Corrected Transcript

KMG Chemicals, Inc. KMGB Q3 2011 Earnings Call Jun. 9, 2011

PARTICIPANTS Corporate Participants

J. Neal Butler – President, Chief Executive Officer & Director
John V. Sobchak – Chief Financial Officer

Other Participants

Daniel D. Rizzo – Research Analyst, Sidoti & Co. LLC
Rosemarie J. Morbelli – Research Analyst, Gabelli & Co., Inc.
Stephen DeNichilo – Analyst, ACK Asset Management LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the KMG Chemicals Incorporated Third Quarter 2011 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 not prove 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 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 prices 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 current (sic) [currency] (1:10) fluctuations, and general economic conditions, environmental liability, the ability to obtain registration and re-registration of products, increased environmental compliance costs 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. Neal, please go ahead.

J. Neal Butler, President, Chief Executive Officer & Director

Good morning and welcome to KMG's fiscal 2011 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, including progress in integrating the March 2010 Electronic Chemicals acquisition. We will also discuss the outlook for the remainder of fiscal 2011. After our comments, we will address your questions.

Our earnings release was filed earlier today, and I hope all have had an opportunity to review it. You can access it on our website. We also plan to file our 10-Q later today.

While our third quarter results were below our expectations, we experienced solid sales across all three of our segments, and have

confidence in the performance of these businesses over the next several quarters.
Net sales rose by 26% to $65.1 million for the third quarter of 2011 and were up by over 30% for the nine months ended April 30th as our markets continue to recover from the lower demand experienced last year.

Our Electronic Chemicals business experienced sales growth of 30% in the third 2011 fiscal quarter versus the prior year, due primarily to the March 2010 acquisition as well as the recovery in the semiconductor market we have seen throughout the fiscal year.

Creosote saw strong top line improvement over prior year levels with higher volumes driving a 37% increase in sales for the third quarter, which were still below our expectations. Penta and Animal Health were in line with last year's revenue numbers, which we'll discuss in greater detail shortly.

For the third quarter of fiscal 2011, operating income was $4.6 million and net income was $2.6 million or $0.23 per diluted share. This compared to operating income of $5.8 million and net income of $3.3 million or $0.29 per diluted share for the same period in fiscal 2010.

For the first nine months of fiscal 2011, net sales rose 31% to $192.1 million, operating income was $14.9 million, and net income was $8.5 million or $0.74 per diluted share. In the same period last year, net sales were $146.2 million, operating income was $20.7 million, with net income of $11.9 million or $1.05 per diluted share.

Regarding our Electronic Chemicals segment, sales increased by 30% to $38.5 million from $29.6 million in the prior year period, due primarily to the acquired business along with increased demand due to improvement in semiconductor manufacturing.

In the fiscal 2011 third quarter, we benefited from a full three months of sales from the acquired business as compared to only one month of sales in the third quarter of fiscal 2010. We also generated improved sales due to a healthier end market that drove product demand in the U.S., Europe, and Asia.

This segment contributed $1.6 million to operating income, down from $2.2 million in last year's third quarter. This decline was due primarily to higher raw material costs as well as the higher manufacturing and distribution expenses associated with the integration of our most recent acquisition.

Raw material cost increased through much of fiscal 2011. In response, we implemented a global price increase that phased in during the third fiscal quarter. Fourth quarter 2011 results will reflect a full three months benefit from these price increases. Earlier this week, we announced an additional price increase for certain products that are continuing to be impacted by escalating raw material costs. We will first see the full impact of this second price increase in our first quarter of fiscal 2012.

Distribution expense for this business increased by $2.5 million to 16.7% of revenues from 13.2% of revenues in last year's third quarter. This increase was due to higher sales volume associated with the acquisition, transportation lanes that are temporary to less than optimized, as we consolidated production from two contract manufacturing locations, the continued rise in diesel prices and a tightening of the market for common carrier services. We did see some notable improvement relative to the second quarter of fiscal 2011 as we were able to achieve our previously stated goal of distribution expense as a percentage of revenue in the mid 16% range. While we believe additional improvements can be achieved, we do not anticipate being able to regain 13.2% level of last year's third quarter, which benefited from dramatically lower diesel prices and a very competitive common carrier market.

Our integration and consolidation initiatives are progressing very well. All production slated for movement out of General Chemicals' Baypoint plant has already been relocated to our Pueblo facility somewhat ahead of schedule. All but one product previously manufactured for us at Air Products' Dallas plant will be transitioned to our Hollister plant on schedule by the end of this month. We will continue to have one product made for us in Dallas for one or two months longer to accommodate our customer schedule.

As a result of additional production volumes, our Hollister and Pueblo plants are expected to run at over 80% of capacity as compared to approximately 50% prior to the plant consolidation. We project that the consolidation of production will increase operating margins by 200 basis points in fiscal 2012. We maintain an average of 60 days of inventory for our customers, so the reduction in manufacturing costs that we achieve in July will generally lower our cost of goods sold in September.

As we mentioned on last quarter's call, we have won significant additional business from a large customer expanding operations in the U.S., the impact of which we expect to realize in the first quarter of fiscal 2012. Additionally, we have recently won significant new business from a large customer building a new fabrication plant in the U.S. that is slated to go on stream in the third fiscal quarter of 2012. The combined annual sales that these two new pieces of business will generate has not been definitively determined, but we expect it will initially represent in excess of $6 million per year of new business with the potential to ramp in future years.

We are encouraged by other expansion plans that our customers have in various stages of planning and development, and believe we are well positioned to supply their future growth needs.

Moving on to our Wood Treating Chemicals business. Wood Treating sales were $23.4 million in the third quarter, an increase of 25% compared to last year's $18.8 million due primarily to higher sales volume in the Creosote segment. Overall, Wood Treating contributed $3.2 million to operating profits in the third quarter of fiscal 2011, compared to $4.2 million in the same period last year.

In our Creosote segment, sales in the fiscal 2011 third quarter rose 37% to $17.8 million from $13 million. Income from operations in the Creosote segment was $1.5 million for the current quarter compared to $2.5 million in the third quarter of fiscal 2010.

Margins were negatively impacted relative to 2010 due primarily to lower average prices from a shift in product mix and renegotiated contract pricing coupled with higher average costs for purchased material. We also experienced slower than expected production rates during the quarter by our Wood Treating customers resulting in continued drawdown of treated rail tie inventories.

With industry groups forecasting stronger demand for rail tie purchases by the railroads and inventory to sales ratios falling below the historical norms, we anticipate an increase in demand from our customers as rail tie production rates increase to meet purchased rates. Industry reports issued by the Railway Tie Association forecast rail tie purchases to trend up through 2013.

Increasing demand and declining inventory ratios would indicate a long-term increase in rail tie production and a growing need for Creosote. While monthly or quarterly demand is difficult to predict, we believe the long-term trend will be favorable for our Creosote business. This anticipated upward trend has been seen in our May Creosote sales. Pricing for coal tar, the precursor for Creosote production is expected to increase and we likely will see an associated increase in cost for Creosote. We intend to pass along any and all cost increases in our pricing.

Penta sales were $5.6 million compared to last year's $5.7 million. Income from operations from Penta was $1.6 million, which was flat compared to last year's third quarter. We anticipate volumes to remain at these levels through the end of the fiscal and for margins to be pressured by high oil prices and raw material costs. However, we expect fourth quarter Penta operating income to be approximately equal to last year's fourth quarter performance.

Regarding our Animal Health business, third quarter net sales were $3.2 million, which was consistent with last year's third quarter, resulting in an income from operations of $312,000 compared to income of $228,000 in the same period of last year. Sales volume was impacted by reduced fly pressure in drought stricken areas of the Western and Southwestern U.S., partially offset by increased demand in South America as a result of recently granted product registrations. The wet spring in the Midwest and Southeast should have a positive impact on fly pressure. However, that will be at least partially offset by continued drought in the major cattle regions of ranches of Texas and the Southwest.

For the fourth quarter of 2011, we expect to see an increase in sales volume for our Animal Health products in South America, having recently obtained product registrations in some key cattle producing countries. We continue to pursue additional registrations and sales opportunities in that region.

I will now turn the call over to John to provide additional information on the quarter and fiscal year, as well as discuss certain balance sheet and cash flow highlights. John?

John V. Sobchak, Chief Financial Officer

Thanks, Neal, and good morning, everyone. First, let me remind everyone that, starting in the first quarter of fiscal year 2011, we changed the method we use to allocate corporate overhead costs to our reported segments. All corporate overhead is now allocated to the segments except for those amounts associated with the KMG's operation as a public entity, such as board costs, audit fees, et cetera. The allocation is based on segment net sales. We've revised prior-year amounts to reflect the current method.

Neal has already covered our top line results in detail, so moving down to the gross profit line: on a consolidated basis, gross profit margins were 27% of sales in the third quarter of fiscal 2011, compared to 31% of sales in the third quarter of fiscal 2010. As was the case in the first half of the year, we continued to be impacted in the third quarter by rising raw material costs in the Electronic Chemicals business, which we responded to with global price increases that transitioned into place during the third fiscal quarter.

Gross profit margins continued to be adversely impacted during the quarter by the duplicative plant costs in our U.S. Electronic Chemicals segment as, anticipated. We incurred costs for both the expanded operations at our Pueblo and Hollister facilities, and the contract manufacturing locations operated by Air Products and General Chemical as production was transitioned out of those sites. These additional costs are coming to an end. However, due to the average of 60 days worth of inventory maintained for our customers, we will not realize the impact of these cost reductions on our operating results until the middle of the first quarter of 2012.

Earlier in the fiscal year, we repositioned KMG in the Creosote marketplace following a substantial consolidation of our customer base. We've been able to execute strategic customer contracts that solidify our position as the leading merchant market supplier to the industry. The result of the execution of this strategy has been higher volumes at somewhat lower prices, adversely impacting our gross profit margins relative to year-over-year comparisons, but ultimately benefiting the long-term strategic position of the company in this important U.S. infrastructure market.

As Neal had mentioned, in addition to lower average Creosote pricing in the third quarter, we experienced slower-than-expected production rates by our customers, given the overall U.S. demand for treated rail ties, as well as margin pressure brought on by higher average costs for purchased material.

Gross profits increased 11 – excuse me, gross profits increased by 11.3% to $17.8 million in the current third quarter, compared to last year's $16 million, due to higher revenues, offset by the lower margins discussed above.

Third quarter distribution expenses were $7.6 million, compared to last year's $4.8 million. As a percentage of sales, distribution expense was 11.7% of net sales, compared to 9.2% in the third quarter of fiscal 2010. Most of the increase in distribution expenses can be attributed to the 30% year-over-year increase in quarterly revenues, mainly from business associated with the March 2010 Electronic Chemicals acquisition. We made good progress in reducing distribution expense in the Electronic chemicals business to our targeted levels from 17.4% of net sales in the second quarter to 16.7% of sales in the third quarter, and anticipate being able to make further progress at reducing these costs in the coming quarters.

SG&A was $5.6 million in the third quarter, compared to $5.4 million in the prior-year period. The increase was attributable to the latest acquisition, which was owned for only one month in the prior year's third fiscal quarter. That increase was offset by small SG&A reductions in other areas, as a percent of sales, SG&A declined to 8.6% in the third quarter from 10.4% last year.

For the third quarter, operating margins were 7%, a decline from 11.3% in 2010, a result of the gross margin pressures and distribution expense increases experienced during the quarter as previously explained. Interest expense was $571,000 in the current quarter, compared to $542,000 last year, reflecting the higher debt levels associated with the March 2010 acquisition. Our income tax rate was approximately 34.9% versus 36% in the same period in fiscal 2010; we project that our income tax rate will be 38.8% for the balance of the fiscal year.

For the third quarter, net income was $2.6 million, or $0.23 per diluted share, versus $3.3 million or $0.29 per diluted share in the third quarter of 2010. Net working capital at April 30 was $45.7 million including $927,000 of cash. We continued to pay down borrowings, reducing our long-term debt by $8.1 million to $51.2 million during the first nine months of fiscal 2011. Our current borrowings include $17.9 million drawn on our $50 million revolving credit facility, and $13.3 million on the term loan. Currently, we pay an interest rate equal to 2% over LIBOR on our term loan and revolver borrowings. For the nine months ended April 30, shareholders' equity was $96.5 million, or $8.40 per diluted share. Cash flow from operations was $10 million for the first nine months of 2011.

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

J. Neal Butler, President, Chief Executive Officer & Director

Thanks, John. Before handing the call over for your questions, I would like to provide you with some final thoughts and summarize our favorable expectations for the last quarter of the fiscal year and the beginning of 2012. The market trends we see in each of our business areas are encouraging. We continue to project a strong fourth quarter and fiscal 2012, which we expect will be driven primarily by improved profitability in our Electronic Chemicals business following the completion of the manufacturing consolidation project and the recently implemented price increases and new business coming on stream.

We believe we will see a recovery in Creosote as rail tie production rates are expected to increase as evidenced by our Creosote sales in May. Animal Health should perform well in the fourth quarter as the May, June, and July months are some of the strongest seasonally and as new product registrations take effect in South American markets. We anticipate continued steady performance from Penta. We have confidence in our strategy and believe it will continue to provide opportunities for sustained growth in revenue, earnings, and cash flow. We are optimistic about our prospects for continued growth and look forward to reporting on KMG's continued development.

And, lastly, before answering your questions, I would like to point out that we will be presenting at the Canaccord Genuity Global Growth Conference on August 9 through 11 in Boston. We hope to see some of you there. We will be posting the slides from our presentation on our website. We appreciate your participation today, and now open the floor for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting the question-and-answer session. [Operator Instructions] Our first question comes from Daniel Rizzo with Sidoti & Company. Please state your question.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Hi guys.

<A – **Neal Butler** – **President, Chief Executive Officer & Director>**: Good morning Dan. How are you doing bud?

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Good, how are you? With the new contract you guys won, is that with a different customer than with the one you announced the last time?

<A – **Neal Butler** – **President, Chief Executive Officer & Director>**: No, same one.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Same one. And, then can you just refresh my memory how these work – are these contracts like over a set of number of years or is it just as needed, how does it work?

<A – **John Sobchak – Chief Financial Officer>** Well, Dan, I'm sorry, a clarification. In the last earnings call, we reported on a new contract win and in this earnings call we confirmed that that contract was progressing on schedule, but we also won an additional contract....

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Right.

<A – **John Sobchak – Chief Financial Officer>...** which is expected to come on stream in the first calendar quarter of 2012, so that's two additional contract wins.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Right. Now with those two contracts, could you just refresh my memory, are they for a set number of years, how do they work?

<A – **John Sobchak – Chief Financial Officer> >**: It really depends on the contract and the requirements. One actually required a bit of capital investment which you'll see in our fiscal 2011 results; we've had to invest in some additional high purity bulk trailer capacity. So, we're spending close to $3 million over the next several quarters to do that and then it's, I'd say a five-year agreement. So it depends on the circumstances around each of the contracts and they are not for a set volume so the contract terms generally refer to payment terms, product quality, how do you handle excursions from product quality, that type of thing.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Is the second new one for five years as well?

<A – **Neal Butler – President, Chief Executive Officer & Director>**: No, the second was not for five-year timeframe. It is going to be – as it stands right now, the finalization of that contract is still a little bit before us only because we continue to add some additional products to it.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Okay. And then with Creosote you said that industry reports indicate that there is going to be an increase

in demand over the next three years I think through 2013. That's above the 18 million to 20 million that's been referenced in the past as the annual replacement [ph] full contracts (22:30)?

<A – **Neal Butler – President, Chief Executive Officer & Director>**: If you look at the forecast from the Railway Tie Association going forward, you look at – and it's always calendar year, but the calendar year 2011, the forecast for total rail tie purchases is a little over 20 million ties, I think it's like 20.4 million ties. 2012 is 20.8 million ties, and in 2013 it actually ramps up to about – a little over 21 million ties. So the demand for rail ties is forecast to continue to trend upwards. One of the things that we've seen in the last year or so is that the inventory to sales ratio has declined, which means very simply the production has not been keeping up with the total purchases. So there is going to be a little bit of a catch-up, so we believe there will be an additive effect going forward from this – from right now going forward as a result of the rail tie demand plus the need to build inventories.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Okay. All right, thank you for clarification. And then one final question. I think last conference call somebody asked if $13 million was going to be the run rate – or around $13 million, if it was going to be the run rate for operating expenses, and you said it would probably come down. Is that still your outlook, because it didn't really – I mean it came down a little bit but not much for the quarter, I was wondering if you're still expecting it to go down to $12 million or $11 million going forward.

<A – **John Sobchak – Chief Financial Officer>** The big item in operating expenses, the big variable there, is distribution expense and we made some pretty good progress this past quarter of reducing that, bringing a little more efficiency into the supply chain after integrating the General Chemical acquisition and we believe there is more opportunity to make improvements there, we're hard at work there.

<Q – **Daniel Rizzo** – Sidoti & Co. LLC>: Okay. Thank you guys.

<A – Neal **Butler – President, Chief Executive Officer & Director>**: Thank you Dan.

Operator: Our next question comes from Rosemarie Morbelli with Gabelli & Company. Please state your question.

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: Good morning all. Just following up on the distribution expense, you – it used to be 13.2%, it is now around 17%. How low can you get and I think Neal you said that it would be difficult to get back to that 13.2% of revenues, what do you think is a reasonable number that you can achieve?

<A – **John Sobcha**k – **Chief Financial Officer>**: We're currently at 16.7%, that's down from 17.4% in the previous quarter -

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: Okay. Okay.

<A – John **Sobchak – Chief Financial Officer>**: ...the second quarter of fiscal 2011. And going forward, for the fourth quarter and beyond we believe we can get that down to 16%, potentially lower depending upon what happens to diesel prices.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: We feel pretty confident Rosemarie that we can get it down to certainly the 16% level.

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: What was the number, I am sorry Neal?

<A - **Neal Butler - President, Chief Executive Officer & Director>**: 16%

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: 16%?

<A - Neal **Butler - President, Chief Executive Officer & Director>**: Yes.

<Q - Rosemarie Morbelli - Gabelli & Co., Inc.>: But there is no way you are going to go back down to 13% or anywhere between 13% and 16% it sounds?

<A - **Neal Butler - President, Chief Executive Officer & Director>**: We may get below 16%, but I don't think it'll be dramatically below 16%. The 13.2% in all honesty was a bit of an anomaly and a portion of that was driven by much lower diesel prices.

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: Okay. All right. Looking at the Creosote and the demand for railroad ties, I recently took a train ride between Boston and New York and on the side of the tracks there is a huge amount of concrete ties. Could you talk about the inroad of concrete ties replacing the wooden one needing Creosote and what that impact could be?

<A - **Neal Butler - President, Chief Executive Officer & Director>**: Certainly. Concrete in various composite ties have been in the marketplace for a long time. Our estimation, it is only an estimation on our part, is that they tend to represent about 10% of the tie demand, and it's somewhere in that range. And we have - you've seen that a number of the concrete ties tend to go in subways, you know, some of the passenger lines, on the much heavier gauge railroads, and most of the railroads in the United States are for freight, the heavier gauge railroads still tend to prefer the wooden ties, so it's not surprising that you see it on passenger lines but if you go out to the major rail ties, the railways across U.S. which are freight, their preference is still for wooden ties there.

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: Okay. So when we look at your 20.4 million ties if we take 2011, are you saying that of that 10% could be concrete or are those all wood ties - wooden ties?

<A - **Neal Butler - President, Chief Executive Officer & Director>**: That's wood ties.

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: Wood ties, okay. And how about a similar question for Penta and electrical poles, do you see a replacement of wooden poles by concrete poles as well?

<A - **Neal Butler - President, Chief Executive Officer & Director>**: There's always been - this is just talking to rail tie market, there always have been markets where they've used concrete, and they use steel and there is a certain portion of the market where they use some of the composites in the concrete. But from our viewpoint going forward, certainly for the foreseeable future, we believe that the demand for wooden utility poles will remain about where it is today.

<Q - **Rosemarie Morbelli** - Gabelli & Co., Inc.>: Okay. So you don't see it declining?

<A - **Neal Butler - President, Chief Executive Officer & Director**>: Not in the near future, the near future being in the next several years, no.

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: Right, okay. And then if you could touch on the Electronic Chemicals. The operating margin – and I understand that you are duplicating some costs, and are the distribution costs included in that $1.6 million of operating income you are reporting for this quarter?

<A – **John Sobchak – Chief Financial Officer>**: Yes, that's net of the distribution expense.

<Q – **Rosemarie Morbelli – Gabelli & Co., Inc.**>: Okay. So we have two costs then in that, right? We have the fact that you are duplicating production and then the fact that, as you are moving to Hollister and Pueblo – and I may be wrong on that assumption, so please correct me – is the distance between your customers and your new location longer than what it is with Air Products and – I mean with your new acquisitions?

<A **– John Sobchak – Chief Financial Officer>**: That's an excellent point Rosemarie. Actually the – General Chemical had a fairly optimized system of transportation lanes servicing their customers from their production site, and when we move those production sites to our locations, right, the transportation lanes in many instances get longer and less efficient. If you look at these transportation lanes graphed out on a map, it's like a spider web going around the country. So the trick is to optimize those lanes, reducing the ton miles traveled, while at the same time being able to service your customers and reducing the number of less-than truckload quantities so it's a pretty complicated exercise. We have enough data now to be able to conduct that exercise, so what you saw in – the reduction in expenses that you saw between the second quarter and the third quarter was the result of some of that and there'll be more of that in the next couple of quarters.

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: But as you are producing more at your own facilities, how do you reduce the time travel since you have extended the distance? Are you saying that you will supply to your customers maybe not four times a week but only twice a week with fuller truckloads? Is that something that can work or am I missing something?

<A – **John Sobchak – Chief Financial Officer>**: Actually if you look at it, the product really travels from plant to semiconductor fab site. It'll go to one or two different distribution centers where it's aggregated and shipped to the customer fab site as required. So it's a question of optimizing those transportation locations. And in some cases we might choose to actually package the material in another location – at a third-party location, if it's closer to the customer site rather than shipping it across the country. So there are a various options to do that.

In general, the transportation expense – I think the original question was – are some of the shipping lanes longer, and yes. So when we had a – when we came up with our 200 basis point improvement in operating margins for the Electronic Chemicals business as a result of this acquisition, some of that was mitigated by the fact that we were going to be paying a little bit more for distribution cost because the ton-miles traveled will be a little bit higher. But that's going to be – the overall benefit is going to be – will justify that.

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: Okay, and then last question if I may. When I look at the operating margin in the quarter and even last year, the Electronics Chemicals which is supposed to be, I would have thought, the most profitable business, has the lowest margin.

Can you comment on that and how high can those margins go over the next couple of years, let's say?

<A – **John Sobchak – Chief Financial Officer>**: That's interesting. You know, the Electronic Chemicals business is where Penta and Creosote were when we first acquired them, in fact Penta and Creosote weren't as attractive when we first acquired them. So I kind of look at the Wood Treating business as the poster child of what we're looking to accomplish in Electronic Chemicals through consolidation and efficiency improvements.

We do anticipate margins to improve significantly in the Electronic Chemicals business from the price increases that have been put in place now to recover the raw material costs we've been absorbing for the last few quarters and also the efficiency gains from the manufacturing consolidation.

<Q – **Rosemarie Morbelli** – Gabelli & Co., Inc.>: And of the long-term, what are you looking at – where would you be satisfied at which kind of an operating margin for that business?

<A – **Neal Butler – President, Chief Executive Officer & Director>**: We really haven't quantified a target operating margin. I think what we would probably be safer stating is that we're looking at an operating margin trend and we'll continue to trend the operating margins upward but we haven't put a ceiling on where that might go.

<Q – **Rosemarie Morbelli – Gabelli & Co., Inc.>**: Okay. Thanks.

Operator: Thank you. [Operator Instructions] Our next question comes from Tom Claugus with Graham Partners (34:49). Please state your question.

<Q>:Hi guys, just curious.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: Hi [ph] Tom (35:02).

<Q>: Hi. On the – so the 200 bps op margin, I guess – so that's how we should expect to see improving from current level. So it's – we're not going to get the 12% op margins, as I had previously – I sort of previously thought we might get to 12% op margins, so it's 2% above where we are today correct?

<A – **John Sobchak – Chief Financial Officer>**: No, we had a – we had said that we expected operating margins – what we've been telling the market is that operating margins would be able to get back to 15%. The 200 bps was off of where we were prior to the acquisition.

<Q>: Okay. So what I'm confused by is – so is this operating margin improvement from where we are today after this next quarter closer to like 400 bps by the end of the year or something – by the end of the calendar year?

<A – **John Sobchak – Chief Financial Officer>**: We're not giving specific segment by segment operating profit forecast [ph] Tom (36:06), I'm sorry. There is various moving pieces that are going to occur as we finish up the manufacturing consolidation that we're discussing. The math that you're – the piece of the math I think you might be missing is the price increases that were implemented.

<Q>: Okay. And is – the full effect of those is not until the September quarter, right?

<A – **John Sobchak – Chief Financial Officer>**: Yes, so we were looking at a..

<A – **Neal Butler – President, Chief Executive Officer & Director>**: As we go forward [ph] Tom (36:43), we think that the operating income, the operating margin for Electronic Chemicals, we should be in – hopefully by the end of this year somewhere in the 15% range.

<Q>: Okay. I'm just confused by the 200 bps versus that number...

<A – **Neal Butler – President, Chief Executive Officer & Director>**: Yes the 200 bps that John said, I mean, I guess we should have gone back and just continued to clarify that because when we first started talking about it, our baseline was the operating margin that we had gotten the Air Products
acquisition to once we had finalized all the integration processes – it got to the point where we fairly well maximized the operating income generation at that point prior to the acquisition of General Chemical – so our baseline was that just – was a number just prior to the acquisition.

<Q>: So I guess what we should be expecting to see is a fairly dramatic improvement in the gross margin not so much in the other two items in the costs?

<A – **John Sobchak – Chief Financial Officer>**: It'll be on the gross margin line. There'll still be some improvement in operating expense and some on SG&A also. But most of it is manufacturing costs because our – because the contract manufacturing sites will be going away and also now versus where we are now where we're going to be recapturing some of the cost increases through our – the price increases we've implemented.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: It's a combination of all the above, but we will see just through increased plant utilization – plant capacity utilization, will have a notable impact on cost of goods.

<Q>: Okay. Thanks for the clarification.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: Certainly.

Operator: Thank you. [Operator Instructions] Our next question comes from [indiscernible] (38:47). Please go ahead sir.

<Q>: Yes, thank you. I'd like to understand your Electronic Chemical business from a value added perspective. I'd like to hear your thoughts, but I'm kind of wondering along the lines: do you do chemical reactions? Do you add value by blending or formulating? Do you add value by purifying the chemicals? And if you do add value by purifying, what steps do you do to purify the chemicals? And if you add value by purifying the chemicals, my intuition is that it's better to purify the chemicals closer and sooner to their final use. So why don't your customers just do it themselves? I'd like to hear your thoughts on the whole value chain that you use in that process? Thanks.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: When you look at the value-added that we bring to the high purity acids and the high purity solvents, there are just several key components, key

headings to the outline. And the first is the point you just made a while ago is that we go through a purification process for a lot of our chemicals and some of this is done through distillation, some of it is done through filtration, some of it is done through a combination of all of the above. So we bring it to the prescribed purity levels and we track over 35 different metals in this process in determining purity levels and purity level requirements to meet our customer demand. So when somebody says you just purify, there's actually a bit more involved than we just made it pure, it is important to realize that there are a lot of components in that than we test for. So that's a key point of being – key point of the value-added prospect.

A second key element though is the actual packaging of the material because, when you take these products to purity levels that are [ph] sub BPD (40:50) then you are looking at parts per trillion kind of levels, it doesn't take much to contaminate that purity level. So the packaging process, the packaging equipment, the choice of packaging containers, whether it's resins or whether you're using Teflon-coated stainless steel or the other components, is the other key value-added, because once you purify it, the next critical factor is to make sure that you get it to your customers' loading dock and that purification level has remained the same.

For a customer to do this it just wouldn't be cost effective, and we also do some blending of these products. There are a number of blends, a lot of these blends are specific to particular customers and those blends again have to meet these purity requirements and it goes through the same process of ensuring that the purity levels are being delivered to their loading dock with no contamination and no reduction in the purity. So the value added is sort of a component of purity and also the packaging and delivery.

<Q>: Okay. I still don't understand why it's not cost effective for your customers to buy impure raw materials and blend them and filter them and distill them right next to their process?

<A – **Neal Butler – President, Chief Executive Officer & Director>**: Well, it's strictly a cost-related factor. The volumes that a customer may be purifying would be sufficiently small enough not to justify the CapEx that would be required to put equipment in to do it because you'd need to run a huge volume through that equipment to make it – to make it cost effective. It's no different than the acids for instance that we produce or some acids that we purchase and we purify them, the question is why don't you vertically integrate and produce those acids. We don't – it's not cost effective, simply because we would not run the levels-the volume levels through that production facility to justify the CapEx.

<Q>: Okay. That's very interesting, I appreciate it.

<A – **John Sobchak – Chief Financial Officer>**: I think the other part of the value chain to keep in mind too is that the cost of these chemicals is less than 1% of the final cost of the manufactured ship. So, while it's an important product in the manufacturing process, it's not on the top of their concerns in terms of where their costs are.

<Q>: Yeah. It seems like a key thing to all this is your ability to distribute these things all around the place without losing quality.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: That's the crux of it. That's the final – the final value-added is indeed that.

<Q>: Okay. You must be able to do it. I mean parts per trillion is pretty tough, but I guess you can do it.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: It amazes me too, but we can indeed do it.

<Q>: Okay. Good. Thanks very much.

Operator: Thank you. Our last question comes from Steve DeNichilo with ACK Asset Management. Please state your question.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Hey guys. How are you?

<A – **John Sobchak – Chief Financial Officer>**: Hi Steve.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: You mentioned – Neal, you mentioned 15% operating margin target in Electronic Chemicals, is that with the new reporting structure with all the corporate expense allocated?

<A – **John Sobchak – Chief Financial Officer>**: Good question. No, that's pre-allocation.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Okay. And what would that be post-allocation?

<A – **John Sobchak – Chief Financial Officer>**: Well, in our segment reporting Steve we provide all of the allocations, so you can easily back that out and how most of the folks have been modeling the company and how I do it too, is building up the operating profits on a pre-allocation level and then calculating the corporate overhead as a separate entity – separate number because it's been – it doesn't scale up the same way.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Right. Is there just a ballpark number that we can use, just the difference between the two?

<A – **John Sobchak – Chief Financial Officer>**: Steve, you could – it's just math. I mean you could...

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Okay. Okay, all right, I will figure it out myself.

<A – **John Sobchak – Chief Financial Officer>** [indiscernible] (45:11) back into it from the report.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Got it. Okay. So then when we look at this 15% pre-corporate allocation number, this is when all of the production has moved over, all the price increases have gone through, with the new business we think will be on that run rate?

<A – **John Sobchak – Chief Financial Officer>**: Correct.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: And your target from a timing standpoint is it sounds like the middle of the first quarter?

<A – **John Sobchak – Chief Financial Officer>**: That's right. That's – middle of the first quarter is wherein all those costs have kind of run through the P&L.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Right, right, okay, okay. And just my final question, you put a comment in your press release on acquisitions, is there anything more imminent? It just – it surprised me for you guys to call it out while that's always been your strategy longer term, is there something that's come into your radar?

<A – **John Sobchak – Chief Financial Officer>**: There is always stuff in the radar Steve.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: There is nothing that we have today that we were close to signing agreements, but to John's point, it's a bit of a daily exercise for us. So we do have a pretty full plate of acquisition opportunities that we're looking at and assessing as we speak, yes.

<A – **John Sobchak – Chief Financial Officer>**: I'd tell you, we've been

– I've been in KMG for 10 years and work on the M&A program and this is one of the most active periods of time I've seen.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Right. And just from a size standpoint, I mean is there any type of gauge on what type of acquisitions you're looking at?

<A – **Neal Butler – President, Chief Executive Officer & Director>**: We don't have a specific target for acquisitions but if you wanted – if we range the sizes, the range of these probably is going to be anywhere from $25 million to $60 million of revenue.

<Q – Stephen DeNichilo – ACK Asset Management LLC>: Got it, okay. All right, great. Congratulations, thanks.

<A – **Neal Butler – President, Chief Executive Officer & Director>**: Thank you.

Operator: Thank you. I will now turn the conference back to management for closing remarks.

Neal Butler, President, Chief Executive Officer & Director
Well, John and I want to thank everybody for being on the conference call with us today. As we mentioned we'll be in Boston in August and we look forward to seeing a number of you there. So with that we thank all of you.

Operator: Thank you. This concludes today's conference. All parties can now disconnect. Have a great day.