KMG CHEMICALS INC.

Moderator: Eric Glover
June 8, 2012
10:00 a.m. ET

Operator: Good day, ladies and gentlemen, and welcome to the KMG Chemicals Third Quarter 2012 Financial Results conference call.

At this time, all participants are in a listen only mode. Later, we will have a question and answer session and instructions will follow at that time. If anyone should require assistance during the conference, please press star then zero on your touch-tone telephone. As a reminder, today's conference is being recorded for replay purposes.

I would now like to turn the conference over to your host for today, Mr. Eric Glover, Investor Relations Manager. Sir, you may begin.

Eric Glover: Thank you, (Mary). Good morning, everyone, and welcome to the KMG Chemicals, Inc., fiscal 2012 third quarter financial results conference call.

I'd like to start by introducing myself. I am KMG's new Investor Relations Manager. I am very excited to have joined the Company recently. I met some of you already, but for those I haven't met, I hope to see you in the near future. If you have any questions, always feel free to call me directly at 713-600-3865 or by e-mail at eglover@KMGChemicals.com.

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 the 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 the 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 a registration and reregistration of product; increased environmental compliance costs for product; and general, political, and economic risks and uncertainties.

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

Neal Butler: Thank you, Eric. Good morning, and again, welcome to KMG's fiscal 2012 third 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 the remainder of fiscal 2012. After our comments, we will be pleased to address your questions.

Our earnings release was issued this morning, and we plan to file our 10-Q on Monday.

During the fiscal third quarter, we officially closed on the sale of our Animal Health business to Bayer Healthcare on March 1, 2012, and generated diluted earnings per share of 34 cents versus 23 cents in the third quarter of last year. Operating income increased to $6.9 million for the quarter, representing 66 percent year-over-year growth.

As we had communicated to you in prior calls, our solid financial performance this quarter was fueled by operating efficiencies resulting from the completion of our plant consolidation efforts, the implementation of pricing actions to recoup raw material cost increases, and benefits from our continuing improvement efforts, which produced supply chain and logistics efficiencies with associated expense reductions.

I am pleased to report that consolidated gross profit margins this quarter reached 30.9 percent, up five percentage points sequentially and nearly four percentage points on a year-over-year basis. In addition, consolidated operating margins expanded to 10.3 percent, up from approximately 6.7 percent in the same period last year.

Within our Electronic Chemicals business, we experienced relatively healthy overall demand as segment sales grew 2.4 percent year over year to $39.4 million. Aided by targeted pricing actions and the roll off of higher-cost inventory, this business generated a significant uptick in segment operating margin, after corporate allocation expenses, to 9.9 percent from 4.1 percent in the year-ago period.

Operating margins in the Electronic Chemicals business averaged 13.6 percent before corporate allocations over the quarter, and are on track to meet our fiscal year-end operating margin goals. We anticipate achieving further incremental gains in operating margins as we reap the benefits from our continual improvement program.

Our Wood Treating business generated 16 percent year-over-year sales growth to $27.2 million. This significant increase primarily reflected higher realized pricing for all of our product lines as we successfully passed through price increases to our customer base in response to increased raw material costs. Operating margins in this segment, before corporate allocations, were 18.8 percent in the fiscal third quarter, up 160 basis points from 17.2 percent in last year's fiscal third quarter.

At this juncture, we anticipate that Wood Treating segment net sales will remain essentially flat in the fiscal fourth quarter and for the remainder of the calendar year.

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

John 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 the change from four to three reportable segments – Electronic Chemicals, Wood Treating Chemicals, and Animal Health.

In addition, due to the sale of the Animal Health business in March, this former segment is now classified as a discontinued operation. Prior-year information has been reclassified by conform to the current-period presentation.

Consolidated net sales increased 7.6 percent year over year in the first – in the fiscal third quarter, reflecting 6 percent – excuse me, reflecting 16 percent year-on-year growth in Wood Treatment sales and 2 percent year-on-year growth in Electronic Chemicals sales.

Consolidated gross profit was $20.6 million, or 39 percent of sales, up from $16.8 million, or 27.1 percent of sales, in last year's fiscal third quarter. The year-over-year increase in gross margins was attributable to higher product pricing in both the Wood Treating and Electronic Chemicals segments.

Distribution expenses for the fiscal third quarter were $7.4 million, or 11.1 percent of total net sales, and were essentially flat on a year-over-year basis. On a fiscal year-to-date basis, distribution expenses were 9.4 percent of total net sales, down from 11.2 percent in the corresponding period a year ago, reflecting efficiency improvements in our supply chain and the completion of our integration effort in the Electronic Chemicals business.

SG&A expenses were $6.3 million in the fiscal third quarter, or 9.5 percent of total net sales, and were $1.1 million higher compared to last year's fiscal third quarter. This increase was primarily attributable to higher employee-related expenses. In the prior-year third quarter period, downward adjustments to incentive compensation accruals reduced SG&A expense for that period. The increase in employee costs for the third quarter of fiscal 2012 was mainly due to the resumption of normal incentive compensation accruals and annual increases in salary and benefit costs.

Operating income from continuing operations increased to $6.9 million, or 10.3 percent of sales, from $4.1 million, or 6.7 percent of net sales, in last year's fiscal third quarter. The significant year-over-year increase in operating income was largely attributable to the improvement in gross profitability, as well as the increased relative weighting of Wood Treating Chemicals in our total revenues. The Electronic Chemicals business is more supply chain intensive and accounts for approximately three-quarters of our total distribution expense.

Turning to the balance sheet, our cash position increased to $5.2 million at April 30, 2012, from $1.8 million at the close of fiscal 2011. We continue to pay down borrowings, finishing the third quarter with long-term debt of $28 million, a decline of $13 million on a sequential basis. This $13 million reduction was accomplished using $10 million from the sale of our Animal Health business and $3 million from the cash flow generated in the fiscal third quarter.

Finally, we finished the fiscal third quarter with shareholders' equity of $104.6 million, up from $96.5 million at the end of fiscal 2011. And I'll now turn the call back to Neal.

Neal Butler: Thank you, John. I will now provide some additional color on our outlook for the fiscal fourth quarter and the start to fiscal 2013.

In our Electronic Chemicals business, we believe our sales will increase modestly in the fiscal fourth quarter and to the start of fiscal 2013. While our European Electronic Chemicals business faces headwinds from economic weakness and reduced volumes to photovoltaic customers, our North American operations continue to experience steady to rising demand from our major customers, aided by production ramps at newer fabrication facilities coming onstream.

At this point, we are not overly concerned about the European economies' impact on our business, but do remain cautious with regard to the impact on the global economy. Less than 15 percent of our sales are European fabrication facilities, and while those facilities may be located in Europe, they are supplying semiconductor chips to customers around the world. Although the semiconductor industry's growth expectations for calendar 2012 are now lower than what they were at the beginning of the year, KMG has benefited from a fair amount of organic growth this year.

So despite the most recent economic news, we anticipate marginal growth in our Electronic Chemicals sales through the fourth quarter. We continue to look for Electronic Chemicals segment operating profitability to improve, benefiting from improved manufacturing and logistics efficiencies driven by our continual improvement program.

In our Wood Treating Chemicals segment, we anticipate overall demand to remain essentially flat through the fiscal fourth quarter and into fiscal 2013. We believe that rail-tied demand is running at a sustainable rate for the long-term maintenance of the country's wood-based rail infrastructure.

While demand for treated ties by the railroads has incrementally improved through calendar 2012 that growth has been mitigated by the use of an alternative treatment process that results in less creosote retained in the tie. The technical merits of this alternative treatment process are being debated within the industry, but its adoption has somewhat diminished the sales growth we've experienced this fiscal year, and we anticipate the use of this alternative process will continue.

Looking ahead, we remain active in pursuing acquisition opportunities in both our Electronic Chemicals and Wood Treating Chemicals businesses. Our acquisition pipeline is robust, and we continue to have confidence in our consolidation strategy. Additionally, we are currently evaluating opportunities to create a new segment platform by the end of fiscal 2014.

I'd like to end my remarks by reminding you that KMG will transfer its stock listing from NASDAQ to the New York Stock Exchange on June 20, 2012. In conjunction with this transfer, the stock's ticker symbol will change to KMG from KMGB.

To celebrate our move to the New York Stock Exchange, KMG will hold an analyst investor meeting at 2:00 p.m. on June 20 and will ring the closing bell at 4:00 p.m. that day as well. If you're in New York City on June 20, please join us for the analyst investor meeting at the New York Stock Exchange. You can call or e-mail Eric Glover, our Investor Relations Manager, to RSVP.

I'll now turn the call over to the operator for questions.

Operator: Certainly. Ladies and gentlemen, if you have a question at this time, please press star then one on your touch-tone telephone. If your question has been answered or you wish to remove yourself from the queue at anytime, please press the pound key. Once again if you have a question, please press star then one.

Our first question comes from Rosemarie Morbelli from Gabelli & Company. Your line is open.

Rosemarie Morbelli: Thank you. Good morning all.

Neal Butler: Good morning.

Rosemarie Morbelli: Neal, could you give us a little more on the creosote change? How much – let's say that the entire industry moves over to this alternative treatment. How does that translate into the volume of creosote sold, the pricing, and the impact on your business?

Neal Butler: Should the entire industry shift over to this alternative treatment, which basically reduces the amount of creosote that's retained in the tie, it would probably have an impact of around 15 percent on the total volume.

Rosemarie Morbelli: So the volume will decline by 15 percent. And this, I am guessing, is triggered by environmental concern for creosote. Is that what is triggering it, or is it a lower cost to the tie industry?

Neal Butler: No, not at all. It's not an environmental issue. It's predominantly an issue of cost.

Rosemarie Morbelli: OK. And could you talk a little bit about the electronics? I mean, you already gave us some feel for the electronic industry, but let's say that the fabs – actually the new fabs start operating at a much lower – lower rates than anticipated. How much of the decline, based on what you are hearing in terms of the overall electronics demand, do you think that we could see in 2013, which is not now yet taken into consideration in your projects or your estimates?

Neal Butler: Rosemarie, if I'm understanding your question correctly, I really don't believe you're going to see a decline. You probably will see a reduced growth projection.

Rosemarie Morbelli: Not a decline?

Neal Butler: I don't think you're going to see a decline in production overall, certainly not in North America.

Rosemarie Morbelli: If Europe goes into a bigger recession than it is currently, China has lowered its rates, so obviously they are expecting even more of a decline than was previously anticipated, you don't think that that would result in a decline in demand, just slower growth? And if that is the case, then from what to what in terms of the growth rate? I mean, best estimate, obviously.

Neal Butler: I'm really not in a position to give you a forecast on what to what in terms of the semiconductor demand. Of course, you know, the volume of semiconductors is what drives our business.

I do know that SEMI, the organization, has downgraded somewhat their forecast for growth in calendar 2012. And of course, we stay pretty closely in touch and canvas our customers regularly on forecasts, and at this juncture we're not seeing a decline in demand, certainly not domestically.

In Europe, we've already experienced decline in demand there, and it's manifested itself in a slight reduction in our net sales overall, most of it – all of it, actually, coming out of Europe. But at this juncture, we believe that's basically flatlined.

Rosemarie Morbelli: OK, thank you. That is helpful.

John Sobchak: Rosemarie, I might add, if you look at our fiscal 2009 as a good indicator of the impact of a downturn, the business we had acquired from Bayer Products was – had a forward revenue rate of – just shy of $100 million. And in fiscal 2009 with the economic downturn, we had $86 million of revenue that year. So, we saw probably somewhere around a 13 percent reduction in our overall sales due to that downturn.

Rosemarie Morbelli: And you have done a lot since then. So that 13 percent downturn, let's say that you experience another one of those. With all of the changes that you have made in your distribution, in consolidating the manufacturing plants, and so on, do you think that you could maintain the margin at current level, or that would be too optimistic?

John Sobchak: We do have a much better position in terms of capacity utilization and operating efficiencies now than we did when we first acquired that business entering into our fiscal 2009. So, while a 13 percent downturn would not – would have some level of impact on our operating margins, we think that we'd be able to maintain good margins through that period.

Rosemarie Morbelli: OK, thanks.

Operator: Thank you. Once again, if you have a question, please press star then one.

And we have a follow-up from Rosemarie Morbelli from Gabelli & Company. Your line is open.

Rosemarie Morbelli: It looks as though this is my call, isn't it? Could you talk about the trends you are seeing in your cost of raw materials on the electronic side and actually on the wood side, given the changes and the anticipation in the industry?

John Sobchak: I'm sorry, Rosemarie, was that with regards to raw material costs?

Rosemarie Morbelli: Yes, and for both categories.

John Sobchak: In the Wood Treating business, the situation is in a bit of a flux right now because of the situation in Europe. So, we have seen increases in costs for all coal tar-based chemicals, including creosote. We think given the current economic situation in Europe that might be alleviating a little bit.

Rosemarie Morbelli: But wouldn't you – actually, it sounds as though, given the situation in Europe, I am surprised you did not – you're not getting raw material costs' decline, and my next question was going to be, then if you get them, will you have to give up some pricing at your end?

John Sobchak: In the creosote business, these products are actually global products, and Europe is just one piece of the overall pie.

And in general, that whole industry has been experiencing what's been commonly called as carbon inflation. And so, we do think that the situation in Europe is going to be relieving some of that cost pressure. But the jury is still out as to what the total impact is going to be.

On the Electronic Chemicals side, about 30 percent of our sales in Electronic Chemicals are related to solvents or organic chemicals and things that might be impacted, generally speaking, by petroleum prices. And of course, petroleum prices have been erratic lately, but overall we've seen fairly steady raw material prices on that side.

The other side of the business, 70 percent of our revenues in Electronic Chemicals are related to acids and other etchants use on the semiconductor wafers. That's a mixed bag of products, but it's generally driven, what we've seen, by the agricultural industry, which is the biggest consumer for some of these original products. And the cost situation for those products has been fairly stable, too.

So, we're fairly optimistic regarding our costs – our cost (add) going into fiscal 2013.

Neal Butler: Yes, we've experienced some rather notable price increases over the course of the last 12 months or so, and as we've reported earlier, that's what we were chasing with price increases and we've successfully, I think, accounted for all of that now.

Rosemarie Morbelli: So you have accounted for the dollar amount, Neal, but what about on the margin side? I have not had time to look at the numbers very closely yet.

Neal Butler: We have indeed accounted for the dollar side, and our goal, as we've been reporting, is to achieve what we consider to be normalized margins. And we do believe we'll be at that level by the end of this fiscal quarter – fourth quarter.

Rosemarie Morbelli: Could you remind me what the normalized margin is?

Neal Butler: Our goal – our normalized margins were somewhere around 14 percent, and we said our goal for the end of the fourth quarter was to achieve about a 15 percent operating margin before corporate allocations.

John Sobchak: And that's in the Electronic Chemicals.

Neal Butler: Yes, that's Electronic Chemicals.

Rosemarie Morbelli: OK, and is that just for the fourth quarter, or you think you will be higher for the fourth quarter and get that 15 percent for the full year?

Neal Butler: That's a run rate.

Rosemarie Morbelli: Run rate, OK.

John Sobchak: So in the third quarter, Rosemarie, we had 13.6 percent on average for the quarter. We feel like we're on good track to achieve our objectives.

Rosemarie Morbelli: And on the Wood side, the margin trend?

John Sobchak: We think that the margins we have in the Wood Treating business now, in the third quarter, are reflective of what we will be able to achieve going forward.

Rosemarie Morbelli: Even with a slower demand, even with less creosote use, taking all of those trends into consideration?

John Sobchak: We've seen an impact of the alternative treatment that Neal discussed already. And what that has done is it's mitigated the growth that we would've seen in overall creosote sales, but we haven't seen a significant erosion in our demand base.

Neal Butler: I think it is important to note that it was not a decline. It was simply a mitigation in growth.

Rosemarie Morbelli: OK, mitigation in growth, but no impact on the margin.

Neal Butler: Yes.

Rosemarie Morbelli: All right. As long as I am on, do you mind sharing the likelihood of making an acquisition in the fourth quarter, or is that more – and I am not talking about the new leg, or is that more of a 2013 story? And while you are at it, could you talk a little bit about the valuations you are seeing out there? Have they changed recently, given the economic uncertainty?

Neal Butler: I don't anticipate us closing on an acquisition in the fourth quarter. As we've mentioned, we're actively pursuing some opportunities as we speak. But nothing will close this fiscal year, I don't believe.

In terms of the valuations, I think that what we see right now going forward is fairly consistent with what we saw coming into this fiscal year, so we haven't seen any dramatic uptick, nor the other direction, in terms of the valuations.

Rosemarie Morbelli: Are we talking about eight times EBITDA, is that more or less the norm out there?

John Sobchak: No, Rosemarie. We typically are in a part of the M&A environment that we don't see a lot of competition from private equity or other large strategic acquirers. In fact, we purposely stay away from areas like that.

So the valuations that we've seen for our businesses have been fairly steady, really over the 11 years that I've been here. And what we try to look at is acquiring the PP&E and other long-lived assets for approximately four times EBITDA. And then, of course, we have to invest in working capital on top of that. And I think going forward, we'll be able to maintain that approximate discipline.

Rosemarie Morbelli: And then, lastly, on the Animal Health, when the agreement to manufacture the product for Bayer ends, let's say it ends in one year, is that going to actually give a boost to your margin, because now it is only tolling, or am I looking at it the wrong way?

John Sobchak: The operations providing the total manufacturing operations that we are providing to Bayer are now accounted for in discontinued operations.

Rosemarie Morbelli: Oh, OK.

John Sobchak: So it won't have an impact above the – it won't have an impact on gross profits or operating income.

Rosemarie Morbelli: OK. All right. I appreciate it, and I look forward to seeing you on the 20th.

Neal Butler: Great, thank you, Rosemarie.

John Sobchak: Thank you, Rosemarie.

Operator: Thank you. Once again, if you have a question, please press star then one.

I show no further questions in the queue at this time.

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may all disconnect.

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