating units. We saw an uptick in activity in this market in the third quarter. Bid activity is slowly increasing, and we expect the peak bidding to occur in the first and second quarters of 2014. Our strategy is to promote the performance and cost benefits of our advanced FLUEPAC products, which are clearly demonstrated when trials are run at current and prospective customers' electric-generating units. Year to date, twelve trials have been conducted using our FLUEPAC products, and at least five more are planned before the end of the year. A number of trials are also pending for 2014. In total, we have participated in 22 full-scale trials.

In addition to conducting trials in our products which are currently available in the marketplace, we have an ongoing program to improve those products. As part of that program, our R&D team conducted a wide range of additional tests during the third quarter at an electric-generating power research facility.

The third emerging market is ballast water treatment. We received orders for 19 ballast water treatment systems in Q3. Most of the orders were for service vessels and other small ships. Inquiries for retrofits continued to increase relative to newbuilds during the quarter. The number of RFQs that include specific drydock dates has also increased, reflecting increasing acknowledgement of the US Coast Guard's compliance schedule, which begins in 2014.

19 companies have been awarded AMS certification by the US Coast Guard. Seven of these, including Hyde Marine, provide US -- UV-based systems. Through our participation in the US Coast Guard's environmental technical verification panel, progress is being made in the development of a certification test protocol that will accurately reflect the performance of UV-based ballast water treatment systems. UV, combined with filtration, continues to be the technology of choice in the marketplace.

Also during the quarter, we formed a partnership with Cammell Laird, the largest shipyard in the UK, for installation of our Hyde GUARDIAN systems in a wide variety of vessel types.

As I mentioned, much more detail about these markets will be provided on our investor day this Thursday.



Gail Gerono - *Calgon Carbon Corporation - VP IR and Communications*

Thanks very much.

Steve Schott - *Calgon Carbon Corporation - CFO*

Regarding our fourth quarter, first, sales. We expect our fourth quarter sales to be better than our first quarter of 2013 but slightly lower sequentially. Contributing to the small, sequential decline are Calgon Carbon Japan sales, as some of their expected fourth quarter sales were accelerated into earlier periods this year.

Margins. We expect our gross profit before depreciation and amortization as a percent of sales to also decline slightly sequentially. Our expected lower sequential sales and costs related to our improvement initiatives should negatively impact this metric.

Operating expenses. We expect our operating expenses to be higher sequentially and estimate they may approach 16% of sales. There will be higher spending on corporate initiatives and our cost improvement programs during the fourth quarter.

Gail Gerono - *Calgon Carbon Corporation - VP IR and Communications*

Thanks, Steve. Randy's up next.

Randy Dearth - *Calgon Carbon Corporation - CEO*

Well, first, I would like to bring you up to date on a few developments.

On September 30, we completed our \$50-million accelerated share repurchase program. The final number of shares repurchased under the program was 2,935,668, and our outstanding share count has been reduced accordingly. As you may recall, our board authorized share repurchases up to \$100 million, and we will continue to evaluate share repurchase programs as a way to return value to shareholders.

In another development, Calgon Carbon and the Department of Justice reached a settlement related to the 2005 inspection at our Big Sandy plant. As a result of that inspection, the EPA cited violations of RCRA and the Clean Water Act related to waste management. By way of background, the government was initially seeking a \$13-million civil penalty and the closing of our storage lagoons at the plant. This would have cost us an additional \$10 million.

The signed consent decree calls for the following. First, we have agreed to pay a settlement of \$1.6 million. We make no admission of any violations of any law or any regulation. Our onsite storage lagoons will not be deemed hazardous, and the material in the lagoons may be handled as solid waste. No capital expenditures related to the lagoons will be required. We have agreed to conduct limited testing on certain sediments in ground water. The consent decree was filed with the court on October 28. The Department of Justice will publish the consent decree on its Website. There will be a 30-day public comment period, and, after 30 days, the EPA will respond to public comments. And, last, the court will enter the consent decree as a binding court order.

We have made significant improvements to both our environmental staff and processes since the 2005 inspection. The EPA, in Kentucky, conducted a comprehensive inspection in 2010 and found no continuing violations.

This is a very good result for us, and we are happy with the outcome.

Having concluded our remarks on the third quarter, let me give you an overview of what to expect at Thursday's investor day.

First, you will have the opportunity to learn more about our markets, both our traditional businesses as well as much more detail around our three emerging markets.

We will also provide more detail on our cost improvement program and other initiatives.

If you can't join us either in person or via the Webcast, look for the presentation on the Investor page of our Website.

It should be a great day, and I look forward to sharing our story.

So that concludes our presentation, and we will now take your questions. Again, given Thursday's full agenda, I would ask that you focus your questions on the third quarter, if possible.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Dan Mannes, Avondale.

Dan Mannes - Avondale - Analyst

A couple quick follow-ups. First, and just to clarify, Steve, your comments, were you indicating that the gross margins for the fourth quarter were actually going to be a little bit lower than the third? I was just trying to understand the way you had stated that.

Steve Schott - Calgon Carbon Corporation - CFO

Yes, Dan.

Dan Mannes - Avondale - Analyst

Maybe a little bit of margin degradation?

Steve Schott - Calgon Carbon Corporation - CFO

Yes. There will be a slight -- we expect a slight decline in our gross margins for two reasons. One, of course, we forecasted slightly lower sales. And then, second, as we work on our cost improvement initiatives, there are costs we're incurring related to them. And we expect that will also burden the fourth quarter a little bit.

Dan Mannes - Avondale - Analyst

Sure. And then, second, and this may be answered more fully on Thursday, but the pace on ballast water -- it sounded like a lot of small orders during the third quarter. Any feedback on that as it relates to maybe some changes on the international front in terms of maybe a longer schedule for IMO compliance potentially?



Bob O'Brien - *Calgon Carbon Corporation - COO*

Certainly, the market is being impacted by the IMO pending ratification. And, as you know, it's continued to drag. And our current estimate now -- we don't expect approval of that -- or ratification until mid 2014. And then, after that's ratified, there's still a year until ships' owners are required to actually comply with the regulation. So that is being a drag in the market.

We continue to see new shipbuilding being slow. And we're just starting to see the impact of the Coast Guard regulations in the US. As such, we don't really see the ballast water opportunity for us now really beginning to pick up speed until late in 2014 and then into 2015.

Randy Dearth - *Calgon Carbon Corporation - CEO*

We have John Platz on the agenda for Thursday, so you'll get to see a presentation from John. John's our Head of the UV division, and he'll provide a lot more insight into this market.

Dan Mannes - *Avondale - Analyst*

I figured that was the case. I'm also going to hold off on the mercury questions until Thursday too.

My only other question was -- since you mentioned the completion of the ASR, and, again, this may be premature as well, you've obviously had a large investor come out saying you probably should do \$150 million to \$200 million of buybacks. Can you maybe address what some of your thoughts are as you look a little forward in terms of being able to do some more on the buyback front and then maybe any constraints you feel in terms of a target capital structure? Or, again, am I kind of going with what you're looking at for Thursday?

Steve Schott - *Calgon Carbon Corporation - CFO*

Well we are going to address Thursday our case for value creation. So that really will be the appropriate time to do so.

But, that being said, and I've said this on previous calls, I value when I get input from shareholders and ideas. We take the ideas back. We vet them amongst the management team. We take some of these to the board and discuss them. So I think that's an important part of the process, and we value that.

And, like I said, Thursday, we'll present our case, and we'll address some of those concerns.

Dan Mannes - *Avondale - Analyst*

Thanks much. Appreciate it.

Operator

(Operator Instructions). Jinming Liu, Ardour Capital.

Jinming Liu - *Ardour Capital - Analyst*

Recently, there is acquisition of one of the coconut activated carbon producer. I understand you export a lot of -- import a lot of coconut carbon into the country. Is there any impact on your business in terms of that acquisition?



Bob O'Brien - *Calgon Carbon Corporation - COO*

We don't really see any, certainly, immediate impact to our business. We are a large distributor of coconut carbon on a global basis, not only the US. And, certainly, it's a market where we face competition, and we do relatively well there. So we don't really see any immediate impact of that purchase.

Jinming Liu - *Ardour Capital - Analyst*

Okay. Just related to your resale business, how much was the resale of -- percentage of resale in your total sales in third quarter?

Bob O'Brien - *Calgon Carbon Corporation - COO*

I don't think we normally report that.

Randy Dearth - *Calgon Carbon Corporation - CEO*

No. We don't. That's not a number that we give out.

Jinming Liu - *Ardour Capital - Analyst*

Okay. Got that. Thanks a lot.

Operator

Steve Schwartz, First Analysis.

Steve Schwartz - *First Analysis - Analyst*

I think you mentioned in your prepared remarks there was an improvement in food carbon. And we've heard for so long that that market was declining for you. Can you talk a little bit about what's behind that?

Bob O'Brien - *Calgon Carbon Corporation - COO*

Food -- our improvement quarter to quarter included in the sweetener market, which we lump as both cane sugar and corn sweeteners. And that can be affected by weather. A new fill is taking place. So there are some ups and downs in that market. And I think what we are basically seeing there is there were some initial fills of new plants going online that helped increase our sales.

Steve Schwartz - *First Analysis - Analyst*

New plant. Okay. Sounds good, Bob. All right. That's it for me. See you on Thursday.

Operator

(Operator Instructions). Christopher Butler, Sidoti & Company.



Christopher Butler - *Sidoti & Company - Analyst*

I'm sorry if I missed it. Did you indicate what the volume growth was in the quarter for activated carbon and what the impact of that shift from Japan was?

Steve Schott - *Calgon Carbon Corporation - CFO*

As it relates to Japan -- Are you referring, Chris, to my fourth quarter comment, where I said some sales had been moved forward?

Christopher Butler - *Sidoti & Company - Analyst*

Right. Exactly.

Steve Schott - *Calgon Carbon Corporation - CFO*

We did not give the impact. I can tell you, in US dollars, it's probably, on balance, about \$4 million that had been moved into earlier quarters and, thus, the expectation our fourth quarter will be slightly less than the third quarter.

Volume was strong and, I think, moved in sync with the markets that we discussed as having increased -- environmental water, food, and potable water. So volume was definitely up. I don't have the percentage in front of me. But no question, in the Carbon and Service, segment it was a very good quarter for us.

Christopher Butler - *Sidoti & Company - Analyst*

And, just to quickly follow up, it sounds as if that shift wasn't just the third quarter but the first half of the year, as well, that saw some of the benefit.

Steve Schott - *Calgon Carbon Corporation - CFO*

Yes. Volume's been good this year. Obviously, we've had headwinds with FX, particularly in Japan. And that will persist through the fourth quarter. But the Carbon and Service business has grown for us during the year, and we're pleased with what we're seeing this year.

Christopher Butler - *Sidoti & Company - Analyst*

I appreciate your time.

Operator

(Operator Instructions). There appear to be no other questions. I would like to hand the floor back over to Randy for any closing or additional comments.

Randy Dearth - *Calgon Carbon Corporation - CEO*

As I mentioned in my opening remarks, we are pleased with the results for the quarter, and we're also pleased with the progress we've made on improving our cost structure and our gross margin during the first nine months of this year. So improvement in those two areas are going to remain a focus throughout the rest of the year and into 2014.

That concludes my remarks and the remarks of my colleagues.

We look forward, again, to having the discussion with all of you on Thursday. Thank you.

Operator

Thank you. That concludes today's conference. You may now disconnect.

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