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KMG - Q4 2015 KMG Chemicals Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the KMG fourth-quarter 2015 earnings conference call. (Operator Instructions). As a reminder, this call will be recorded. I would now like to introduce your host for today's conference, Eric Glover, Investor Relations Manager. Sir, you may begin.

Eric Glover - *KMG Chemicals, Inc. - IR Manager*

Good afternoon and welcome to the KMG Chemicals, Inc. fourth-quarter and full-year 2015 financial results conference call. I am joined today by Chris Fraser, our Chairman and CEO, and Mindy Passmore, our CFO. In a moment we'll hear remarks from them followed by Q&A.

During today's call we will refer to financial measures not calculated according to generally accepted accounting principles. Please refer to today's earnings release available on our website for the reasons we are presenting non-GAAP financial information and for the appropriate tables that reconcile these measures to our GAAP results.

Before we begin I would like to remind everyone that the information on this conference call includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to significant risks and uncertainties including statements as to the future performance of the Company. I will now turn the call over to Chris Fraser, Chairman and CEO. Please go ahead, Chris.

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Thank you, Eric. Good afternoon and thank you, everyone, for joining us today. Our Q4 earnings release was issued today after the market closed. After my remarks I will turn the call over to Mindy for a review of the financials; after Mindy's comments we will take your questions.

Two years ago we made a commitment to preserve our core strategy and increase the intensity with which we focus on execution and operational efficiencies. Over this relatively short time we have accomplished a great deal, financially, operationally and strategically, and built KMG into a fundamentally stronger, more efficient and more capable Company.

Our fourth-quarter results capped off a strong year with record EBITDA in the fourth quarter as well as for the year. We reported adjusted EBITDA of $10.1 million in the fourth quarter, a gain of 12% over the comparable quarter last year. This marked our sixth consecutive quarter of double-digit growth in adjusted EBITDA on a year-over-year basis. Fourth-quarter adjusted EPS grew 19% from the prior year period.

Entering fiscal 2015 we forecast adjusted EBITDA of $32 million to $35 million, or an increase of approximately 10% year over year at the midpoint of that range. We ended fiscal 2015 generating record adjusted EBITDA of $37.1 million, a 21% gain over the prior year, well above our initial expectations despite the headwind from foreign currency and higher stock-based compensation expense.

Adjusted earnings grew 49% to $1.21 per share, representing our highest EPS on an adjusted basis in the past three years. Our solid cash flow and proceeds from the sale of the creosote business enabled us to pay down $30.5 million in debt during the year and we closed fiscal 2015 in a strong financial position. Even after borrowing $23.5 million for the Val-Tex acquisition we ended the year with $7 million less debt than at the end of the prior year.

We enter fiscal 2016 with a stronger balance sheet to support our strategic growth objectives. As well, as always, we remain amended to investing for the long-term in people, facilities and infrastructure to expand our capabilities and enhance long-term shareholder value.

From an operational standpoint we made substantial progress in fiscal 2015 completing the integration of the UPC chemicals business nearing the completion of the consolidation of our global manufacturing operations. The cost savings and operational benefits resulted from our integration and restructuring efforts helped drive significant improvement in our margin and profitability over the past year.

In North America we achieved record production levels in fiscal 2015, benefiting from our strong relationships with leading global semiconductor manufacturers. We also continue to drive volume growth by diversifying our market positioning, extending our involvement in several growing semiconductor segments, including data center, automotive, mobile and Internet of Things.

At the corporate level we took an important step forward with the implementation of new ERP software within our US operations. We plan to extend this ERP system to other regions so that our entire global operations are unified on a single technology platform.

We advanced our growth strategy with two key transactions last year. First, we divested our creosote business. While this business was fundamental to KMG's early growth and success, challenging market dynamics limited its growth potential in recent years.

Additionally, we established a new growth platform with the acquisition of Val-Tex, a manufacturer of lubricants and sealants for the global industrial valve maintenance market. We are excited about Val-Tex's potential for growth both domestically and internationally. The highly fragmented nature of the Industrial Lubricants market offers possibilities for consolidation, a fundamental component of our long-term growth strategy.

Looking ahead to fiscal 2016, we are planning for continued EBITDA growth and margin improvement. Since there are several moving pieces to our guidance I will provide some color to the forecast we provide in today's earning release.

We anticipate sales of approximately $300 million compared to fiscal 2015 sales of $320.5 million. The projected decline reflects the divestiture of our creosote business partially offset by growth within our Electronic Chemicals business and the addition of the Val-Tex Industrial Lubricants business. We also anticipate a continued headwind from the strong US dollar.

Our Electronic Chemicals business is closely tied to global semiconductor production. According to current industry forecasts, the global semiconductor market is forecasted to be flat to up slightly in calendar 2016; a lower rate of growth than forecasted for 2015. We expect our global EC sales to be about flat in fiscal 2016 when taking account the strong US dollar.

In our Other Chemical segment we expect continued solid demand for utility poles treated with penta as utilities in the Western US upgrade their distribution infrastructure and other purchases throughout North America continue their normal pole maintenance and replacement programs.

We believe we will experience steady demand for our lubricant, sealants and related equipment which are used primarily for the maintenance and service of existing energy-related infrastructure. The full-year contribution to our sales from this business will be positive, but the prospect of continued low energy prices is likely limit drilling and well service sales.

Our adjusted EBITDA guidance for fiscal 2016 is $40 million to $42 million, reflecting our expectations for efficiency improvements from the restructuring of our manufacturing operations and margin expansion supported by the enhanced market positioning of our Electronic Chemicals business. In addition, we will benefit from the addition of the Industrial Lubricants business for a full 12 months.

We expect raw material costs in our Wood Treating Chemicals business will increase relatively to the unusually low level we experienced in fiscal 2015. Taking into account an anticipated $2.5 million impact from foreign currency translation headwinds and an increase in non-cash stock-based compensation expense, we still anticipate adjusted EBITDA will grow by approximately 10% in fiscal 2016.

As noted in today's earnings call, we expect to file our Form 10-K for fiscal year 2015 in the next two weeks. While the implementation of our new ERP system has been successful, it has taken somewhat longer than expected to integrate financial data from our prior system.

In addition, we experienced unusual complexity with respect to our foreign tax provision, partly due to our restructuring program in Europe and an increasing volume of intercompany transactions among US, Europe and Asia. We do not expect any changes to the financial information in our press release or as discussed today.

In closing, our strong results in fiscal 2015 reflect our continued efforts to optimize our business, improve our efficiency and enhance our growth for strategic M&A. I am pleased with our achievements in fiscal 2015 and the growth trajectory we are on.

While there is still work to do, I'm proud of the progress we've made and we intend to build on our momentum in fiscal 2016. With that I will turn the call over to Mindy for the financial discussion.

Mindy Passmore - *KMG Chemicals, Inc. - VP & CFO*

Thank you, Chris, and good afternoon, everyone. In my remarks I will discuss adjusted or non-GAAP numbers as we believe non-GAAP information can provide useful insight into the underlying operating performance of our business. The non-GAAP numbers I reference are reconciled to the corresponding GAAP numbers in today's earnings release.

You will note that in today's earnings release Wood Treating Chemicals has been combined with the newly acquired Industrial Lubricants business to form the Other Chemicals segment. These businesses were combined into one segment as separately they were immaterial to our overall results.

Fourth-quarter consolidated net sales were $76 million compared to $91.2 million in last year's fourth quarter. Sales declined on a year-over-year basis due to our divestiture of the creosote business in the second quarter. Gross profit margin in the fourth quarter was 34.9%, up 420 basis points from last year's fourth quarter.

Gross profit margins improved due to higher sales volumes in Electronic Chemicals, the absence of creosote sales in the Other Chemical segment, and cost savings resulting from the restructuring of our Electronic Chemicals operations.

Fourth-quarter distribution expense declined to $10.8 million or 14.2% of sales compared to $13.3 million or 14.6% of sales last year. Distribution expense decreased primarily due to lower Electronic Chemical volume shipments in Europe, the absence of creosote sales in the fourth quarter of fiscal 2015 and lower distribution costs in Asia.

Fourth-quarter SG&A expense was $9.3 million unchanged from last year's fourth quarter as higher stock-based compensation expenses offset with lower professional service fees. SG&A decreased in fiscal 2015 as compared to the prior year primarily due to the nonrecurring CEO transition costs in fiscal 2014. Increases in stock-based compensation in fiscal 2015 were offset by lower professional service fees and other cost containment measures.

Including $89,000 in acquisition and integration expenses and $575,000 in restructuring and realignment charges, consolidated adjusted EBITDA in the fourth quarter was $10.1 million, up 12% from $9 million in last year's fourth quarter. Foreign-exchange translation reduced Q4 2015 adjusted EBITDA by $400,000 compared to the same period last year.

The improvement in adjusted EBITDA was due to higher profitability in our Electronic Chemicals business and the addition of the industrial lubricants business partially offset by lower penta sales as compared to an unusually strong prior year Q4.

Fourth-quarter interest expense was $309,000 versus $604,000 in the same period last year. The decrease was due to lower debt levels and reduced interest rates resulting from the refinancing of the term notes and our revolving credit facility.

Our income tax rate was 39.9% in the fourth quarter as compared to 37.3% in the prior year. The increase in Q4 2015 tax rate compared to Q4 2014 was primarily due to discrete items in our foreign tax provision. We project a fiscal 2016 tax rate of approximately 35%.

Fourth-quarter fiscal 2015 GAAP net earnings were $0.28 per diluted share versus a loss of $0.07 per share in last year's fourth quarter. Adjusted diluted EPS for the fourth quarter of fiscal 2015 was $0.32, up from $0.27 in the fourth quarter of fiscal 2014.

Adjusted EPS increased year-over-year primarily due to higher revenue in Electronic Chemicals, improved margins in both Electronic Chemicals and Other Chemicals segments and lower interest expense. This was partially offset by a higher effective tax rate and purchase accounting adjustments related to the acquisition of the Industrial Lubricants business. As a reminder, Q4 2015 adjusted EPS excludes restructuring and realignment charges as well as acquisition and integration expenses.

Turning to our segment results. Fourth-quarter Electronic Chemicals sales were $66.3 million, unchanged from last year. Excluding the effect of the stronger US dollar Electronic Chemicals sales grew by 5.9% compared to the prior year fourth quarter. Our continued focus on supplying our global customers with the highest purity products for use in their most advanced production processes was a key factor in driving our growth in the fourth quarter and in the fiscal 2015 year.

Q4 adjusted EBITDA in the Electronic Chemicals segment was $8.4 million compared to $7.8 million in last year's fourth quarter. Foreign currency translation reduced EC segment adjusted EBITDA by $400,000 in the fourth quarter of 2015 as compared to the prior year.

Before corporate allocations, EC adjusted EBITDA improved to $12 million in the fourth quarter of fiscal 2015 compared to $11.2 million in the third quarter of fiscal 2015 and $10 million in the fourth quarter of fiscal 2014. Before corporate allocations EC adjusted EBITDA margins improved 294 basis points year-over-year due to higher volume in North America as well as enhanced manufacturing efficiency from our restructuring and realignment initiatives.

Our Other Chemicals segment includes wood treating and our Val-Tex Industrial Lubricants business acquired on May 1, 2015. In our Other Chemicals segment Q4 sales were $9.7 million compared to $24.8 million in the comparable quarter last year. The sales decrease reflected the divestiture of the creosote business in January 2015.

Penta sales decreased on a year-over-year basis due to unusually strong shipment volume in the [fourth] quarter of last year. However, the impact of the decrease in penta sales was mitigated by our acquisition of the Industrial Lubricants business.

Other Chemicals' Q4 adjusted EBITDA was $2.7 million compared to $2.9 million in the prior year. The decrease in adjusted EBITDA was due to lower penta sales in Q4 2015 and the sale of the creosote business partially offset by the addition of the industrial lubricants business.

Segment EBITDA margin benefited from lower from material cost in the penta business, the addition of the Industrial Lubricants business and the divestiture of our creosote business which has lower margin.

During fiscal 2015 we used cash generated from operations plus proceeds from the sale of the creosote product line to reduce our debt by $30.5 million. In the fourth quarter of fiscal 2015 we borrowed $23.5 million to acquire Val-Tex under our existing credit facility. Overall we reduced debt by $7 million in fiscal 2015 ending the year with a debt balance of $53 million, down from $60 million at the close of fiscal 2014.

Operating cash flow for fiscal 2015 was $17.6 million down from $40.4 million in fiscal 2014. Although our net income increased significantly from fiscal 2015, operating cash flow declined primarily due to increases in income tax payments, cash expenditures related to restructuring and realignment activities, some large payments for professional services in 2015 and substantial improvements in our fiscal 2014 working capital.

Capital expenditures were $13.8 million for the 12 months ended July 31, 2015, up from $9.5 million last year. CapEx increased due to our ERP system implementation, UPC integration and asset investments to support increased shipment volume in our Electronic Chemicals business. Operator, now let's open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mike Harrison, Seaport Global Securities.

Mike Harrison - *Seaport Global Securities - Analyst*

Was hoping that maybe you could walk us through the operating margin in the Electronic Chemicals segment. There was a decline compared to last quarter even though we were on a similar revenue level and I think some of us were expecting to see some additional benefits from restructuring. So can you just walk through the sources of that decline quarter on quarter?

Mindy Passmore - *KMG Chemicals, Inc. - VP & CFO*

Sure. So for one thing I think I mentioned previously that we did have -- we do have some normal variation in margins. So when you compare last quarter to this quarter, there was a slight decrease in margin in EC North America, which was offset by a slight improvement in Europe. And in addition there was a decrease in Asia as well due to some of the restructuring that Chris talked about in prior calls was related to the TCM business there.

Mike Harrison - *Seaport Global Securities - Analyst*

Okay. And you mentioned the raw material tailwind in the penta business year on year. Was hoping you could just kind of give us a sense of where we are in the process of benefiting in terms of raw material versus pricing. Is that a benefit that we should expect to wane as we get into the calendar fourth quarter or is it something that we should continue to see into next year?

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Yes, so Mike, what I discussed earlier was that we benefited in 2015 from it. And we anticipate that that tailwind will moderate in 2016. So actually in our guidance we have assumed less of a tailwind. We still think the raw material cost will be, on a historical level, at a good point, but not to the level they were in 2015. So we are anticipating some increasing costs on raw materials and so therefore some margin erosion in 2016 in the penta business. But that is all assumed in our guidance of $40 million to $42 million.

Mike Harrison - *Seaport Global Securities - Analyst*

Okay. And you -- on the Val-Tex business you kind of touched on the oil and gas exposure and that maybe you are seeing a little bit of pressure on the business. Can you talk about what the declining commodity environment means to that business both in terms of the top line and what the margin could look like?

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Yes. So the -- so some of their sales go to the drilling industry. And so obviously if there is less drilling going on it does impact their business. It is not the majority part of their business however. The majority of the business is around pipeline maintenance and other maintenance items that, regardless of the price of oil or gas, that still continues.

But having said that, there is some impact based on oil well drilling. So, we have taken that into account when we looked at the guidance going forward. We don't see it as a margin impact, we see it as a top-line potential impact and then thus obviously the impact as it flows down to the EBITDA level.

Mike Harrison - *Seaport Global Securities - Analyst*

And can you talk a little bit on how the Val-Tex integration is coming along? I think you expected maybe some early opportunities to improve operations and start to leverage that business for growth. How is that going so far?

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Yes, it is going very well actually. So the integration has primarily been around the back room functions like HR, IT, accounting. And so, we have been transitioning those services over where the KMG home office is able to provide that support and relieve Val-Tex from some of those responsibilities and free them up for more of the more value added activities, if you will, around sales and marketing and production.

So from that standpoint that has gone very well. In fact we are moving ahead with implementing SAP to Val-Tex. That will be going live sometime in 2016 with Val-Tex on SAP. So that will give them a great tool to use as managing their business as well.

As far as the other aspects that we look forward to the growth of Val-Tex is the consolidation and that industry. Obviously we are looking at multiple opportunities there. In addition we are looking at organic growth from an expansion into the North American market in a larger way as well is in the international market.

So, I am pleased with the progress we are making on those fronts. We are taking the appropriate steps to further those efforts. And I am really delighted with what the team is doing there. So still very confident about where that business is going and delighted it is part of KMG.

Mike Harrison - *Seaport Global Securities - Analyst*

All right, and then the last one for me is just looking at the cash from operations this year, came in well short of where EBITDA was. And I was just curious as I look at the $40 million to $42 million in EBITDA guidance for next year, how should the cash from operations compare to that number? Will it be a little bit better matched up with it or are there still some cash outs that I need to keep in mind as I look at the cash from ops?

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Yes, that is a good question, Mike. Mindy, why don't you walk him through and bridge them from this year to next year?

Mindy Passmore - *KMG Chemicals, Inc. - VP & CFO*

Yes, so, we don't obviously give guidance on that number, but just some things in this year that would -- I think will taper off or not be recurring next year. As I have mentioned previously, there was tax payment of about $4 million in this year relating to the sale of the creosote business where we had a significant cash tax gain that we had to pay taxes on.

And there was also about $5 billion of restructuring realignment payments in this year which there will be some next year but they will taper off. And then in addition, there were some pretty large accruals at the end of last year in July of 2014 that ran through as cash or payments in 2015 relating to professional services and a large creosote accrual that we're not really anticipating to recur. So we expect improvement.

Mike Harrison - *Seaport Global Securities - Analyst*

And sorry, just one more. In terms of the CapEx for next year, you did about $14 million last year. Is that going to come down a little bit next year?

Mindy Passmore - *KMG Chemicals, Inc. - VP & CFO*

So, we gave CapEx guidance of about a $15 million CapEx this year -- for next year. And I think the reason it is a little bit up is because there is some timing of payments again that I think we had guided to $16 million prior to that. And there is some timing of payments, things that were in accruals at the end of this year for some CapEx items that will roll -- and just some projects that will roll over into next year that were not completed.

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Just to complete that thought, so we had previously said our CapEx was going to be $15 million to $16 million this year, and it is actually come out to $14 million. And that is not because we limited projects, it was just timing, as Mindy said. So when you carry those expenditures into 2016 it gives a number that is approximately $15 million is what we are anticipating from a spending standpoint in 2016.

Mike Harrison - *Seaport Global Securities - Analyst*

All right, got it. Thanks for the color there.

Operator

(Operator Instructions). I am not showing any further questions. I would like to turn the call back to Chris Frazier for any further remarks.

Chris Fraser - *KMG Chemicals, Inc. - President, CEO & Chairman*

Okay, well thank you. We appreciate your participation today and your interest in KMG. We look forward to speaking with you on our first-quarter conference call in December. Thank you again.

Operator

Ladies and gentlemen, thank you for your -- participating in today's conference. This does conclude today's call. You may now all disconnect. Everyone, have a great day.
