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KMG - Q3 2016 KMG Chemicals Inc Earnings Call

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## CONFERENCE CALL PARTICIPANTS

**Rosemarie Morbelli** *G. Research, LLC - Analyst*

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## PRESENTATION

### Operator

Good day, ladies and gentlemen. Thank you for standing by. Welcome to KMG Q3 2016 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded for replay purposes.

Now I will hand the call over to Eric Glover, Investor Relations Manager. Please proceed, sir.

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

Thank you, Brian. Good afternoon, and welcome to KMG's third quarter fiscal 2016 financial results conference call. With me today are 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'll discuss 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'd like to remind everyone that the information on this conference call includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to significant risks and uncertainties, including statements regarding the future performance of the company.

I'll now turn the call over to Chris Fraser, Chairman and CEO.

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Thank you, Eric. Good afternoon, and thank you, everyone, for joining us today. Our Q3 earnings release was issued today after market close, and our 10-Q will be filed shortly. After my comments, Mindy will review the financials, and then we'll take your questions.

I'm pleased to say that KMG reported strong third quarter results, generating adjusted EBITDA of \$11.2 million and adjusted EPS of \$0.41. Each was a record high for the third quarter. The 23% increase in adjusted EBITDA compared to last year's third quarter was the ninth consecutive quarter that adjusted EBITDA grew at a double-digit rate on a year-over-year basis, and a 17% increase in adjusted EPS over last year's third quarter was the seventh consecutive quarter of double-digit adjusted EPS growth year-over-year.

With our consistent focus (technical difficulty) driving operational efficiencies and maximizing cash flow, KMG generated \$15.3 million in cash from operations in the third quarter, increasing our year-to-date cash flow from operations to almost \$30 million, more than triple the level from the prior year.



Subsequently, we paid down debt by \$8 million in the third quarter, reducing our long-term debt to \$41.8 million, which includes the drawdown on our revolving credit facility for our acquisition of Nagase Fine Chemicals (sic - see press release, "FineChem").

Our performance in the third quarter relative to the same period last year was driven by increased Electronic Chemicals product volume in North America and Asia, continued cost improvements from the consolidation of our manufacturing operation, improved pricing and lower distribution expense in Electronic Chemicals business, the contribution from the industrial lubricants business and continued favorable raw material costs in our Other Chemicals segment.

On a consolidated basis, KMG generated substantial improvements and profitability compared to the prior year. Gross margins increased 250 basis points to 38.8%, and our adjusted EBITDA margin increased to 15% versus 12.4% in last year's third quarter.

Conditions within the global semiconductor manufacturing market remained sluggish, with recent data from semi indicating worldwide silicon wafer area shipments decreased approximately 4% in the calendar first quarter compared to the prior year, continuing a recent trend of market softness due to macroeconomic headwinds and soft demand in major end markets such as PCs. Looking forward to current industry consensus calls for global semiconductor wafer production volume be essentially flat in calendar 2016, down from approximately 4% growth in 2015.

Despite these market conditions, our Electronic Chemicals business continued to perform well. Our fiscal third quarter Electronic Chemicals sales were up 1% on a year-over-year basis, excluding a \$400,000 foreign currency translation impact and increased 7% from the second quarter, driven by product volume across all geographic regions.

Our solid performance reflects our enhanced market positioning, strong customer partnerships and dedication to supplying the highest-purity chemicals for leading-edge manufacturing processes. As semiconductor manufacturing becomes even more complex with increasingly finer process geometries, semiconductor manufacturers require higher reliability, consistency and purity from the chemical suppliers. With a global presence, proven reliability and relentless focus on product purity and quality, KMG plays a crucial role in helping our customers meet the challenges of manufacturing today's advanced semiconductors.

Our third quarter Electronic Chemicals product volume improved from last year's third quarter as we experienced relative strength in certain faster-growing end markets such as data storage, for cloud computing, automotive and the Internet of Things.

Regionally, our business in North America continued to perform well, with product volume increasing year-over-year driven by demand for our high-purity products. Our product volume declined slightly in Europe compared to last year's third quarter, largely due to the weak Eurozone economy. However, the impact of the year-over-year decline in product volume was substantially offset by improved product mix. Compared to the second quarter, we experienced positive sequential sales growth in this region, driven by strengthening demand throughout the quarter for many of our key customers.

In Asia, our product volume increased from last year's as well, reflecting higher customer factory utilization levels and improved market share. In addition, the contribution from the recently acquired Nagase Fine Chemicals (sic - see press release, "FineChem") exceeded our expectations for the month of April and contributed positively to our overall results in Asia during the third quarter.

The acquisition of Nagase and our planned capital investment in those facilities represents an important step forward for our Electronic Chemicals business. The addition of Nagase's talented team and manufacturing assets strengthens our Electronic Chemicals position and offers compelling (technical difficulty) growth by expanding our capability and platform and more broadly serve the semiconductor market in this important region.

The integration of Nagase in our existing Singapore operations is well underway. We're currently performing preliminary engineering work as part of our planned capital investment of approximately \$8 million to \$10 million over the next few years, and we expect both of this investment to occur in fiscal 2017. Our planned investment involves upgrading the sites manufacturing, filtration and packaging capabilities to expand and enhance our product offering. The response to this transaction from our global customers has been very positive. And we continue to collaborate closely with them to ensure that our products and capabilities can address their growing needs in the region.

We anticipate that Nagase will contribute adjusted EBITDA exceeding \$500,000 in the first 12 months since the closing of the acquisition in April. By the fourth year, we anticipate an EBITDA contribution in excess of \$5 million per year.

Turning to Other Chemicals segment, which includes our penta and industrial lubricants business. Third quarter sales improved nearly 13% from the prior year due to the contribution from the industrial lubricants business that we acquired in May of 2015. Penta sales were softer compared to last year's third quarter due to fluctuations in shipments timing, reduced demand for oilfield transmission poles and a slowdown in utility pole replacement program.

Other Chemicals segment profitability improved significantly, however, in the third quarter, with EBITDA increasing 35% over the prior year period, benefiting from the contribution from the industrial lubricants business and favorable raw material costs. On a sequential basis, we experienced an increase in raw material costs, consistent with our expectations and we anticipate a further increase in raw material costs in our fourth fiscal quarter.

Excluding corporate relocation and acquisition expenses, corporate overhead expenses increased by \$1.7 million compared to the third quarter of last year. The increase in corporate overhead expenses over the prior year period is primarily due to higher stock-based compensation cost, increased depreciation expenses related to our ERP system and additional audit expenses. We remain committed to optimizing corporate expenses and expect a reduction in these expenses in fiscal 2017.

Now turning to our fiscal 2017 outlook -- '16 outlook -- I'm sorry, we (technical difficulty) net sales with [approximately] \$300 million, which is consistent with our prior guidance. In the Electronic Chemicals segment, we project fiscal 2016 sales will be up slightly compared to the prior year excluding an estimated (technical difficulty) impact of approximately \$6 million.

In the Other Chemicals segment, we forecast fiscal 2016 sales will decrease compared to fiscal 2015 due to the divestiture of our creosote business, partially offset by the contribution from industrial lubricants business.

Based on our strong third quarter results and our expectation for continued year-over-year EBITDA growth in both our Electronic Chemicals and Other Chemicals segment in the fourth quarter, we forecast adjusted EBITDA will be at upper end of our guidance range of \$43 million to \$45 million. Our fiscal 2016 adjusted EBITDA forecast includes approximately \$5 million of stock-based compensation expense, representing an increase of \$2 million compared to the level in fiscal 2015 and a negative impact for approximately \$600,000 from foreign currency.

In summary, I'm pleased with our continued operational, financial and strategic process. Our manufacturing consolidation has significantly enhanced our manufacturing efficiency, improving our margins. In addition, our improved market and product positioning is helping to drive strong growth in EBITDA and cash flow. Our balance sheet remains strong, providing significant financial flexibility for us to pursue additional value-creating acquisitions.

With the acquisition of Nagase Fine Chemical (sic - see press release, "FineChem"), we advance our growth strategy and elevated our market presence in Asia, the world's largest region for semiconductor production. And we continue to see significant upside potential from this transaction as we expand our manufacturing, purification and packaging facilities to more comprehensively serve our global customers. We continue to pursue additional acquisition opportunities to further expand our presence in Asia as well as the industrial lubricants market.

Now I'll turn the call over to Mindy for details of our financial performance in the third quarter.

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**Mindy Passmore** - KMG Chemicals, Inc. - 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 insights into the underlying operating performance of our business. The non-GAAP numbers I referenced are reconciled to the corresponding GAAP numbers in today's earnings release. We've added some additional reconciliations (technical difficulty) with recent guidelines on non-GAAP measures. Third quarter consolidated net sales were \$75.2 million, up 1.6% compared to \$74 million in last year's third quarter. Sales

increased year-over-year due to an uptick in Electronic Chemicals sales volume and the contribution from the industrial lubricants business. Foreign currency translation reduced consolidated net sales by \$400,000 in the third quarter as compared to the prior year period.

Gross profit margin in the third quarter was 38.8% compared to 36.3% in last year's third quarter. Gross profit margins increased primarily due to higher volume and pricing in our Electronic Chemicals business, favorable raw material costs and the addition of the industrial lubricants business. Third quarter distribution expense decreased to \$9.2 million compared to \$11.7 million last year. Distribution expense was lower due to lower freight cost and reduced cost in Asia. Lower freight cost resulted from higher availability of preferred carriers and a favorable customer and product mix.

SG&A expense increased by \$3.3 million from last year's third quarter. Of this amount, \$400,000 was attributable to the relocation of our corporate headquarters to Fort Worth from Houston and \$500,000 was due to increased stock-based compensation expense. In addition, we incurred \$300,000 incremental expenses related to SOX compliance and audit fees. We also incurred higher expenses for depreciation and amortization expense for our new ERP system and SG&A expenses from the addition of the industrial lubricants business and Nagase FineChem.

Going forward, we anticipate SG&A expense in the fourth quarter of fiscal 2016 will decline compared to the third quarter of fiscal [2015] due to lower corporate relocation and acquisition costs.

Consolidated adjusted EBITDA, which excludes acquisition and integration expenses, corporate relocation expenses and restructuring charges, was \$11.2 million in the third quarter, up 23% from \$9.1 million in last year's third quarter. The improvement in adjusted EBITDA primarily reflected favorable EC product volume mix and pricing, favorable raw material costs, lower distribution costs and the contribution from our industrial lubricants business.

Third quarter interest expense was \$201,000 versus \$111,000 in the same period last year due to a higher debt level following the acquisition of the industrial lubricants business in May of 2015 and the acquisition of Nagase FineChem in April 2016 as well as the increase in LIBOR. Our interest rate in the third quarter was 1.4%. As a reminder, the interest rate on our revolving credit facility is based on a [bearing] rate of 30-day LIBOR rate plus the margin based on our funded debt-to-EBITDA.

Our income tax rate was 25.3% in the third quarter as compared to 24.5% in the prior year period. The Q3 2016 tax rate benefited from the gain on the bargain purchase of Nagase FineChem, which is not taxable. Excluding the year-to-date impact of this gain, we project the fiscal 2016 tax rate of approximately 35%.

Third quarter fiscal 2016 GAAP net earnings were \$0.53 per diluted share versus \$0.18 per share in last year's third quarter. GAAP EPS in this year's third quarter benefited from \$0.17 per share gain on the purchase of Nagase FineChem. GAAP EPS in last year's third quarter was negatively impacted by a \$0.07 per share charge for environmental cleanup reserve. The adjusted diluted EPS in the third quarter fiscal '16 was \$0.41, up 17% from \$0.35 per share reported in the third quarter of fiscal 2015.

Turning to our segment results. Third quarter Electronic Chemicals sales were \$66.6 million, including a foreign currency impact of \$400,000, up from \$66.4 million in the same period last year. Excluding the foreign currency impact, Electronic Chemicals sales increased 1% compared to the prior year third quarter due to increased product sales and pricing. These gains were partially offset by lower service-related revenue in Asia and lower product volume in Europe.

Q3 EBITDA in Electronic Chemicals segment was \$10.7 million, an improvement of 14% compared to \$9.4 million in last year's third quarter. Foreign currency translation had no material impact on third quarter EBITDA compared to the prior year period.

EC EBITDA margins improved 190 basis points year-over-year, primarily due to favorable volume and pricing and lower distribution costs. Compared to the second quarter of fiscal 2016, third quarter Electronic Chemicals EBITDA declined \$500,000. Although EC product volume improved sequentially, we experienced less favorable product and regional sales mix as well as a \$400,000 foreign currency impact. As we noted in our Q2 conference call, our EC segment benefited from an unusually favorable regional and product sales mix in that quarter. In our third quarter, we moved back to a more normalized mix of regional and product sales.

In our Other Chemicals segment, Q3 sales were \$8.5 million compared to \$7.6 million in the comparable quarter last year. The increase was due to the addition of the industrial lubricants business, partially offset by lower sales of penta. Other Chemicals Q3 EBITDA was \$3.2 million, representing a segment margin of 37% compared to the prior year level of \$2.3 million, representing a segment margin of approximately 31%. The increase in EBITDA was due to lower raw material cost and the addition of the industrial lubricants business.

During the third quarter of fiscal 2016, we used cash generated from operations to reduce debt by \$8 million and drew \$2.8 million on our revolver to acquire Nagase FineChem. As of April 30, 2016, our debt balance is \$41.8 million compared to \$47 million at the end of fiscal Q2 and \$53 million at the end of fiscal 2015.

Operating cash flow increased primarily due to higher net income and improvement (technical difficulty). Operating cash flow in the first nine months of fiscal 2016 was \$29.4 million compared to \$8.2 million generated in the first nine months of fiscal 2015. Capital expenditures were \$5.4 million for the third quarter of fiscal 2016 and \$11.4 million for the year-to-date. We expect 2016 full year capital expenditures will be less than \$15 million.

Operator, now let's open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from the line of Rosemarie Morbelli with Gabelli & Company. Your line is now open, please go ahead.

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### Rosemarie Morbelli - G. Research, LLC - Analyst

Thank you and good afternoon, everyone. And I should add my congratulations. Do I remember properly, weren't you expecting EBITDA in Q3 to be lower than that of Q2 because all of the stars were aligned in the second quarter? And if this is correct, what's surprised you in the third quarter?

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### Chris Fraser - KMG Chemicals, Inc. - Chairman and CEO

Yes, so we -- I don't want to say we expected it to be lower, we just knew that we -- in Q2, things did align, as you said, both from a product mix as well as from a regional mix to give us a very favorable Q2. So our Q3, as we said, actually grew, and we did see not as favorable product mix and not as favorable as a regional mix, but our operating cost benefited us. The volume improved from Q2 to Q3 across all regions, even in Europe, which has been sluggish up to this point. So that helped all along. So overall, when it came together, it led to a better quarter than anticipated initially.

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### Rosemarie Morbelli - G. Research, LLC - Analyst

Okay. That is helpful. When you look at -- and I realize it is early, but when you look at 2017, what do you hear from your customers regarding on the Electronic Chemicals side? Are there any fabs -- new fabs coming up? Are they getting into some smaller type of wafers, which are going to require more of your products versus moving out of the bigger ones? Could you give us a feel for what you see going out?

**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes. So the messages are mixed. I mean, the people are seeing some improvement from prior quarter because of the normal seasonality. But the overall year-over-year, as I talked about, we're expecting it to be relatively flat. So the customers are expecting in the second half of the year to be a little bit better than the first half, that's second half of 2017, which is our -- second half of 2016, which is our 2017.

From a PC standpoint, there is anticipation of Windows 10 as well as the adaptation of Skylake, which we think will help PCs. There is forecast now for calendar 2017 have PC volume actually start to increase after being down for quite some time. So it's a mixed message.

There has been a consolidation going on in the industry. So some of that has to work its way out. But we do anticipate for calendar 2017, which is half of our '17, to be an increase over this year. So we're projecting about a 3% to 3.5% growth, which is consistent with when we add up all what customers were saying that we anticipate.

Now as I identified that we have outgrown what the market has been doing on an overall basis, because of the way we are positioned and because of the way our products are used, so we continue to benefit from the fact that our products go into the more complex, higher-end chips. We have a good portion of our sales going into the higher-end fabs, so as they we move closer and more to the 10-nanometer chips, we get a increasing share. And our increasing global presence in Asia is going to help us grow because that's the fastest growing region in the world.

So we think we're aligned very well. We continue to outpace the overall marketplace. So we're optimistic about 2017.

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**Rosemarie Morbelli** - G. Research, LLC - Analyst

So when you talk about the market, the demand for Electronic Chemicals next year being up 3% to 3.5%, are you talking volume? Are you talking revenues? And do you grow at 1.5 times the market or more than that?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes, so we're talking about volume. And it's hard to say exactly how much we'll outpace the market. But historically, we've been 1% to 2% above the market. Now when I say that the 3.5%, I want to make sure I say that clearly, that's 2017 calendar versus 2016 calendar. Our 2017 is half in calendar year 2016. So we sometimes get confused by that. But calendar year 2017, we do expect -- the market expects a 3% to 3.5% growth, and we expect to outpace that ourselves.

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**Rosemarie Morbelli** - G. Research, LLC - Analyst

That is great. And if I may ask one last question, and then I'll get back in the queue. What is behind lower penta sales? Or rather I should say because you gave us that, what is behind the utilities slowing down the pole replacements?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes, that's a great question. So it's something recent that we've just started to see. We don't know if it's going to be long-term or mid-term or short-term, but we've noticed that some of the utilities have slowed down their maintenance spending on utility pole replacement. So that impacted us this quarter.

We do not expect that to be a long-term issue. If you look at the lifespan of poles and the existing pole infrastructure, wooden pole infrastructure that exists in the U.S. specifically in the regions that they utilize penta, there is a continuing need for pole replacement. We expect it to grow significantly over the next 10 to 15 years. I think what we're seeing right now our interpretation is, there is a short-term hiatus on that. And what's the real driver behind that? We can speculate, but it's just we anticipated it being in short-term, but -- and it did affect us this quarter.



**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

Thank you.

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**Operator**

Our next question comes from the line of Mike Harrison with Seaport Global Securities. Your line is now open, please go ahead.

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**Mike Harrison** - *Seaport Global Securities LLC - Analyst*

Hi, good evening. I was wondering if you could discuss a little bit more around some of the mix issues that you were seeing in the Electronic Chemicals business. It sounds like that was the main driver of the sequential decline in margin. You mentioned it was both product mix and regional mix. But can you give us a little more color around that?

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Sure. So in the second quarter, to use Rosemarie's term, the stars aligned, and so we got -- there's obviously certain products we have higher profit margins on. And we saw a high sales relative to others during the second quarter. And in Q3, we saw it become more normalized, more typical, get back to the normal pattern of our sales. And so that's why we saw the decline from Q3 -- from Q2 down to Q3.

In addition, we have a regional mix. Our margins are highest in North American region, and our sales in North America were a higher percentage in the Q2 than they are normally. And that normalized again in Q3, so we got back to the normal level. So it's more about the sequential explanation that we got into that. When we look at year-over-year, where I think we're comparing apples-to-apples on a more regular basis. But the sequential movement on product and regional mix was what we're trying to help people understand.

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**Mike Harrison** - *Seaport Global Securities LLC - Analyst*

So maybe to just get a little more clarity on the strength in high-margin products that were sold in the second quarter, does that indicate any kind of a shift in the way customers are processing some of the semiconductors? Or did it just happen to be that the timing worked out that way and there's not really a whole lot to read into it?

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

There's not a whole lot to read into it. I mean, we clearly are positioning ourselves to continue to increase our share of the higher margin products and we think, as I've said, it's part of our strategy and tactics are to maximize our position to increase those sales and increase our presence. So over time, we like to continue to see that. But from one quarter to the next, it was more of just happens stance and it's not something more to read into it than that.

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**Mike Harrison** - *Seaport Global Securities LLC - Analyst*

Okay. Are you seeing any indication that some of your Electronic Chemical customers are working down inventories as the outlook is maybe a little bit worse than it was a quarter ago?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Well, relative to our products, we don't see that. And it has to do with the fact that our products are critical to their supply chain. So maintaining a good inventory level and supply chain for reliability purposes, so we're not seeing that. And so we're -- when we look at production levels at the various fabs, as I said, we saw a nice volume increase from Q2 to Q3. We anticipate a good seasonality improvement from Q3 to Q4. And so we're not seeing anything from a reduction of inventory or reduction in production. Actually, we're seeing it move up as you would expect from a seasonal perspective right now.

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**Mike Harrison** - Seaport Global Securities LLC - Analyst

Okay. And can you talk at all, I believe this was the first quarter that we started to see the impact of the Altera business being part of Intel. Did you see any benefits from the integration of the Altera business with that important customer?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes. So what the Intel has been commenting about is the integration of Altera. What they're really referring to is Altera's sales. As far as where it's going to impact us is when they shift the production into their own fabs. And that's -- we do not anticipate that that's going to happen until 2017 -- calendar 2017, which is aligned with what Intel have said.

So we've not seen any direct impact from it. Yet, what Intel has referenced is Altera -- really referencing Altera sales, not really production, which is where it's going to dramatically impact us as they use their -- utilize their fabs at a higher level as they move the production of Altera away from some foundries today that are currently producing it and move it in-house. And that's where we anticipate the biggest impact for us will be. And we've not seen that yet, and we don't anticipate that until 2017.

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**Mike Harrison** - Seaport Global Securities LLC - Analyst

Okay. You mentioned that the NFC contribution was better than you had anticipated in April. Can you disclose what the revenue contribution was in the Electronic Chemicals business from NFC in Q3?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes, we're really -- we're not going to break that out, Mike. But when I say it was better than we anticipated, we've given the perspective that we anticipate EBITDA contribution of \$500,000 over the course of the first 12 months. And we exceeded that expectation on a monthly basis here in actually a short month of April. We acquired it in April 4, so it's actually not a full month, and we exceeded it already for that one month.

Whether or not that will continue or not, we'll see. All indications are good. I would just like to say that we are very pleased with that acquisition. The assets and the people we got are very strong, and we're very excited about the future that, that asset, along with the capital investment we'll make is going to be a material benefit for the company, both strategically and financially.

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**Mike Harrison** - Seaport Global Securities LLC - Analyst

Maybe now is a good time for kind of a strategic question then. You have the NFC acquisition that bolsters your position in Asia. Maybe it sets the stage for some additional M&A if the opportunity should arise in Asia. And then you also have the Val-Tex business, and you've talked about potentially adding additional industrial lubricants businesses to that. How do you prioritize those two strategic areas right now? Is it just whichever opportunities come first? Or is there an area that you -- or let me ask it different way. Now that you've done the NFC acquisition, do you let that percolate, let that integrate and work through that and then shift your attention over to Val-Tex?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes. So the acquisitions we're looking at, both in Asia and for EC and industrial lubricants, we feel we have the capacity to make both of those happen if it in fact, happened simultaneously, but fairly close together.

The industrial lubricants space that we're in, it's a very fragmented space. We don't see a large acquisition in that. In fact, we see it in similar sizes to Val-Tex that are possibly smaller. So we feel very comfortable that we could handle one or two of those to further acquisitions in Asia. We do not anticipate anything more in Singapore at this point. We're looking to other regions in Asia. And of the opportunities that we see out there, we think they're of size again, that we could handle that, plus be able to do industrial lubricants.

So there is no real prioritization going on. We're working both of them in earnest and pursuing as many opportunities as we can get our arms around. And we feel good about the progress we're making. Obviously, I'd like to be able to say we have something near-term, but I can't. But I do feel good about the opportunities that are presenting themselves, and I'm confident that we'll be able to execute on some of them.

But a lot of these things we don't control, and so what we're doing is making ourselves available and making sure we're out in front with the right people to take advantage of the opportunity when they present themselves.

So long short answer, Mike, is both of them happen and present themselves at the same time, we feel confident we can execute them. If they don't and they're in series, one won't detract from the other.

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**Mike Harrison** - Seaport Global Securities LLC - Analyst

I appreciate that. It was a long question. So last question I have for you is in the Other Chemicals business. You've been able to sustain this low to mid-30% EBIT operating margin for a few quarters here. You kind of alluded to your expectation that raw material costs are going to be coming up. Is that low to mid-30% margin number sustainable into fiscal '17? Or is that a number that you would expect to decline because of some raw material pressure?

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**Chris Fraser** - KMG Chemicals, Inc. - Chairman and CEO

Yes. That's a great question. So we don't typically give guidance on margins, but I can give you some elements of information.

So we do see this raw material cost increasing. We did get the benefits over time in both of our other chemical businesses over the past year. But we are now seeing some increases, specifically in the area of penta. Chlorine prices have gone up as well as phenol costs has gone up and we anticipate them going up further.

So we'll be watching that closely to the extent that, that requires that we put a price increase in place to maintain what a reasonable return for that business is, we'll do that. We have that option. So it's something we'll be watching closely. We also are looking in the industrial lubricant space as Val-Tex continues to make progress that they'll continue to find opportunities for improvement there as well.

So I don't want to give out projections. But I feel good, Mike, that we'll be able to continue to have good margins in both of those business and our overall other chemical space.

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**Mike Harrison** - Seaport Global Securities LLC - Analyst

All right. Thanks very much.



**Operator**

(Operator Instructions) We have a follow-up question from the line of Rosemarie Morbelli with Gabelli & Company.

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**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

Thank you. Just going back on the EC margin, which obviously is a little lower in the third quarter. As volume is growing seasonally in the fourth quarter, do you anticipate that margin to decline from the third quarter level, which seems to be the trend in previous years? But can it go below that of the first quarter when it was 11%? Or do you think that because of the seasonality actually that fourth quarter is usually even lower than that?

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Yes. We anticipate, Rosemarie, that the margin for the fourth quarter will be in line with the third quarter, even with higher volumes that will help us drive efficiencies. Based on what we see right now and our year-end projections, we do anticipate keeping the EC margin comparable to what we accomplished in Q3 and not going back to where it was in Q1. We've made progress during the course of the year on operating efficiencies, on other elements, and so we anticipate that we'll be able to continue those into the fourth quarter.

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**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

And if I may, looking at Nagase, if you could give us a better feel for what they are doing now, which is more or less earning \$500,000 a year in EBITDA. And what you are going to do there in order to get to the \$5 million in year four? What is it that is needed that requires if I take the middle number of \$9 million? So \$9 million of an investment and then you get \$5 million a year. What are you actually doing?

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Yes, so we'll be adding and modifying certain equipment. So right now, the \$500,000 is primarily a toll arrangement that we have that was part of the acquisition. So we'll be tolling for Nagase. And what will be happening in year two and beyond and some of which is happening as we speak, is we'll start to add to the capability, to the investment that we're looking at is adding some bulk handling, modifying some bulk handling so we can do some packaging that don't currently exist today. So we'll be increasing the analytical capabilities.

So today, in Singapore, we do a lot of buy and resell. We're going to be doing more what I'll call manufacturing, whether it means filtration, purifying, packaging, things that we may not have been doing in-house in the past. We're going to invest in the facilities. And when I say invest, part of it is utilizing what exists there today, modifying what exists there today and adding on to what exists there today to give us the full complement of business that we like.

So there will be a ramp of profitability. I'm trying not to give out an annual expectation because we've got capital to do and work to be done as we work through that specific plan. But what we said is in year four, we'll exceed \$5 million. And that's by utilization of the investment that we make and shifting some of the capabilities and synergizing the capabilities between our existing operations as well as the Nagase site. We look to expand our presence there, so we'll be adding not only quality capabilities, but scale as well. So we'll be looking for increased volume in various chemicals and various products there as we increase our presence. So hopefully, that gives you some perspective, Rosemarie.

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**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

Yes, just one last thing as a follow-up. So that \$5 million in EBITDA, do you think -- how much revenues do you think is necessary in order to generate that particular amount in the region? And for what the new product lines you are going to be introducing there?



**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Yes. So we really haven't given out revenue numbers. But I would say we're -- I think we're balanced on our approach in what we think the revenue relative to EBITDA and the margins that we'll need in order to accomplish that. So I don't want to give out the exact revenue number, but we think it's very balanced in our expectation, both from a cost saving as well as increased revenue generation by increased business.

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**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

So more or less, the current EBITDA margin that you see generates at the moment, right? There is no reason why we'll have a lower profitability level.

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Right. So we expect the profitability in Asia to improve through this acquisition, which we'll be able to -- we'll be doing -- increasing, improving our operational capabilities. So we expect a margin improvement in Asia from this investment, which is the return on the capital we'll be looking at.

Our margins today in Asia are -- some of them -- most are lowest that we have today, and it's partly because of the marketplace. It's partly because of our capability. So we'll be looking to enhance those margins in Asia with this investment at the Nagase site.

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**Rosemarie Morbelli** - *G. Research, LLC - Analyst*

Okay. Thank you very much.

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**Operator**

There are no further questions. I will now hand the call back to Chris Fraser, Chief Executive Officer, for closing comments.

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**Chris Fraser** - *KMG Chemicals, Inc. - Chairman and CEO*

Thank you. We appreciate your participation today and your interest in KMG. We look forward to speaking with you on our fourth quarter and fiscal year-end conference call in October. Thank you.

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**Operator**

Ladies and gentlemen, this does conclude today's program, and you may all disconnect. Everybody, have a wonderful day.

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