Corrected Transcript

KMG Chemicals, Inc. Fiscal 2011 Fourth Quarter and Full Year Financial Results Conference Call

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Participants

Corporate Participants

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

Other Participants

Eric Glover – Analyst, Canaccord Genuity, Inc.
Daniel D. Rizzo – Analyst, Sidoti & Co. LLC
Rosemarie J. Morbelli – Analyst, Gabelli & Co., Inc.
Jay Richard Harris – Analyst, Goldsmith & Harris, Inc.
Steven K. Schwartz – Analyst, First Analysis Securities Corp.

Management Discussion Section

Operator: Good morning and welcome to the KMG Chemicals Incorporated Fiscal 2011 Fourth Quarter and Full Year Financial Results Conference Call. We would like to begin by reminding you that the information in this conference call includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to significant risks and uncertainties, including statements as to the future performance of this company.

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

With that, I would now like to turn the call over to Neal Butler, President and CEO. Thank you, sir you may begin

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

Thank you. Good morning and again welcome to KMG's fiscal 2011 fourth quarter and year-end 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 also discuss the outlook for fiscal 2012. After our comments we will address your questions. Our earnings release was filed earlier today and I hope all of you had a chance to review it. You can access it on our website. We also plan to file our 10-K tomorrow.

We generated record revenues in both the fourth quarter and full year of fiscal 2011, driven by increased sales of Electronic Chemicals and higher volumes of Creosote in the Wood Treating Chemicals business. We operated profitably in each quarter of fiscal 2011, and generated positive cash flow for the year, while making substantial investments in our corporate infrastructure, paying down debt and increasing our cash dividend.

As many of you are aware, we announced our expectations for the fourth quarter in early September. While our record revenues have in large part validated our targeted consolidation thesis and growth strategy, our bottom-line results were below expectations, driven by a combination higher than expected raw material prices, distribution costs and some lingering duplicative manufacturing costs associated with the consolidation of our electronic chemicals manufacturing following our acquisition from General Chemical.

With this consolidation initiative completed, the higher-cost material that was produced during the transition period is being worked down, and we expect that any consequential costs associated with those activities will be behind us by the end of this first fiscal quarter of 2012. Additionally, the pricing actions we put in place in the second half of fiscal 2011 and the first quarter of 2012 are expected to offset the raw material cost increases in both the Electronic Chemicals and Wood Treating Chemicals businesses.

Fiscal 2011 was a transformative year for KMG. Following the acquisition of General Chemical's Electronic Chemicals business and successful integration into our operations, we consolidated manufacturing, expanded critical capabilities necessary to facilitate organic growth and established ourselves as the leading U.S. supplier of high-purity process chemicals to the semiconductor industry. This is an important achievement, given the solid demand environment for these products and the additional business associated with the more than $15 billion of customer expansion initiatives in the United States, many of which are currently underway.

We completed several important supply contracts in our Wood Treating business, and have also solidified our position as a major supplier and manufacturer of wood treating chemicals. This will allow us to benefit from the strong maintenance and railroad tie replacement rates that are anticipated through calendar 2013.

With fiscal 2012 underway, many aspects of our strategy are coming together. The actions we have taken and investments we have made have positioned KMG to capitalize on the wealth of opportunities inherent in our markets and deliver superior returns to our shareholders.

Before turning things over to John, I will discuss the 2011 performance and outlook for our business...

Regarding our Electronic Chemicals segment….

For the fiscal 2011 year, sales increased 35% to $151.5 million from $112.0 million last year, due primarily to the acquired business along with increased demand due to an improvement in semiconductor manufacturing. In the fiscal 2011 fourth quarter, sales increased by 10% to $40.2 million from $36.5 million in the fourth quarter of last year.

The majority of our growth in the fourth quarter was organic, as the 2010 fourth quarter included a full three months of sales from the Electronic Chemicals acquisition. We continue to see a healthy end market, but recognize that a recession, or a significant global economic downturn, could negatively impact sales.

Our customers are taking a cautious outlook, but so far we have not seen a material decline in demand. Although some European semiconductor manufacturers have advised of a slowdown in the fourth calendar quarter, the European market is a relatively small part of our Electronic Chemicals sales and we have not seen that response in North America.

This segment contributed $6.2 million to operating income in fiscal 2011, down from $8.4 million in fiscal 2010. In the fourth quarter, operating income was $262,000 in fiscal 2011 versus $2.8 million in fiscal

2010. This decline was due primarily to the aforementioned higher raw material costs, as well as higher manufacturing and distribution expenses associated with the integration of our most recent acquisition.

Global price increases were phased-in during the end of fiscal 2011, and additional product specific increases are planned for second quarter implementation. As we mentioned previously, we held off on implementing these pricing actions earlier in fiscal 2011 in order to facilitate a smooth and complete requalification process for our customers.

While this approach impacted our earnings in fiscal 2011, we were able to maintain virtually all of the pre-integration sales volumes of these products. These pricing actions will move us to a more normalized operating margin. Our consolidation initiatives were completed in the fourth quarter and, with the exception of one product group, we have eliminated outsourced production at third-party manufacturing sites, significantly increasing capacity utilization in our Pueblo and Hollister plants.

We will continue to have one product group made for us in Bay Point, California, consistent with our original plan. As a result of additional production volumes, our Hollister and Pueblo plants are expected to run at over 80% of capacity beginning in fiscal year 2012, as compared to approximately 50% during the same timeframe last year and prior to consolidation.

We're achieving the manufacturing efficiencies we anticipated and, along with the pricing strategy to offset raw material cost increase, anticipate in the second half of fiscal year being able to regain a 15% operating margin for this business before the inclusion of corporate allocations and of course absent a sudden downturn in the market.

In fiscal 2011, we won significant additional business from a larger customer that's expanding operations to the U.S., the impact of which we expect to realize in the first quarter of fiscal 2012. We also 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 our third fiscal quarter of 2012. Although the amount that these two expansions will generate for us is not yet certain, we expect they will initially represent in excess of $6 million per year of additional revenue, with the potential to ramp up in future years.

As noted above, we are encouraged by the 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.

Now, moving on to our Wood Treating Chemicals business Wood Treating sales were $30.7 million in the 2011 fourth fiscal quarter, an increase of 40% over the 2010 fiscal quarter. For the 2011 fiscal year, sales rose by 21% to $104.1 million. The quarterly and yearly increase was due primarily to higher sales volume in the Creosote segment. Entering fiscal 2011, a portion of the market that was using a higher grade of creosote blended with petroleum oil to treat railroad ties, shifted to a lower grade of creosote that is not blended with petroleum oil. The shift to a pure creosote treatment, however, yields a better quality, treated railroad tie. The shift also results in greater sales volumes of creosote, although the lower grade of creosote employed commands a lower price and yields a lower unit margin.

Overall, Wood Treating contributed $3.4 million to operating profits in the fourth quarter of fiscal 2011 and $14.8 million for the fiscal year, compared to $4.7 million and $23.0 million, respectively, in the 2010 fourth quarter and fiscal year.

In our Creosote segment, sales in the fiscal 2011 fourth quarter rose 53% to $24.5 million from $16.0 million and for the fiscal 2011 year, sales increased by 27% to $80.5 million.

Income from operations in the Creosote segment was $2.2 million for the current quarter compared to $3.0 million in the fourth quarter of fiscal 2010. Margins were negatively impacted relative to 2010, due primarily to lower average prices from the shift in product mix and renegotiated contract pricing, coupled with higher average costs for purchased material.

In early fiscal 2011, we repositioned KMG in the creosote marketplace following a substantial consolidation of our customer base. We have been able to execute strategic customer contracts that solidify our position as the leading merchant market supplier to the industry. While 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, we believe it will ultimately benefit the long-term strategic position of the company in this important U.S. infrastructure market.

Industry reports issued by the Railway Tie Association forecast rail tie purchases to remain strong through 2013.

Penta sales were $6.2 million in the fourth fiscal quarter compared to last year's $6.0 million. For the fiscal year, sales were $23.6 million versus $22.8 million in fiscal 2010. We have seen a modest rebound in the volume of utility poles treated as compared with the downturn in treating in fiscal2010. Income from operations from Penta was $1.2 million in the fourth quarter, down from $1.7 million in last year's fourth quarter. For fiscal 2011, Penta's operating income was $6.5 million, compared to $7.1 million last year. Margins were pressured by high raw material costs. We implemented a price increase in the first quarter of fiscal 2012 to offset these costs.

Now, looking at our Animal Health business - Animal Health represents about 4% of our revenue. Fiscal 2011 fourth quarter net sales were $3.3 million and $10.8 million for the year, compared to $4.0 million and $10.6 million in the respective periods last year. In the fourth quarter, sales suffered slightly from reduced fly pressure in the Western and Southwestern U.S. as a result of drought in those geographic areas.

Income from operations in the quarter was $2,000, compared to a loss from operations of $31,000 and for the 2011 fiscal year, income from operations was $61,000 compared to a loss of $86,000 in fiscal 2010

We recently obtained product registrations in some key South American markets, produced and have begun selling products into those new markets. We continue to pursue additional registrations and sales opportunities in that region. We are pursuing a variety of opportunities in this segment that are in line with our strategic growth plans.

I'll 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, Vice President & CFO

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 reporting 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, etc. The allocation is based on segment net sales and we've revised prior year amounts to reflect the current method. The segment operating profits provided by Neal just now were net of those overhead allocations.

For fiscal 2011, net sales rose 28% to $266.4 million, producing net income of $9.7 million, or $0.85 per diluted share, versus fiscal 2010 sales of $208.6 million and $15.3 million of net income, or $1.34 per diluted share. Net sales rose by 19% to $74.2 million for the fourth quarter of 2011, versus $62.5 million in the final quarter of fiscal 2010, with the increase the result of increased sales of Electronic Chemicals and higher volumes in our Wood Treating Chemicals business.

Gross profits increased to $71.4 million, or 26.8% of sales, in the 2011 fiscal year, compared to last year's $69.7 million, or 33.4% of sales. For the fourth quarter, gross profits were $18 million, or 24.2% of sales in fiscal 2011, versus $18.6 million, or 29.8% of sales in fiscal 2010. For the fiscal

2011 year, operating income was $17.7 million, or 6.7% of sales, compared to $27 million, or 12.9% of sales in fiscal 2010. And for the fourth fiscal quarter, operating income was $2.7 million, or 3.6% of sales, compared to $6.3 million, or 10% of sales, in the final quarter of fiscal 2010.

The decline in gross profits and operating income in the fourth quarter and fiscal 2011 year, as Neal mentioned, was primarily driven by higher raw material costs in both Wood Treating Chemicals and Electronic Chemicals, and costs associated with the consolidation of our Electronic Chemicals manufacturing base following our last acquisition.

Most of the additional costs related to our consolidation initiative were the result of the expanded operations at both our Pueblo and Hollister facilities, while our contract manufacturing locations continued to be operated on our behalf by Air Products and General Chemical as production was being transitioned out of those sites. The manufacturing plant consolidation was completed in June, and these extraordinary costs have been eliminated.

To provide a high level of supply surety to our customers, we built inventory in advance of the cut over of manufacturing and expect to have virtually all of that higher cost product sold out of inventory in this first quarter of fiscal 2012.

Fiscal 2011 distribution expenses were $29.0 million compared to last year's $19.3 million. As a percentage of sales, distribution expense was 10.9% of net sales compared to 9.3% in fiscal 2010. Most of the increase in distribution expense can be attributed to the 28% year-over-year increase in revenues mainly from business associated with the March 2010 Electronic Chemicals acquisition and a 2011 runup in diesel prices.

SG&A was $24.8 million for the fiscal 2011 year compared to $23.4 million in the prior year period. The increase was mostly attributable to the last acquisition, offset by small SG&A reductions in other areas. As a percent of sales, SG&A declined to 9.3% for fiscal 2011 from 11.2% last year.

Interest expense was $2.3 million in the fiscal 2011 year, essentially flat with fiscal 2010's interest expense in fiscal 2011; our income tax rate was approximately 35.1% versus 37.5% in fiscal 2010.

Net working capital at July 31 was $45.2 million, including $1.8 million of cash. We continued to pay down borrowings, reducing our long-term debt by $10.1 million to $49.3 million during fiscal 2011. At fiscal year-end our borrowing included $17.9 million drawn on our $50 million revolving credit facility and $11.3 million on the term loan. Currently, we pay an interest rate equal to 2% of the LIBOR on our term loan and revolver borrowings. For the 12 months ended July 31, shareholders' equity was $96.5 million, or $8.40 per diluted share, and cash flow from operations was $12.7 million for fiscal 2011.

And now I'll hand it back to Neal.

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

Thank you, John. Now for some final thoughts and our expectations for the new fiscal year. My reasons for confidence in 2012 include the market trends we're seeing in each of our business areas are encouraging. We expect better results in fiscal 2012 and beyond to be primarily driven by improved profitability in our Electronic Chemicals business now that we've completed our manufacturing consolidation project and taken pricing actions to offset raw material cost increases.

We're seeing organic growth in our Electronic Chemicals business, particularly in the United States. To date, this has been driven by a solid demand environment and additional business coming on stream. We remain optimistic about this market but keep a close watch on the dynamics of the global economy, recognizing that a significant downturn could negatively impact demand for electronics.

Semiconductor manufacturing forecasts indicate a flattening to slightly declining global semiconductor market. We're seeing a minor downturn in semiconductor production in Europe, but have not experienced a material effect or seen a decline in our business forecast in the United States market, we have – where we have a far greater presence.

In our Wood Treating segment, we expect to see strong demand for creosote continue to be driven by railroad maintenance programs. We have confidence in our strategy, and believe it will continue to provide opportunities for sustained growth in revenue, earnings and cash flow. We have a comprehensive five-year strategic plan, and are confident in our ability to meet the objectives it lays out. At fiscal year 2011, that plan has produced a tripling of revenues since 2007, a compound annual growth rate of 21% for EPS as measured off a five-year regression line, and a 70% rise in shareholders' equity.

Building upon this success is what drives each of us every day at KMG. In that regard, we're seeking ways to expand our Electronic Chemicals and Wood Treating businesses both organically and via acquisitions. We have a robust pipeline of acquisition prospects in both our current businesses, as well as opportunities to create a new segment platform, which we intend to establish by fiscal 2014.

And lastly, before answering your questions, I would like to point out that we will be presenting at the Sidoti's & Co. Fourth Annual New York Conference on November 10th and the Gabelli & Co. Specialty Chemical and Ag Conference on November 18th. Both conferences will be taking place in New York City. 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. Our first question is from Eric Glover of Canaccord. Caller, please proceed with your question.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Good morning guys.
<A – J. Butler – KMG Chemicals, Inc.>: Good morning Eric. How are you doing?

<Q – Eric Glover – Canaccord Genuity, Inc.>: Fine, thanks. First question is on the SG&A line. That was about $2 million higher than our forecast for the quarter and I was wondering if you could just explain that? And then can we assume that goes back down to approximately high 5s, $6 million for fiscal 2012?
<A – John Sobchak – KMG Chemicals, Inc.>: Good morning Eric. Yes, SG&A was somewhat by the increase in the duplicative plant expenses as we were ramping those down. But I'd have to take a look at what might have been included in your total assumptions there.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Okay, well on a sequential basis it was up pretty significantly. So, you think it's just the increased expenses from the duplicative plant operations?
<A – John Sobchak – KMG Chemicals, Inc.>: We had some increases in the administrative costs associated with that, there were some increases in regulatory spending in our Animal Health business that increased that by a couple of $100,000 also. We do expect the SG&A expenses to trend back down. In the first quarter they still will be a little bit higher than the previous quarter's trends but then we expect them to come back down following the completion of some of those regulatory spendings I talked about.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Okay. And then on the Electronic Chemicals business, should we assume that the price increases that you've implemented will be fully in effect in the October quarter so we should see a meaningful bump-up in margins in Electronic Chemicals starting in October?
<A – J. Butler – KMG Chemicals, Inc.>: I think if you look at the price increases that we've implemented – we've actually implemented two of them, the impact of those – they have been fully implemented, the impact of those will be seen in the second – you actually see a bit of in the first quarter but the full impact would be seen in the second quarter and that will be primarily as a consequence of us burning down the higher-cost inventory that we talked about as a consequence of running both of the plants. So, the answer – the long oration, but the answer to your question is yes.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Okay, great. And then finally, you mentioned about

$15 billion of semiconductor plant expansions occurring in the U.S. What the portion of that will be in fiscal 2012?
<A – J. Butler – KMG Chemicals, Inc.>: Well the – if you are asking what portion of that will manifest itself in 2012 in business for us.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Yes.
<A – John Sobchak – KMG Chemicals, Inc.>: It's about half of that.

<Q – Eric Glover – Canaccord Genuity, Inc.>: $8 million in sales?
<A – John Sobchak – KMG Chemicals, Inc.>: $8 billion of that CapEx expansion was planned for completion in our fiscal 2012. Then we start to see the revenue from that in 2012 and more so in 2013. The rest of it is going to be primarily spent in our fiscal 2013. And again, there's a kind of a lag before that manifests itself as revenue for KMG.
<A – J. Butler – KMG Chemicals, Inc.>: One of the two is actually coming on as we speak. The second one actually comes on stream – it will have a material impact on revenue in our third quarter of 2012, at least that's the forecast now.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Is there a way to ballpark that estimate of how it will impact your electronics business?
<A – J. Butler – KMG Chemicals, Inc.>: We believe in 2012 we will see an impact. We can calculate about $6 million. Beyond that it's hard to guess because we won't know that until the second really comes on stream.

<Q – Eric Glover – Canaccord Genuity, Inc.>: Okay, great. Thank you very much.

Operator: Our next question comes from Dan Rizzo of Sidoti & Company. Caller, please proceed with your question.

<Q – Daniel Rizzo – Sidoti & Co. LLC>: Hi, guys. Creosote sales were up 53% in the quarter and that's great, is that because of the change in the product like to the less – the lower-margin mix? I mean, it doesn't seem that would be sustainable.
<A – J. Butler – KMG Chemicals, Inc.>: I'm sorry, Dan, can you say that one more time?

<Q – Daniel Rizzo – Sidoti & Co. LLC>: Creosote is up 53% and that just seems like unusually high. I was wondering, I mean, is that, could you just elaborate on what's from? Is it from you just selling a different type, the lower-margin type of creosote or is it just, just increased rail tie insertions?
<A – J. Butler – KMG Chemicals, Inc.>: The increase in creosote volumes, Dan, was primarily related to that shift in the market from the higher-grade, petroleum-blended creosote to the lower grade that's not blended with petroleum oil, so that results in an increase in creosote volumes. We've also seen a recovery in the rail tie treating market, and if you look at the Rail Tie Association's web site note a substantial increase in production volume of treated rail ties, which – we don't think that that kind of increased trend is going to continue, but we do think that the level that we're at now does represent the level where we'll be for at least through calendar 2013.

<Q – Daniel Rizzo – Sidoti & Co. LLC>: Okay. And then with the acquisitions, I mean, it seems that you've got your debt down to a pretty nice level here, so I would imagine that I mean you're much more comfortable doing something going forward. I guess, how is the pipeline looking these days and is there is anything particularly that you're looking at?
<A – John Sobchak – KMG Chemicals, Inc.>: Yes, we're actually very encouraged by the pipeline. As Neal mentioned there are some interesting opportunities in our existing businesses that we're very encouraged by. But we're also seeing some very interesting new segments, new platforms that we're looking at.

<Q – Daniel Rizzo – Sidoti & Co. LLC>: And that would be a completely fourth platform?
<A – John Sobchak – KMG Chemicals, Inc.>: Yes.

<A – J. Butler – KMG Chemicals, Inc.>: Yes. Dan today we probably have the most robust pipeline we've had probably ever.

<Q – Daniel Rizzo – Sidoti & Co. LLC>: Okay. All right, thanks guys.

Operator: Our next question comes from Rosemarie Morbelli of Gabelli & Company. Caller, please proceed with your question.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Good morning.
<A – J. Butler – KMG Chemicals, Inc.>: Good morning, Rosemarie. How are you doing?

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: I am doing fine. Thanks. How are you?
<A – J. Butler – KMG Chemicals, Inc.>: Well, thank you.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Just following up on the benefit from the extension from your two customers, that $6 million of revenues. Is that annualized as of the third- quarter level? Or is that the full amount that you are expecting to see in 2012?
<A – John Sobchak – KMG Chemicals, Inc.>: That's annualized from the third-quarter level. I'm sorry, the third calendar quarter. I think it's what you were referring to, right?

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Yeah, when the second plant comes on stream. I am assuming that it's your third quarter, not calendar's.
<A – John Sobchak – KMG Chemicals, Inc.>: It's going to approximate what we expect to see in fiscal 2012, Rosemarie.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Okay, so we will see $6 million in 2012. And do you have an estimate for 2013, since you will have only one quarter of the second from the second plant benefit?
<A – John Sobchak – KMG Chemicals, Inc.>: No, you know in the – we don't have yet, we're still working on that with our customers and really one of the main reasons is one of these new facilities is a foundry, so it's contract manufacturing for semiconductor companies that don't have their own manufacturing facility. So, our sales to that foundry is largely dependent upon what kind of manufacturing contracts they have, which they haven't shared with us of course.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Right, okay, but I'm assuming that they would not be building it if they did not expect to have quite a bit business.
<A – J. Butler – KMG Chemicals, Inc.>: Yeah, the facility itself actually is just about completed. We've actually started begun shipping some small quantities of material to the facility to them as they are getting – bringing equipment online and it won't be fully operational until fiscal – I mean until calendar 2012. But the facility itself is completed to the point that equipment's been installed and they are actually purchasing systems now.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Okay thanks. And on the distribution expense, I mean it was I know 9% for last year's full year, but for last year's fourth quarter it was 8.3% of revenues, and this year 10.3%. How much can you get it back down? And besides diesel, does it depend on anything else that you have control over?
<A – John Sobchak – KMG Chemicals, Inc.>: Part of the shift in the distribution expense, Rosemarie, was the increase in percentage of revenue that our Electronic Chemicals business represents. The Electronic Chemicals business is a distribution expense in Penta business, whereas in Wood Treating Chemicals we are selling that product at our plant gate, so distribution expenses are generally much less We did have some increases in Wood Treating Chemicals this year over last year from additional railcar cleaning, which was several hundred thousand dollars, so that accounted for a small portion of the increase. But most of it was due to the fact that Electronic Chemicals is now a bigger part of our pie, if you will.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: So, if the cost of diesel – because you mentioned that

as being one particular reason – if it goes down, and you pick the number, how much of an impact will it have on your overall distribution expense? Or is it actually not that big a deal?
<A – John Sobchak – KMG Chemicals, Inc.>: Well, we estimate that in fiscal 2011 diesel price increases across the fiscal year accounted for approximately $1.5 million more in distribution cost to us. So, if they went back down to the same levels as approximately a year ago that'd be about a $1.5 million savings.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Thanks, that is very helpful. And then you are seeing that you can go back to your normalized margin on the Electronic Chemicals now that you have reshuffled your capacity. Do you have some kind of timing as to when you can get back to that 15%? And I understand it is prior to corporate expense.
<A – J. Butler – KMG Chemicals, Inc.>: What we've communicated thus far is that we anticipate being back at that 15% kind of level in the second half of 2012 – our fiscal 2012.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: And does that imply demand at the level it is today?
<A – J. Butler – KMG Chemicals, Inc.>: Basically, yes.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: Okay, thanks. And if you could give us a better feel on what you are seeing in the cost increases on your raw material, and whether the price increases you have instituted recently will fully offset not only the dollar amount, but will get you back to the previous margins? Or can you just – are you just getting the dollar amount increase?
<A – John Sobchak – KMG Chemicals, Inc.>: Rosemary, I'm sorry, would you repeat that one more time please?

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: I wasn't very clear, I apologize. On your raw material cost increases, are they going to be fully recovered by price increases, but not just on a dollar basis? In other words your cost goes up $1, you get $1 in price increases, but your margin comes down. Are you going to fully recover not only the dollar amount but also the margin?
<A – John Sobchak – KMG Chemicals, Inc.>: Of course our intent is to recover the margin and to get back to a 15% margin as we've said, before corporate allocations for the Electronic Chemicals business. We actually estimate that during fiscal 2011, we fell short by about $3.4 million in operating income due to raw material cost increases. We've made up a portion of that, a good portion of that, with the price increases that were implemented in the fourth fiscal quarter. We have some additional pricing actions planned, as Neal mentioned, coming up in the second fiscal quarter of 2012. You can imagine it's a bit of moving target because some raw material costs are continuing to go up, whereas others are not. So, going forward it's going to be on a much more targeted basis.

<Q – Rosemarie Morbelli – Gabelli & Co., Inc.>: And you really held off on those price increases in order to maintain the volumes. Do you think that you are not going to lose any volume as you are now increasing your selling prices?
<A – J. Butler – KMG Chemicals, Inc.>: One of the things Rosemarie, obviously, you always run the risk of losing business as a consequence of your pricing actions. But we really don't anticipate the pricing action we're taking having a material impact on the volume of business or on revenues. Typically when we have cost increases we've always been able to pass those increases along and our pricing has usually been maybe about quarter lag time. Obviously in 2011, we consciously made the decision from a strategic standpoint to hold off on those until such time as we completed the re-qualification process, because the re-qualification process was a critical element for us to ensure that we got completed and completed effectively. We didn't lose any business as a consequence, no material business, we lost maybe a few small pieces but they were inconsequential. And going forward as we implement the price increases going forward they're done underneath the same kind of approach we've historically taken, and we don't believe that it's going to have a major shift in business now. Sometimes you do lose a bit but you'll gain a bit, but it won't have – we don't believe a material impact anywhere.

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

Operator: Our next question comes from Jay Harris of Goldsmith & Harris. Caller, please proceed with your question.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: I'm going to phrase a question, and I'm not sure how to phrase it. If you ignore raw material cost changes in creosote, the switch from the lower grade, which was blended with, I'd say fuel oil, to a higher grade, which has a lower margin. What does that do to your overall profits? Not profitability, but profits. In other words, for individual railroad tie treated, do you make less money, the same amount of money or more money now?
<A – John Sobchak – KMG Chemicals, Inc.>: Yeah, actually Jay, the product that is blended with petroleum oil, that grade of creosote is actually a higher grade. The market has moved to a lower grade that is not blended with petroleum oil. The pure creosote treatment does yield a higher-quality railroad tie, though a pure creosote treatment is more efficacious for this application. Our approach, Jay, has been that with the pricing that comes along with selling the lower grade material but higher volumes, that our operating profit would be approximately flat as a result of this transition. Now, fiscal 2011 were a bit of a transitional year and we saw a significant recovery during the year in the rail tie treating industry. And you could see from the revenues in our fourth quarter that the rail tie treating has picked up significantly from the prior quarter.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: What is the mix now between the two grades that you are selling or will sell in fiscal 2012?
<A – J. Butler – KMG Chemicals, Inc.>: We haven't reported that blend, that ratio.
<A – John Sobchak – KMG Chemicals, Inc.>: We can't disclose that Jay.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: Are you eventually going to get a 100% to what John has indicated is a lower-grade, lower-priced, lower-margin material?
<A – J. Butler – KMG Chemicals, Inc.>: There are still some markets that are specific for the higher grade of the P1 level of creosote. For instance, the utility pole market still uses creosote that uses the higher grade and that portion of the market will remain at the P1 level.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: And just to delve a little further into Creosote before I go on to Electronic Chemicals. When do you know that your – how much advance notice do you get that your purchase materials costs are going up?
<A – J. Butler – KMG Chemicals, Inc.>: You're talking about Creosote now?

<Q – Jay Harris – Goldsmith & Harris, Inc.>: Yes.
<A – J. Butler – KMG Chemicals, Inc.>: Typically it's about 90 days.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: And so why – what was there in your sales contracts that caused you not to raise your prices earlier in the fiscal year that just ended?
<A – J. Butler – KMG Chemicals, Inc.>: There are blend of events. One of the things that we mentioned, well today and in some earlier releases and reports, is that there were some notable consolidation that occurred in the customer base and in that process we had to renegotiate some supply contracts. One of the things that occurred in renegotiating some of the supply contracts was setting prices and pricing concessions made in the early portion of that, and then the increases would come subsequent to that. So, that had an impact on it. And the other one is just mix. We have creosote that comes from multiple sources, it's not all the same price, and the mix has an impact on the margin as well. And the mix very important in the early part of the year had a more negative impact on it.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: If crude oil prices come down and the BTU value of creosote declines will you get a cheaper purchase material? And then will you have to pass that through to your customers?
<A – John Sobchak – KMG Chemicals, Inc.>: We've actually looked at the correlation between creosote prices and crude oil prices and you can imagine there is not a very tight statistical relationship. However, directionally there does seem to be a relationship. And in Europe, primarily, creosote is used not as a wood preservative but as a fuel source for carbon black production, the alternative being low-grade residual fuel oil. So, it stands for reason that there would be some relationship between that residual fuel oil and creosote costs. However, the supply and demand market for creosote products is

more complex than that. It's a byproduct for one and it's driven by – the supply of creosote is driven by the steel and aluminum industries. So, it's tough to give a blanket comment about that, Jay.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: If your purchase costs come down do you have to reflect that in your selling prices?
<Q – Jay Harris – Goldsmith & Harris, Inc.>: Or would you prefer not to answer the question?
<A – John Sobchak – KMG Chemicals, Inc.>: I mean, Jay, you know, our customers are astute and they understand where the market is. They understand the value proposition we bring to the table, so it's a negotiation and...
<A – J. Butler – KMG Chemicals, Inc.>: And the process just isn't as simplistic Jay, unfortunately.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: Okay. What percentage of your Electronic Chemical revenues are in Europe?
<A – John Sobchak – KMG Chemicals, Inc.>: It's about 20%.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: And what is the outlook in 2012 for those revenues?
<A – John Sobchak – KMG Chemicals, Inc.>: From our perspective, we're looking at fairly flat revenues in 2012. Our team here has made some, I believe, impressive progress at winning additional business. That's going to be offset by the slowdown that's been signaled to us by our customers there for the fourth calendar quarter.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: Are you...
<A – J. Butler – KMG Chemicals, Inc.>: Sans a significant downturn in the market, we forecasted our business to be up slightly out of our European facility in 2012.

<Q – Jay Harris – Goldsmith & Harris, Inc.>: All right thank you very much.

Operator: [Operator Instructions] Our next call comes from Steve Schwartz of First Analysis. Caller, please proceed with your question.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Hey good morning guys.
<A – J. Butler – KMG Chemicals, Inc.>: Good morning.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Hey just back on this creosote dynamic. Can you guys give us an idea of why the market has made this change to pure creosote versus blended?
<A – J. Butler – KMG Chemicals, Inc.>: There are a myriad of reasons for that, and I guess I'll just maybe isolate on a couple of them. One was there was a lot of material available at the P2 level, so it was available to the marketplace, that's the first thing. Second thing is there were number of the treaters that were promoting the pure P2 treated tie as a better-quality tie and – a higher-quality tie than one that was blended with the P1, I mean that was two components. But there are number of factors that went into the market shifting over to the P2.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Got you. Okay, well, thanks Neal. And, John, tell me if I've got this wrong, the pure creosote is of higher value to the railroads, yet it's not reflected in higher value to you guys as the creosote supplier? Because you noted a negative mix impact, is that right?
<A – John Sobchak – KMG Chemicals, Inc.>: Well, let me rephrase for you. The treated tie that is the result of a pure creosote treatment is actually a more efficacious, a better quality tie for the railroads. The creosote that we sell into that tie is actually a bit of lower-quality creosote than the one that's blended with petroleum oil. The reason why the pure creosote tie results in a higher- quality tie is because the petroleum oil dilutes the effectiveness of the creosote treatment.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Okay. And then I did see one thing put out by, I think Progressive Railroading Magazine or something like that, and they had noted the RTA data. And Neal, you talked about the RTA forecast through 2013. But if we could just look at the short term, it

looks like the trailing 12 month purchase rate is like 21 million ties, yet the RTA is maintaining their calendar 2012 forecast for about 20 million ties, which kind of implies that these last few months of this year could actually be weaker year-over-year. Is that kind of a dynamic you are expecting to play out?
<A – J. Butler – KMG Chemicals, Inc.>: Well, I think one of the things to keep in mind is that last year, last calendar year, the demand and the production rate were not in sync. The demand was higher than the production rate, which was – and the reason being that the railroads were actually pulling down inventories of rail ties and I think last RTA report I showed saw that the ratio was about 0.7 to 1. So, it's somewhere around anywhere from three quarters to a year's worth of inventory, and they were pulling down inventory, so the production was running behind the demand. So, I think a portion of it is a little bit of catch up in building the inventories back up.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Okay. Okay.
<A – J. Butler – KMG Chemicals, Inc.>: That's the reason right now you're sort of seeing the demand and production rate a bit out of sync in the other direction.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Okay. So, really need to kind of discount that RTA purchase forecast relative to the type of demand you are seeing. Okay. And then just my last question and again in railroad, in the creosote, related to the 45G tax credits. If I recall, your customer base has a stronger mix of sales to the short-line railroads. And you can correct me if I'm wrong, but I think there's some strong demand being created there by this 45G tax credit, which would expire at the end of the year. Do you expect that that could be an impact on your business in 2012?
<A – J. Butler – KMG Chemicals, Inc.>: We don't see that, and what we are operating off of – and we've done this historically and – is probably proven to be the best leading indicator are the forecast from the RTA.

<Q – Steven Schwartz – First Analysis Securities Corp.>: Okay, great. Thanks guys. Operator:

[Operator Instructions] It appears there are no further questions at this time. I would now like to turn the floor back to management for closing comments.

<A – John Sobchak – KMG Chemicals, Inc.>: Before we embark on closing comments, I would like to go back to the question that Eric Glover had raised about SG&A cost. In the fourth fiscal quarter of 2011, SG&A was $7.7 million, versus $7.2 million in the fourth quarter of 2010. We did incur some additional administrative expenses associated with the ramp up of the transition of manufacturing relative to the consolidation strategy that's behind us. We also saw approximately $220,000 of additional regulatory spending in the Animal Health business associated with a date of calling for some registrations, as I had mentioned in my response to Eric. That accounts for the difference and then, Eric, if you'd like to talk to me later on about those costs I could perhaps give you further insight after we file our 10-K tomorrow, we'll have more information on that. Okay with that, we appreciate your participation today. We equally appreciate the continued support of all our investors. And we look forward to seeing some of you at the upcoming conferences. Have a good day.

Operator: This concludes today's teleconference. You may now disconnect your lines at this time. And thank you for your participation.

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