Corrected Transcript

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

Friday, March 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.
Tom Claugus – Buy-Side Analyst, Graham Partners

Management Discussion Section

Operator
Greetings and welcome to the KMG Chemicals Incorporated Fiscal 2012 Second 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 Mr. Devin Sullivan, Senior Vice President of The Equity Group. Thank you, Mr. Sullivan, you may begin.

Devin Sullivan
Thank you, Jackie. Good morning everyone and welcome to the KMG Chemicals Incorporated fiscal 2012 second quarter financial results conference call. We'd like to begin by reminding you 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 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 the light of interest rate and currency fluctuations and general economic conditions, environmental liability, the ability to obtain a registration and re-registration of products, increased environmental compliance cost of products, and general political and economic risks and uncertainties.

That said 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 second 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 this morning and we plan to file our 10-Q on Monday.

In last quarter's call, we reiterated our optimism following the successful completion of our plant consolidation. I'm pleased to report that narrative continues following the completion of our fiscal 2012 second quarter.

Sales increased at our Electronic Chemicals and Wood Treating Chemicals business segments and we benefited from improved operating efficiencies in Electronic Chemicals both in supply chain and in manufacturing. We also took an important and previously indicated step of selling our Animal Health business. We closed on the sale to Bayer Healthcare on March 1, 2012.

While the business has contributed to our bottom line each and every year that we owned it, we determined that this sector no longer fit with our growth strategies as we were not able to effectively execute the consolidating transactions necessary to drive its long-term success. To that end, we remain focused on finding additional acquisitions in Electronic Chemicals and Wood Treating Chemicals, as well as attractive opportunities to expand to a new platform.

Proceeds of the sale were used to reduce our revolver borrowings by $10 million on March the 1st. As of today, we have $31 million of outstanding debt, an $18.3 million reduction from the beginning of the fiscal year and the balance sheet to support significant future growth. Although we were disappointed in $1.5 million of non-recurring charges taken in the second quarter of fiscal 2012, these expenses should not mask the considerable progress we've made this fiscal year, nor dilute the optimism we feel for the balance of fiscal 2012 and beyond.

We will not rest on our past performance. We have implemented a robust continual improvement program across the entire organization after achieving significant improvement in operational efficiencies through the utilization of this program.

Our goal is to continue to increase the value of KMG for our shareholders. We're confident that barring any significant economic downturn, we will produce improved results for fiscal 2012 compared to last year.

Reflecting this confidence, our Board authorized a 20% increase in our cash dividend to $0.03 per share from $0.025 per share. Hopefully, everyone has had the opportunity to review our press release, so I'll simply provide you an overview of how we did this past quarter and John will provide greater financial detail in his remarks.

Net sales rose about 7.3% to $69.7 million from $64.9 million in the second quarter of fiscal 2011. Our Electronic Chemicals and Wood Treating Chemicals segments reported net sales increases of 7.2% and 10% respectively over the prior-year period while sales in Animal Health declined.

The Electronic Chemical sales rose to $38.6 million driven primarily by price increases implemented at the end of fiscal 2011 in response to raw material cost increases. Additional pricing action was taken beginning in January on certain targeted product groups for that same reason.

The global semiconductor market experienced a softening in production during the fourth calendar quarter roughly to the rest of the year. This was mostly felt in Europe and Asia.

Electronic Chemicals sales were flat in our second fiscal quarter relative to the first quarter as our customer base proved to be relatively stable and sales to newly constructed fabricating facilities in the U.S. offset the general market softness. As a U.S. leader in growing high-purity process chemicals market, we continue to expect this segment will be a strong contributor in the second half of fiscal 2012 due to the post consolidation, operating efficiencies, and recent pricing actions.

Sales of Wood Treating Chemicals increased to $28.4 million from $25.8 million driven by pricing actions taken in the first quarter of the fiscal year in response to raw material cost pressures. We expect sales of this segment will remain relatively stable for the second half of fiscal 2012.

For the entire company, operating income rose 6.8% to $5.1 million from $4.8 million in last year's fiscal second quarter. Operating income for the second quarter of fiscal 2012 included $1.2 million in non-recurring charges in Wood Treating and Electronic Chemicals.

We reported net income of $2.5 million or $0.21 per diluted share for the second quarter of fiscal 2012 on par with net income of $2.4 million or $0.21 per diluted share last year. In addition to the above referenced $1.2 million in charges, net income for the fiscal 2012 second quarter also included $300,000 of non-recurring charges associated with the discontinued operations at our Matamoros facility. On an after-tax basis, these $1.5 million of non-recurring charges impacted second quarter net income by $0.08 per diluted share.

I'll now turn the call over to John who will discuss our financial results in greater detail.

John V. Sobchak

Thanks, Neal, and good morning, everyone. Before I begin, I want to remind everyone that beginning in the first fiscal quarter of 2012, KMG's reportable segments were revised to reflect a 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.

Electronic Chemicals and Wood Treating Chemicals made essentially equal contributions to the $4.7 million rise in second quarter sales versus the prior year, while Animal Health sales declined by about $0.5 million. Gross profit was $18.1 million, down slightly from $18.3 million in last year's second quarter. The decline in gross profit was due primarily to a $501,000 non-recurring charge related to an adjustment in our Electronic Chemicals inventory, as a result of plant consolidation and an exit from tolling arrangements we utilized during last year's period of integration.

While we achieved significant reduction in plant costs during the quarter relative to last year, our product pricing in Electronic Chemicals lost ground relative to raw material costs. Subsequent targeted pricing actions were implemented beginning in January in response to these raw material cost pressures.

Distribution expenses for the second quarter declined by $1.3 million to $5.8 million or 8.4% of total revenues from $7.2 million or 11% of revenues in last year's second quarter. The reduction was attributable to the successful optimization of our distribution channels for the North American Electronic Chemicals business following the completion of the manufacturing consolidation initiative.

Although SG&A rose by $782,000 from last year's second quarter, the majority of this increase was attributable to $731,000 of non-recurring waste disposal costs at our Tuscaloosa facility in connection with waste generated on installation of new dissolving equipment and from disposal of material that was outside of specification.

Operating income rose to $5.1 million from $4.8 million in last year's second quarter. Operating income for the second quarter of fiscal 2012 included the $1.2 million of non-recurring charges referenced above. The $1.2 million increase in the operating income for Electronic Chemicals segment was largely offset by declines at Wood Treating Chemicals and Animal Health.

Interest expense was $556,000 in the fiscal 2012 second quarter versus $599,000 in the fiscal 2011 second quarter. Our income tax rate for continuing operations was approximately 39.5% in the second quarter of fiscal 2012 versus 38% in fiscal 2011.

Turning to the balance sheet, our cash position increased from $1.8 million at July 31, 2011 to $1.9 million at January 31, 2012. We continue to pay down borrowings, reducing our long-term debt to $41 million from $44 million at October 31, 2011 and from $49.3 million at the end of fiscal 2011.

Following the sale of the Animal Health business, we paid down an additional $10 million on our revolving credit facility. As of March 8, 2012, we had total debt of $31 million including $11 million outstanding under our revolver and $20 million of fixed rate notes maturing in December 2014.

In November, we increased the amount that can be borrowed under our revolving credit facility from $50 million to $60 million and extended the maturity date to December 31, 2016.

Working capital rose to $52 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 the fiscal 2012 second quarter, shareholders' equity was $100.5 million or $8.73 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 as to how we see things unfolding for the second half of fiscal 2012. Within Electronic Chemicals, again barring any significant economic downturn, we expect a solid demand environment for our products in calendar 2012. We've seen a recovery from the softness experienced during the holiday season. At the same time with the consolidation initiative in our Electronic Chemicals business completed, we're seeing the positive impact on our operating results.

Electronic Chemicals operating income increased notably in the first half of this year and rose even more dramatically, exclusive of the non-recurring charges relative to what we saw last year. With the costs associated with the consolidation period now behind us and pricing actions taking hold, we remain on track to return to more normalized operating margins in the second half of fiscal 2012.

In our Wood Treating Chemicals segment, we generally expect to see current demand levels remain flat. While raw material costs are expected to continue to exert pressure on margin, it is our intention to maintain a pricing policy that keeps us whole.

We remain confident in our ability to achieve our objectives for sustained growth in revenues, earnings and cash flow. Our balance sheet is strong and provides us with a financial capacity to pursue substantive organic and acquisition-driven growth strategies in both our Electronic Chemicals and Wood Treating Chemicals businesses. We have a healthy pipeline of acquisition prospects in each of our businesses as well as opportunities to create a new segment platform which we intend to establish by fiscal 2014.

With that I would now like to turn the call over to the operator and poll for any questions.

Questions & Answers Section

Operator

[Operator Instructions]

Thank you. Our first question is coming from Rosemarie Morbelli of Gabelli & Company.

Rosemarie Morbelli

Good morning. Neal, could you just talk a little bit about the level of demand on the Electronic Chemicals side? Do you think that what you are looking at, at this stage is more or less inventory build-up following a big destocking in the fourth calendar quarter, or is that behind and you're actually seeing real demand on the semiconductor industry?

J. Neal Butler
What we see – we believe now that we are seeing an uptick in demand. If you look at the area that got most impacted in relation to where we do most of our business, Europe and of course the United States, European semiconductor sales in December were reported to be down about 5% or 5.5% relative to November. And we've seen that movement – now move back up to more – toward more normalized sort of demand in January and in February.

Rosemarie Morbelli
Okay. Thank you. And in terms of the end markets, I mean your products are mostly going for the applications on the semiconductor or am I missing something?

J. Neal Butler
No, you're not missing anything. The majority of our sales go to semiconductor manufacturing. A little bit goes to the photovoltaic market, but it's very small.

Rosemarie Morbelli
What are you seeing on the photovoltaic environment? Do you think that we are getting close to that inventory to be at a more normalized level?

J. Neal Butler
It's possible, but the photovoltaic business is an exceptionally small portion of our whole, and I don't think the movement that you'll see in that market is going to have any substantive effect on our business.

Rosemarie Morbelli
Oh, no, I understand that. I was just wondering if you had some color on the industry that you could share even if it does not necessarily apply to you in a major way.

J. Neal Butler
I think that the most accurate statement I can make is I am not aware of any increase in demand in the photovoltaic business.

Rosemarie Morbelli
Okay, thanks, that's helpful. And on the wood side, if I may ask one last question, you are expecting demand to be flat sequentially or versus last year?

J. Neal Butler
Sequentially.

Rosemarie Morbelli
Okay. That's – and would that be down versus last year, can you remind me?

J. Neal Butler
No, actually it's up versus last year. I think last year's demand in terms of railway ties was somewhere around 18.5 million ties in terms of replacement, and today we're running – we have a run rate somewhere close to the 20 million. So the overall demand is up a bit.

Rosemarie Morbelli
Okay, thanks.

[Operator]
Thank you.

[Operator Instructions]

Our next question is coming from of [ph] Tom Claugus of Graham Partners (17:47).

Tom Claugus
Yeah. Hi, guys. Just quickly, I want to make sure I understood what the received price was for the Animal Health business, was it $10 million flat or what?

J. Neal Butler
I'm sorry. Could you repeat the question, please? Yeah, we're having a hard time. We need it one more time, please.

Tom Claugus
Yeah, I'm sorry. I had to turn up the volume on my phone. What did you get for the Animal Health business?

J. Neal Butler
We netted $10.3 million.

Tom Claugus
Okay. And then I have been hearing that coal tar pricing in Europe is increasing – my understanding was that coal tar out of Europe was cheaper than it was in the U.S. allowing you guys to implement pricing in a more easy fashion. Is my perception correct that coal tar now is approaching levels of the U.S. and so landed cost increased so it would be similar to that for Koppers and therefore, pricing might be more difficult to pass through? I'm just curious as to your thoughts on that.

J. Neal Butler
There is pressure for coal tar – from coal tar prices on all the products, from the coal tar distillation and that's being driven in Europe primarily by the increasing oil prices. So it's not dissimilar from situations we've seen in the past when oil prices rose.

From a standpoint of price increases though, when we had the cost increases, we were typically able to pass those along. Now there is a bit of a lag time, but generally speaking we have been able and believe will continue to be able to pass cost increases along.

Tom Claugus
Okay. And then the level of price increases needed to be taken in Electronic Chemicals, were they what we would term significant or, I mean, is there any percentage level or anything you can give us, any color on how much you have to take pricing up on Electronic Chemicals and whether other people are following or not?

J. Neal Butler
Well if you look at the overall increase on our prices, they kind of range because it depends on the product line you're talking about and the geography, but it ranged anywhere from probably 3% to 5% within that price range.

The cost that we've experienced in the last, oh, I'd say, the last six to 12 months has been reflected in our increases going forward. Again there has been a lag period, but we've been able to capture those.

Tom Claugus
Okay. All right, I think that's it. On the seasonality of railroad ties, anything to think about that? Is it normally flat sequentially in these two quarters?

J. Neal Butler
Yeah, it's not really a seasonal business, not seasonal relative to weather or anything like that except if it gets to be – we have some time periods when we can't get wood out of the – unable to harvest wood or something. But generally speaking, it's not a – this is not a seasonal business and it will be relatively flat. If you look at our current run rate, we expect it's going to be relatively flat through this calendar year.

Tom Claugus
Okay. And then, thanks for doing an excellent job, you guys are doing great. Thank you.

J. Neal Butler
Thank You.

Operator
Thank you. There are no further questions at this time. I'd like to hand the floor back over to management for any closing remarks.

J. Neal Butler
We want to tell everybody that we do again appreciate you taking the time to meet with us today. We hope to see some of you in New York City at our presentation at Sidoti Conference on March the 20th and we look forward to visiting with you on next quarter's conference call. Thank you very much.

Operator
Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you all for your participation.