KMG Chemicals, Inc. Fiscal 2012 First Quarter Financial Results Conference Call

Friday, December 9, 2011 at 10:00am ET

Participants

Corporate Participants

J. Neal Butler – President, Chief Executive Officer & Director
John V. Sobchak – CFO, Vice President
Devin Sullivan – Senior Vice President of The Equity Group, Inc.

Other Participants

Rosemarie J. Morbelli – Analyst, Gabelli & Co., Inc.
Jay Richard Harris – Analyst, Goldsmith & Harris, Inc.
Tom Claugus – Buyside Analyst, Graham Partners

Management Discussion Section

Operator

Greetings and welcome to the KMG Chemicals Inc. Fiscal 2012 First Quarter Financial Results Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation.

[Operator Instructions]

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Devin Sullivan, Senior Vice President of The Equity Group. Thank you, Mr. Sullivan. You may begin.

Devin Sullivan

Thank you, Christine, and good morning, everyone. Welcome to the KMG Chemicals fiscal 2012 first quarter financial results conference call. We would like to begin by reminding you that the information in 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 this company.

Although the company believes that the expectations reflected in its forward-looking statements are reasonable, it can give no assurance that such expectations or any of its forward-looking statements will prove to be correct. Factors that could cause results to differ include, but are not limited to, the loss of primary customers, successful implementation of internal plans, product demand, the impact of competing products, increases in the price of raw materials and active ingredients, successful acquisition and integration of additional product lines and businesses, the condition of capital markets in light of interest rate and currency fluctuations and general economic conditions, environmental liability, the ability to obtain registration and re-registration of products, increased environmental compliance, cost of products, and general political and economic risks and uncertainties.

With that, I would now like to turn the call over to Neal Butler, President and CEO. Please go ahead, Neal.

J. Neal Butler
Thank you, Devin. Good morning. And again, welcome to KMG's fiscal 2012 first quarter conference call. John Sobchak, our CFO, and I will take you through the financials and provide an overview of each of our businesses. We will then discuss our expectations for fiscal 2012. After our comments, we'll be pleased to address your questions. Our earnings release was issued earlier today and we plan to file our 10-Q on Monday.

Many of you listened to us over the past year discuss our optimism for the business once we completed the consolidation of the Electronic Chemicals acquisition. This consolidation was a notable undertaking and, as earlier reported, the associated costs plus higher than expected raw material prices impacted our results during the final three quarters of fiscal 2011.

We were, however, confident that we were on the correct path and the long-term benefits that we would accrue as a result of this consolidation would exceed the incremental costs we incurred during this implementation. We communicated that pricing actions were being taken to move back to more normalized margins, and those have indeed been implemented and margins are moving positively. We believe that our operating results for the first quarter of fiscal 2012 are an indication that the confidence was warranted.

Although we still have some work to do, we believe that barring any significant economic downturn, we will produce significantly improved results for fiscal 2012 compared to last year.

Hopefully everyone has had the opportunity to review our press release, so I'll simply provide you with an overview of how we did this past quarter and John will provide greater financial detail in his remarks.

Net sales rose by 18% to $73.3 million from $62.1 million in the first quarter of fiscal 2011. Each of our segments reported higher net sales over the prior year period with our Wood Treating Chemicals business leading the way with a 37% increase in segment sales due to increased volumes in both our penta and creosote product lines. Electronic Chemicals sales rose about 4% to $38.4 million. This was driven primarily by price increases as the market experienced a slight decline in semiconductor manufacturing in the U.S. and a somewhat greater decline in Europe and Asia during our first fiscal quarter. Per industry forecast, we expect the decline to flat-line through the end of the calendar year and rebound in the January and February time frame.

Overall, we expect this segment of our business to be a strong contributor in fiscal 2012. Following the Electronic Chemicals acquisition in March 2010, we have secured our leadership position in the growing high-purity process chemicals market at what we view as a most opportune time given the activity and calendar 2012 outlook in semiconductor manufacturing.

Sales in our Animal Health segment rose by almost 54% due to higher sales of Rabon in the U.S. and ear tags in our international markets. We also received new registrations for our products in Several Latin American countries.

For the entire company, operating income rose 17.1% to $6.5 million from $5.6 million in last year's fiscal first quarter.

During the quarter, we saw post-consolidation improvements in distribution expenses, which declined in absolute dollars and as a percentage of total sales.

We reported net income of $3.5 million, or $0.31 per diluted share, for the first quarter of fiscal 2012, consistent with the first fiscal quarter of last year. The prior-year period benefited from a decrease in income tax expenses associated with a reduction of valuation allowance related to our Italian subsidiary.

We ended the quarter in a strong financial position with $5.1 million in cash and an improved debt profile. We also generated net cash from operating activities of $13.6 million.

I'll now turn the call over to John.

John V. Sobchak
Thanks, Neal, and good morning, everyone. Before I begin, I want to alert everyone to a change in our reporting. We previously had four reportable segments: Electronic Chemicals, penta, creosote, and Animal Health. After re- evaluating the criteria used to determine operating segments, we concluded that our two Wood Treating product lines, creosote and penta, meetthe criteria of a single operating segment.

Therefore, beginning in this first fiscal quarter of 2012, KMG's reportable segments were revised to reflect the change from four to three reportable segments: Electronic Chemicals, Wood Treating Chemicals, and Animal Health. And prior year information has been reclassified to conform to the current period presentation.

Net sales increased by $11.2 million to $73.3 million; Wood Treating Chemicals was responsible for 80% of that increase, Electronic Chemicals for 14%, and Animal Health for 6%. Gross profit rose to $19.2 million from $17.4 million in last year's first quarter. Although gross margins rose by $1.8 million, as a percentage of net sales, gross margin declined to 26.2% from 28% in last year's first quarter. This percentage decline was due fairly evenly to two factors: an increase in the share of total revenue represented by Wood Treating Chemicals, which has lower average gross margins, and the decline in gross margins in both Wood Treating Chemicals and Electronic Chemicals due to higher raw material prices.

Pricing actions were implemented in the first quarter in our Wood Treating Chemicals business to recapture those cost increases. In Electronic Chemicals, we have seen some raw material price declines and have implemented pricing actions with other products to recover margins in this business.

Distribution expenses for the first quarter declined by $71,000 to $6.1 million, or 8.4% of net sales, from $6.2 million, or 10% of net sales, in last year's first quarter. Electronic Chemicals is more supply chain intensive than our other business segments. The decline in distribution expense as a percentage of revenue was attributable fairly evenly to efficiency improvements in the Electronic Chemicals business and an increase in the weighting of Wood Treating Chemicals' share of total revenue.

Although SG&A rose by just under $1 million from last year's first quarter, SG&A as a percentage of sales declined to 8.9% of net sales from 9% of net sales in the first quarter of fiscal 2011. Almost half of the dollar increase was attributable to testing required by the EPA in support of one of our Animal Health product registrations. There should be a similar spend in the last half of fiscal 2012 for the remainder of this work for the EPA.

Operating income rose 17.1% to $6.5 million from $5.6 million in last year's fiscal first quarter due to a $1.4 million increase in the operating income for our Wood Treating Chemicals business driven by improved sales volumes. This was offset by declines in operating income attributable to Electronic Chemicals and Animal Health relative to the comparable prior-year period. The decline in Electronic Chemicals' operating profit relative to the prior-year period was due to higher cost inventory associated with increased raw material prices and integration-related costs during 2011 when the product was manufactured.

The pricing action mentioned earlier and lower manufacturing costs during 2012 should have a favorable impact on Electronic Chemicals' margins, most notably in the second half of the fiscal year. The decline in Animal Health's operating profit was a result of the already mentioned EPA testing requirement.

Interest expense was $550,000 in the fiscal 2012 first quarter, essentially flat with interest expense in the fiscal 2011 first quarter. Our income tax rate was approximately 39.3% in the first quarter of fiscal 2012 versus 29.9% in fiscal 2011. Income tax expense in the first quarter of fiscal 2011 was reduced by approximately $410,000 with the reversal of a portion of the valuation allowance related to our Italian subsidiary.

Turning to the balance sheet, our cash position increased from $1.8 million at July 31, 2011 to $5.1 million at October 31, 2011. We continue to pay down borrowings, reducing our long-term debt by $5.3 million to $44 million from $49.3 million at the end of fiscal 2011.

As previously announced, we increased our existing revolving credit facility to $60 million from $50 million and extended the maturity date to December 31, 2016 from December 31, 2012. At October 31, 2011, we had repaid the amount outstanding our term loan and there was $24 million borrowed on the revolving facility. Also included in long-term debt at October 31, 2011 was $20 million of fixed rate notes maturing in December of 2014.

Working capital rose to $51.8 million from $45.2 million at fiscal 2011 year-end. The increase was attributable to the elimination of $8 million of current maturities from current liabilities when we repaid our term loan. At the end of fiscal 2012, first quarter shareholders' equity was $99.5 million, or $8.65 per diluted share.

And now, I'll hand it back to Neal.

J. Neal Butler
Thank you, John. Before we take questions, I want to provide a bit more color on how we see things nfolding for the balance of fiscal 2012. Within Electronic Chemicals, again, barring any significant economic downturn, we expect a solid demand environment for our products in calendar 2012 and the additional business associated with a new semiconductor fabrication facility coming on stream. In the near term, we're expecting some seasonal softness in the semiconductor market impacting the second fiscal quarter.

While we have recently seen some softening demand in the U.S., Europe is seeing a somewhat greater decline in semiconductor manufacturing, which began in October. Several fabrication facilities have cheduled temporary closings during the holidays. Forecasts from our key customers and industry resources, however, indicate a rebound in demand after the first of the calendar year.

At the same time, with the consolidation initiative in our Electronic Chemicals business completed, we are seeing a positive impact on our operating results. Electronic Chemicals' operating income increased notably in the first quarter of fiscal 2012 relative to the decline seen in the previous three quarters. Electronic Chemicals' operating income during those final three quarters of fiscal 2011 were adversely impacted by higher cost inventory produced during the transition period, when we were consolidating our manufacturing facilities. That higher cost material continued to adversely impact, to a lesser degree, the first quarter of 2012, but we are on track to return to more normalized operating margins in the second half of fiscal 2012.

In our Wood Treating segment, we generally expect to see current strong levels of demand continue through the balance of the fiscal year with normal seasonal softening in the second quarter. We have responded with pricing actions in all of our segments during the first half of fiscal 2012 to continue to recover the margin loss to raw material cost increases in each of our businesses. We have confidence in our strategy and our ability to achieve our growth objectives and believe it will continue to provide opportunities for sustained growth in revenue, earnings and cash flow.

As John noted, our balance sheet is healthy and poised to allow for substantive acquisitions underneath our consolidation strategy. We are pursuing opportunities to expand our Electronic Chemicals and Wood Treating Business both organically and via acquisitions. Additionally, we have a robust pipeline of acquisition prospects in Electronic Chemicals and Wood Treating, as well as opportunities to create a new segment platform which we intend to establish by fiscal 2014.

Now, with that, I'd like to turn the call over to the operator and poll for any questions. Thank you.

Questions & Answers Section

Operator

Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Thank you. Our first question is from Rosemarie Morbelli with Gabelli & Co. Please proceed with your question.

Rosemarie Morbelli

Good morning, Neal and John. Could you – you mentioned that you were planning in – well, you have announced price increases on the Wood Treatment business, but yet you also mentioned that some of your raw material cost in that particular category were coming down. I understand you have lost some margin, but how confident are you that you're actually going to be able to get those price increases?

J. Neal Butler

Yes. Rosemarie, good morning. How are you doing? The price increases that we've implemented in Wood Treating, they're in place and they'll stick. I mean, we're exceptionally confident that price increases will indeed remain.

Rosemarie Morbelli

And how long do you think this – there is a pent up demand on both if my memory serves me right – on both the rail ties and the electrical pole, how long do you think before you get back to a normalized type of demand and what would be that level?

John V. Sobchak

[Inaudible] (16:53)__________________ and a good average assumption is 35 years of useful life. And that would imply an annual replacement rate of approximately 20 million ties a year, and that's about where we are now. We do think that in prior years the country was under-investing in its railroad infrastructure maintenance. We're back to more normalized levels now. We do think that the business is subject to normal cycles like any business, but currently the railroad industry is operating very profitably and shipments by railroads have a significant cost advantage versus other ways of transportation. So, the Railroad Tie Association currently is expecting the rail tie replacement demand to continue at these approximate levels through calendar 2013. And beyond that, it starts to get a little fuzzy.

Rosemarie Morbelli
Okay. And then if I may ask one last question on the electronics. You are gaining business obviously from the new fabs being built in the U.S. Could you talk about what you have seen in your kind of same-store type of business? I know you talked about a slowdown, but you could – could you give us a better feel as to how big a slowdown and whether it will be even stronger in the second quarter before flattening out in the second half?

J. Neal Butler
Well, what we've seen in our business as it relates to the semiconductor – to the Electronic Chemicals business and semiconductor in the U.S., we've seen a volume decline probably somewhere around the 3% to 4% range. And in Europe, we've seen a decline somewhere between 7% and 10%. Our expectation is that the level that we're at today will maintain itself probably through the end of December.

The expectation is that we will see a ramp up in the calendar – in the first quarter of calendar year 2012, and this is just based upon a forecast that we're seeing from industry associations such as semi, are saying that the semiconductor manufacturing will ramp back up in probably January time – January-February timeframe.

Rosemarie Morbelli
And the new fabs – when do you anticipate them to be on stream and generating revenues for you?

J. Neal Butler
Well, there is one new fab that will become – that will be coming on stream fully in 2012. And our expectation right now is that that will probably come on stream around the first of our fourth fiscal quarter – third or fourth. It will be the middle of calendar year 2012, it will be fully on stream.

Rosemarie Morbelli
Okay, thanks. I'll get back on queue.

Operator
[Operator Instructions] Our next question is from Jay Harris with Goldsmith & Harris. Please proceed with you question.

Jay Richard Harris
Good morning.

J. Neal Butler
Good morning, Jay.

Jay Richard Harris
I'd like to get some insight as to the improvement in operating margins for Electronic Chemicals versus what you've just reported, when your price increases are fully implemented or is implemented as you think they will be, and if your charges of inventories to cost of goods sold are more normal? In other words, forgetting about any volume changes going forward, I wondered what a better operating efficiency would make – what difference would that have made in the first quarter?

John V. Sobchak
The operating margins in the Electronic Chemicals segment before corporate allocations are getting pretty close to where they were in the first quarter of 2010, again, before corporate allocations. That's about 10% operating margin prior to the General Chemical acquisition.

Jay Richard Harris
Which was when? Remind me.

John V. Sobchak
That would be – and now I'm talking about the second quarter of fiscal 2010. We had managed our margins in that business up to just shy of 15% before corporate allocations. And that's our target to get back to a kind of 15% pre-corporate allocation operating margin. We have a series of initiatives in that direction not just on pricing, but also with regards to some efficiency improvements that have been implemented that are beginning to bear fruit.

Jay Richard Harris
Well, if I look at the $38 million Electronic Chemical revenues and the operating income of $2.7 million in round numbers, I don't see 10%. And I presume that's because the corporate overheads – you're talking about three corporate allocation of corporate overheads?

John V. Sobchak
That's correct.

Jay Richard Harris
All right. So, with the allocation – the corporate overheads are not going to change, are they?

John V. Sobchak
Quarter-to-quarter, year-to-year, yes, they do.

Jay Richard Harris
No, no, just from – on subsequent quarters, this fiscal year. What would influence...?

John V. Sobchak
They change from quarter-to-quarter because the total dollar amount changes and it's based on a revenue allocation. And as revenues shift from quarter-to-quarter, the allocation would change due to that factor as well.

Jay Richard Harris
All right. So there's about $1.2 million of corporate overhead allocations in the first quarter in Electronic Chemicals?

John V. Sobchak
Yes.

Jay Richard Harris
All right. Let me think about those. Thank you.

John V. Sobchak
It's closer to $900,000 in the first quarter of 2010.

Jay Richard Harris
All right. Thank you.

J. Neal Butler
Thank you, Jay.

Operator
Our next question comes from Tom Claugus with Graham Partners. Please proceed with you question.

Tom Claugus
Yeah. Hi, guys. The pricing – did I understand it incorrectly or correctly in that exiting the quarter in Elec Chems that op inc pre-corporate expenses running close to 10%, is that what you were saying?

John V. Sobchak
I'm sorry. Could you repeat the question, please?

Tom Claugus
So, the way I interpreted what you guys said was that exiting this quarter that the op margin for Elec Chems was running close to 10%...

John V. Sobchak
Yes.

Tom Claugus
Pre-corporate allocations. Is that...

J. Neal Butler
Pre-allocation, yes, yes.

Tom Claugus
So, that's what you guys were saying. Okay. And so, does that already account for most of the price increase or is there still some higher cost inventory even in that 10% number?

John V. Sobchak
Yes. There was material – we have approximately 60 days worth of inventory in the Electronic Chemicals segment. So the inventory, for instance, that was sold in August would have been produced in June while we were still integrating the two facilities. And, in fact, because of the integration and the cut over from one facility to another, we had built up some extra inventory and we had worked through most of that inventory, sold it during the first quarter of 2012. There'll be some smaller residual impact in the second quarter.

Tom Claugus
Okay. And then, the volumes on Elec Chems, I'm a tech analyst so I watch all this pretty closely, it looks like manufacturing is weaker for semis, in terms of output, especially going into Q4. Most people are doing minus 15%. And what I was trying to understand is, you guys, minus 7% or something – 7% to 10% in volume in Europe and 3% to 4% in the U.S. Is that what it was during this quarter? Do you expect it to decline next quarter? I was a little bit confused about what your outlook was for next quarter. Is it sequentially down in volume? Is that fair or not?

J. Neal Butler
In the second quarter, we'll see probably a slight decline from the first quarter, yes, because what we saw – again, I go back to just the segment of that business that we are supplying. Domestically, we saw that 3% to 4% decrease and we think we'll see a slightly greater softening in the second quarter of this year, our second quarter which runs through February. And then we'll see the rebound subsequent to that. And what we saw, as I mentioned a while ago in Europe, we saw a decline in demand, volume demand for us for about 7% to 10% and we think that will continue to soften a little bit simply because of some of the fabrication shutdown around Christmas time.

Tom Claugus
Okay. And then my last question is, in regards to Animal Health, because I never focus on this segment, but it sounds like you guys are trying to get these registrations for next year, I guess. And since I don't know that business at all, can you tell me what you think the opportunity is for next year on Animal chems. Is it significant?

J. Neal Butler
It won't be significant. I mean, it's additive. The registrations that we are receiving in that marketplace are coming to fruition now. But the thing you have to keep in mind is obviously in an Ag business, you always have a spring/summer demand, and we are approaching the spring/summer demand north of the equator. We're exiting the spring/summer demand south of the equator. So it really – those Latin American registrations won't really manifest themselves to any significant degree this year. They'll actually hit in our fiscal 2013.

John V. Sobchak
The Animal Health business is only 3% to 4% of our total business right now in an annual basis, so even a dramatic increase would not have a very big impact on the company.

Tom Claugus
No, I'm aware. I was just trying to understand it, how interesting it might get,that's all. Okay, I appreciate it. Thank you.

J. Neal Butler
You're welcome

Operator
Our next question is a follow-up question from Jay Harris with Goldsmith & Harris. Please proceed with your question.

Jay Richard Harris
On the Wood Treating Chemicals, traditionally as we go into the winter that business turns down, and then in the spring, late spring, it turns up. Given the fact that there was a depletion of railroad ties downstream from you – treated railroad ties downstream from you, will we get a different profile in this fiscal year?

J. Neal Butler
Jay, I don't think we're going to get a different profile. I do think what you're going to see though is, we're operating from a higher base.

John V. Sobchak
Some of that is weather-related, Jay, too, because you can imagine these rail ties are just stacked up outside waiting to be treated. And then if there is unusually wet period of time, it's difficult for the treaters to get dry ties to run through their process. Also weather can impact the harvesting of wood in certain parts of the country.

Jay Richard Harris
In other words, there's no inventory of untreated ties to be drawn down?

John V. Sobchak
No, there is, and they're cured for...

J. Neal Butler
Nine Months

John V. Sobchak
But..

Jay Richard Harris
But the rate of curing declines obviously in colder and wetter weather?

J. Neal Butler
The typical curing time is nine months. Now, what you're saying is right. I mean, it depends. You can have tepid inclement weather and it may shift it up a little, but the average curing time is nine months.

Jay Richard Harris
All right. Coming back to Electronic Chemicals, I'm not sure how to phrase this question, but I'll ask it and then we can modify it as we go along. The $38 million in revenues, your volumes were off. What should we consider to be a more normalized revenue quarter for you, given your capacity, and I don't know if there are any changes – major changes in mix from quarter-to-quarter?

J. Neal Butler
When you look at the quarterly demand for our Electronic Chemicals and factor in just the two percentages I talked about earlier in terms of the impact that we saw of Q1, which was again 3% to 4% and 7% to 10%. Those reflect the softening impact in Q1 and to a degree in Q2, and those we think will be reversed. So a normalized revenue stream for that business would be a recapture of that kind of volume. And then that stands any notable organic increase that we might see from the new fabrication facilities.

John V. Sobchak
Okay. So, something around $40 million.

J. Neal Butler
Yeah.

John V. Sobchak
[indiscernible] (32:00) JOHN – THIS IS JUST OVERLAPPING SPEAKERS; NOTHING MATERIAL.

Jay Richard Harris
Which is where you were just after the acquisition of General Chem. What magnitude does the new plant provide looking forward in a year?

J. Neal Butler
I'm not sure what you mean, what magnitude?

Jay Richard Harris
In other words, the new fab that the capacity is coming on stream, will that increase your – that $40 million normalize to $42 million, $45 million?

John V. Sobchak
Yeah, we expect the new fab to start up actually and start gearing up in the first calendar quarter and become more fully online in the spring, as Neal had mentioned. So that would just add $1 million or $2 million of – in this fiscal year. But going forward, it could be much more significant. Of course that depends on what their production rates are, and it is a foundry. So it depends on what kind of manufacturing contracts they have.

Jay Richard Harris
I understand the problem. All right. Thanks, guys.

John V. Sobchak
You're welcome, Jay. Thank you.

Operator
Our next question is a follow-up question from Rosemarie Morbelli with Gabelli & Company. Please proceed with your question.

Rosemarie J. Morbelli
You talked about looking at acquisitions from both the Electronics and the Wood Treatment. I mean, in the Electronics, are you concentrating on solely the high purity chemicals? And could you give us a better feel for what you are looking at on the Wood side, considering that penta and creosotes are – I mean, I'm assuming that there is no acquisition possible in those two categories, but I may be wrong.

John V. Sobchak
In the Wood Treatment side, Rosemarie, there could be some tangential product and perhaps some opportunities to expand somewhat overseas.

J. Neal Butler
And on the EC side, Rosemarie, our focus has been with [inaudible] (34:19)____

Rosemarie J. Morbelli
You are breaking up, Neal.

J. Neal Butler
Okay. [inaudible] (34:23)____

Rosemarie J. Morbelli
I can't hear anything. I'm sorry. I will look at the transcript.

J. Neal Butler
[inaudible] (34:35)___________________________

Operator
Thank you. Ladies and gentlemen, we have reached the end of the question-and-answer session. I will now turn the floor back over to management for closing comments.

J. Neal Butler
[inaudible] (35:19)___________________ from KMG, we wish you a very Merry Christmas and a happy holiday season. Thank you.

Operator
Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.