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KMG - Q4 2012 KMG Chemicals Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter 2012 KMG Chemicals earnings conference call. My name is Lisa, and I will be your operator for today. At this time, all participants are in listen-only mode. Later we will conduct a question and answer session. (Operator Instructions).

As a reminder, this 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. Please proceed, sir.

Eric Glover - KMG Chemicals, Inc. - IR Manager

Thank you, Lisa. Good morning, everyone, and welcome to the KMG Chemicals, Inc. fiscal 2012 fourth-quarter financial results conference call. I'm joined today by Neal Butler, our President and CEO, and John Sobchak, our CFO. In a moment, we will hear remarks from them followed by Q&A.

Before we begin, I'd like to remind everyone that the information on this conference call includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to significant risks and uncertainties, including statements as to the future performance of the Company.

I'll now turn the call over to Neal Butler, President and CEO. Please go ahead, Neal.

Neal Butler - KMG Chemicals, Inc. - CEO & President

Thank you, Eric. Good morning and again, welcome to KMG's fiscal 2012 fourth-quarter conference call. John Sobchak 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 first quarter of fiscal 2013 and our outlook for the year. After our comments, we will be happy to answer your questions.

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

I'm pleased to report that KMG achieved significant progress in fiscal 2012 as benefits from our integration and consolidation efforts, coupled with more advantageous pricing, led to strong year-over-year gains in operating profitability, earnings-per-share, and cash flow. We paid down approximately \$25 million in debt during fiscal 2012, finishing the year with a strong balance sheet that provides ample flexibility for us to pursue additional acquisitions or other capital initiatives.



Within our Electronic Chemicals business, we began to realize the associated benefits from having fully integrated the general chemicals assets. Most notably, our Electronic Chemicals segment generated record revenue of \$159 million and record operating income of \$13.4 million in fiscal 2012.

Equally important, Electronic Chemicals segment operating margins -- this was after accounting for corporate allocations -- more than doubled to 8.4% in fiscal 2012 from 4.1% in fiscal 2011. This success was a direct result of our continual improvement initiatives, which increased efficiencies and production, supply chain and support functions, coupled with our ability to meet and increase volume demand in the US for several of our products.

As a result of the integration of the General Chemical assets, we have increased capacity utilization in our plants in California and Colorado. While we're very pleased with these results, we are confident there is room for further improvement within this business, and we continue to identify and implement additional measures to enhance operating profitability.

In our Wood Treating Chemicals business, we reported record revenue of \$113 million in fiscal 2012 and generated operating margins, again after corporate allocations, of 13.8% versus 14.2% in fiscal 2011.

While the business remains an important contributor to our financial performance, particularly in terms of cash flow, generation, and attractive returns in invested capital, it underperformed relative to our expectations in the second half of the fiscal year. Lowered rates of creosote usage by companies that pretreat with boron solution and supplies of competing materials blended into treating solutions have reduced demand by companies that were looking for ways to shave production costs in response to higher cost of creosote. We are responding and are confident that our market-leading positions, comprehensive supply chain capabilities, extensive supplier and customer relationships, and financial strength will continue to provide significant competitive advantages and enable us to address what we believe are temporary issues.

Overall, fiscal 2012 was a successful year for KMG, highlighted by substantial operating profit gains within our Electronic Chemicals business that helped drive 51% year-over-year growth in diluted earnings per share from continuing operations. Through our integration efforts and continuing improvement initiatives, we further demonstrated the benefits of our consolidation strategy. Backed by our strong balance sheet and solid cash flow, we're well positioned to pursue additional acquisitions or other strategic opportunities to enhance our market-leading positions.

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

John Sobchak - KMG Chemicals, Inc. - CFO

Thank you, 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 quarter 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 to conform to the current period presentation.

Fiscal 2012 net sales increased 6.6% to \$273 million from \$256 million in fiscal 2011. For the 2012 year, Wood Treating Chemicals sales increased 8.6%, and Electronic Chemicals sales increased 5.3%.

Consolidated gross profit for fiscal 2012 was \$77.1 million, or 28.2% of sales, up from \$68.1 million, or [26.6%] of sales in fiscal 2011. The year-over-year increase in gross margins was primarily attributable to our Electronic Chemicals segment as we implemented price increases to recover higher raw material costs and also benefited from improved manufacturing efficiencies following the successful integration of our 2010 acquisition.

Operating profit for fiscal 2012 increased to \$25.4 million, or 9.3% of sales versus \$17 million, or 6.7% of sales in fiscal 2011.

Besides the improvement in gross margins and higher revenues, approximately one-third of the increase in operating profit was from efficiency gains in our supply chain as distribution expense decreased from 11.3% of sales in fiscal 2011 to 9.8% of sales in fiscal 2012.

Diluted earnings per share from continuing operations grew 51% year over year to \$1.24 in fiscal 2012 compared to \$0.82 in fiscal 2011. Including discontinued operations, income was \$1.20 per diluted share.

Turning to the fourth fiscal quarter, net sales were \$67.6 million, a decrease of 4.7% from \$70.9 million in the fourth quarter of fiscal 2011. Electronic Chemicals sales increased 7% year over year to \$43.1 million, benefiting from organic growth, as well as higher product pricing. However, Wood Treating Chemicals sales decreased 21% year over year to \$24.3 million. While rail-type production remained healthy in the fourth fiscal quarter, we experienced reduced shipment volumes due to the competitive pressures discussed by Neal.

Our consolidated operating income increased 168% year over year to \$6.7 million in the fourth quarter, up from \$2.5 million in the same period last year. Consistent with our expectations, our financial performance this quarter was driven by three factors. First, operating efficiencies resulting from the completion of our Electronic Chemicals plant consolidation efforts; secondly, more favorable product pricing that enabled us to recoup raw material cost increases; and third, from our continual improvement effort, which produced supply chain and logistics efficiencies with associated expense reductions.

Electronic Chemicals segment operating margin after corporate allocations were 10% in the fourth fiscal quarter, up from less than 1% in the same period last year. We have seen a gradual ramp in operating margins in this segment during the year and anticipate further incremental gains in 2013 from our continual improvement program.

Wood Treating Chemicals segment operating margins after corporate allocations, were at 13.2% in the fourth fiscal quarter, up from 11% in the same period last year, but slightly below the 13.8% we averaged for the year, primarily due to reduced volumes shipped during the quarter. Fully diluted earnings per share from continuing operations in the fourth fiscal quarter were \$0.34 versus \$0.09 in the fourth quarter of last year.

On the balance sheet, we ended fiscal 2012 with debt of \$24 million, down from \$49.3 million, including current maturities in fiscal 2011. Shareholders equity increased to \$106.7 million from \$96.5 million at the end of fiscal 2011.

Meanwhile, cash flow generation improved markedly with operating cash flow nearly doubling to \$25.2 million in fiscal 2012 from \$12.7 million in fiscal 2011. Free cash flow, which we define as operating cash flow minus capital expenditures, rose to \$20 million from \$4.4 million in fiscal 2011.

And now I'll turn the call back to Neal.

Neal Butler - *KMG Chemicals, Inc. - CEO & President*

Thank you, John. I'd like to take a few minutes to provide some additional color on our outlook for the fiscal first quarter and fiscal 2013. We are optimistic about our prospects for the current fiscal year. Absent a major disruption in the global economy, we anticipate another year of record sales, continued growth in net earnings. While we anticipate a softening of semiconductor production in the final months of calendar 2012, primarily due to economic weakness in Europe and to a lesser extent, the US, we anticipate production levels will pick up during the second half of fiscal 2013.

From a cost standpoint, we expect to generate incremental operating efficiency improvements within our Electronic Chemicals business, enhancing market segment margins as the year progresses.

In our Wood Treating Chemicals segment, we anticipate that increased competitive pressures related to alternative processes and materials will impact near-term results in this business. However, we are taking steps to improve performance in fiscal 2013.

Overall, we expect the contribution of Wood Treating Chemicals to our bottom line to remain fairly steady on average through fiscal 2013.

Looking ahead, we remain active in pursuing acquisition opportunities in both our Electronic Chemicals and Wood Treating Chemicals businesses. As John mentioned, we have a very healthy balance sheet which provides the ability to aggressively pursue our growth through consolidation

strategy. We continue to have confidence in this strategic approach. And in addition to opportunities in Electronic Chemicals and Wood Treating, we are also evaluating opportunities to create a new segment platform by the end of fiscal 2014.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Rosemarie Morbelli, Gabelli & Co.

Rosemarie Morbelli - Gabelli & Co. - Analyst

Could you, Neal, update us on the new fabs whether they are actually coming on stream, whether they are beginning to place orders, or whether this is in the future when the demand for electronics picks up?

Neal Butler - KMG Chemicals, Inc. - CEO & President

They are, indeed, coming onstream. There are some small orders being placed as they bring the systems up. We don't expect what I would deem to be true to commercial orders probably until the first quarter of the calendar year 2013.

Rosemarie Morbelli - Gabelli & Co. - Analyst

Okay. So, in other words, now what you are selling into those fabs, the new fabs, are mostly small quantities in order to get your products qualified?

Neal Butler - KMG Chemicals, Inc. - CEO & President

The products are already qualified. What they are doing is just ramping up systems.

Rosemarie Morbelli - Gabelli & Co. - Analyst

Okay. I see what you mean.

And you -- John, talked about additional margin improvement on the electronic side. If you eliminate what remains to be achieved from the recently-achieved -- I mean the recently finished I should say, integration of your latest acquisition, are there any benefits to come from other steps you are taking in addition to whatever is going to flow through the next six months?

Neal Butler - KMG Chemicals, Inc. - CEO & President

Yes, there are, indeed, some additional -- we do believe there are going to be additional improvements in efficiencies. We have a number of continuing improvement initiatives. We have a very robust process in looking at this. And we are identifying a number of areas where we can continue to bring our costs down and try to extract greater value out of the marketplace. So yes, we anticipate -- it's a little difficult to actually quantify what that's going to be, but we do believe we'll see improvements in the trend line.



Rosemarie Morbelli - *Gabelli & Co. - Analyst*

So when we look at the first half of 2013, you had after corporate expenses, you had an Electronic Chemicals margin of 7% in the first quarter, 6.5% in the second, and then you are reaching, I think 10% -- I haven't done the math yet -- for the fourth quarter. Is that 10% something that we should be looking for at least in the first half of next fiscal year? And then based on the additional steps that you are taking, it could go up slightly in the second half as well on a year-over-year basis?

John Sobchak - *KMG Chemicals, Inc. - CFO*

We are, Rosemary, we are at 10% operating margin for the Electronic Chemicals segment in the fourth fiscal quarter.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Okay.

John Sobchak - *KMG Chemicals, Inc. - CFO*

And we anticipate to see some incremental gains over that in the first half and then again in the second half.

The low-hanging fruit, as you can imagine, has been already picked. But, as Neal mentioned, we have a very robust project list of continual improvement initiatives that have been prioritized and are being pursued in a systematic basis. And they are all going to add to the efficiencies bit by bit.

We're not anticipating any major jumps in operating margin over the coming quarters, but our objective is just continually to improve our position.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And if we look at your margin goal, including corporate expense, then do we move that over the next couple of years, or maybe just when the fabs start really operating, we can move that from 10% to, let's say, 12% on that basis?

Neal Butler - *KMG Chemicals, Inc. - CEO & President*

I don't know, Rosemarie, that we can sit here and again quantify what the numbers are going to be, but I do believe that we definitively will see the trend line moving upwards. So yes, we will continue to see that.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Okay, thanks. And one last question on the wood treatment, have you seen further -- I mean, in the third quarter you started already seeing some of the use of boron and, therefore, less creosote being integrated into all -- impregnating the wood, if that is the right term. So have you seen that trend deteriorating in the fourth quarter, or are we kind of staying at the third-quarter level?

John Sobchak - *KMG Chemicals, Inc. - CFO*

In general, we've seen the impact of that leveled off in the second half of the year. The issue of whether you can reliably reduce the amount of creosote retained in a railroad tie just because it was pre-treated with boron has been a subject of debate within the wood treating industry.



The American Wood-Preservers' Association recently came out with standards that take our position, which is that boron is not a substitute for creosote.

So we anticipate that as those standards start to take hold, that will start to see some recoveries in those volumes.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Okay. And any timing as to when this is going to come into -- when it will become the norm and customers will actually follow suit as opposed to finding reasons not to do it?

John Sobchak - *KMG Chemicals, Inc. - CFO*

I believe the proposal right now is for those standards to go into effect at the first of the calendar year. However, they are guidelines; they are not law. And so we have a marketing program around furthering those standards within the industry, furthering the adoption of those standards.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Okay. Thanks very much.

Neal Butler - *KMG Chemicals, Inc. - CEO & President*

Thank you, Rosemarie.

Operator

(Operator Instructions). Daniel Rizzo, Sidoti & Company.

Daniel Rizzo - *Sidoti & Company - Analyst*

In terms of the issues with treatment in creosote, is cost cuts for creosote something you guys are considering, or --?

John Sobchak - *KMG Chemicals, Inc. - CFO*

Dan, we're working with our suppliers to address the competitive pressures that have been on the product line, but we can't really discuss pricing strategies over the phone.

Daniel Rizzo - *Sidoti & Company - Analyst*

Okay. And then how have your raw material costs been acting lately? I know you raised prices to play catchup, but have they declined? Have they eased off?

John Sobchak - *KMG Chemicals, Inc. - CFO*

I'm sorry. Dan, could you repeat that, please?



Daniel Rizzo - *Sidoti & Company - Analyst*

Raw material costs, what are they doing currently? Are they still -- are they easing back? Are they going up?

John Sobchak - *KMG Chemicals, Inc. - CFO*

So raw material costs throughout the Company, Wood Treating and Electronic Chemicals, have been fairly steady, and we see some easing in certain areas.

Daniel Rizzo - *Sidoti & Company - Analyst*

Okay. So that could provide some more margin relief as well going forward over the next couple of quarters?

John Sobchak - *KMG Chemicals, Inc. - CFO*

Yes. It's certainly not going in the other direction. And I think that's an impact of the overall global economy that we're looking at.

Daniel Rizzo - *Sidoti & Company - Analyst*

Okay. All right. Thanks, guys.

Operator

(Operator Instructions). Robert Henderson.

Robert Henderson - *Rutabaga Capital Management - Analyst*

Could you give us an idea what capital spending will be this fiscal year?

John Sobchak - *KMG Chemicals, Inc. - CFO*

Our maintenance CapEx is generally around \$3 million to \$3.5 million. We anticipate spending approximately \$3 million more on the expansion of our bulk delivery fleet to accommodate higher customer demand in the future.

Robert Henderson - *Rutabaga Capital Management - Analyst*

Okay, good. Thank you.

Operator

There are no additional questions at this time. I would now like to turn the presentation back to Mr. Neal Butler for closing remarks.



Neal Butler - *KMG Chemicals, Inc. - CEO & President*

We do appreciate your participation today, and we thank you for your interest in KMG. We look forward to meeting you again in future conferences or during future conference calls. Thank you very much.

Operator

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

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