THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

KMG - Q1 2017 KMG Chemicals Inc Earnings Call

EVENT DATE/TIME: DECEMBER 12, 2016 / 10:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

Marcelino Rodriguez *KMG Chemicals, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Mike Harrison *Seaport Global Securities - Analyst*

Rosemarie Morbelli *Gabelli & Co. - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to your KMG first-quarter 2017 financial results conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded. I would like now to turn the conference to Eric Glover, Investor Relations Manager. You may begin.

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

Thank you, Grace. Good afternoon and welcome to the KMG first quarter FY17 financial results conference call. I'm joined today by Chris Fraser, our Chairman and CEO, and Marcelino Rodriguez, 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'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 hand it over to Chris Fraser, Chairman and CEO. Please go ahead, Chris.

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

Thank you, Eric. Good afternoon and thank you, everyone, for joining us today. Our first quarter earnings release was issued today after market closed and our 10-Q will be filed shortly. I'll keep my remarks brief this evening, as our last update was just two months ago, following the release of our Q4 and FY16 results. After my remarks, Marcelino will review the financials and then we'll take your questions.

Our fiscal year is off to a great start, as we reported a 24% growth in first quarter GAAP net income to $5.7 million and a record quarterly adjusted EBITDA of $12.6 million. This marked our 11th consecutive quarter of double digit year-over-year growth in adjusted EBITDA. GAAP earnings per share increased 21% from the prior year, to $0.47 per share, representing the highest level of operating quarterly EPS in KMG's history.

During the first quarter, we further strengthened our balance sheet, reducing debt by $2.5 million. Over the past 12 months, our strong cash flow has enabled us to reduce our debt by more than $18 million, resulting in net to total debt to total capital ratio of less than 10% at the close of Q1

2017. Supported by our strong balance sheet and cash flow, we can invest strategically in our current businesses and we have substantial financial capacity to pursue acquisitions to enhance our long-term growth.

Operationally, we continue to make solid progress in the first quarter, driving further efficiencies throughout our global operations, strengthening our customer relationships, and maintaining our rigorous focus on supply reliability and product consistency. While the first half of calendar 2016 was sluggish for the global semiconductor market, our electronic chemicals volume grew during our first quarter, both sequentially and on a year-over-year basis.

This improvement was driven by our enhanced market positioning that has diversified our sales across a range of semiconductor end markets, including automotive, next-generation memory, and the Internet of Things. We also strengthened our position with manufacturers relying on KMG to supply increasingly high purity and high quality process chemicals on a global scale.

In our other chemical segment, sales volume was softer compared to last year's first quarter and we experienced higher costs for raw materials. Despite these challenges, profitability in this segment benefited from improved pricing and our continued focus on cost controls.

During Q1, we continued the integration of NFC into our existing electronic chemicals operations in Singapore and made progress on the engineering design work to upgrade the NFC site's manufacturing, filtration and packaging capabilities. This process remains on track and we continue to estimate a total plant capital investment at the NFC site of approximately $10 million.

From a strategic standpoint, we remain active in pursuing acquisitions to drive growth and expand our geographic reach. Overall, I would characterize our acquisition pipeline as robust and I'm excited about the opportunities we are currently pursuing. With our acquisition of NFC earlier this year, we strengthened our electronic chemicals capabilities and market presence in Singapore and Southeast Asia. Looking forward, our objective is to further extend and enhance our presence in Asia, one of the world's largest producers of semiconductors today.

The industrial lubricant space remains a key area of M&A focus for us, as well. This market is highly fragmented and we see compelling opportunities to expand and build on our existing business for acquisitions that would provide complementary or adjacent products, primarily serving the pipeline and energy distribution markets.

Finally, we're continuing to evaluate acquisitions that would constitute a fourth growth platform. Consistent with our growth strategy, we specifically look for businesses that have mature niche products, barriers to entry and strong cash flow.

In summary, I'm pleased with our performance and continued progress in the first quarter. Our FY17 is off to a strong start and I'm excited about our opportunities for further growth this year and beyond. We'll review and update our annual financial outlook at our customary time, when we report our second quarter results. I'll now turn the call over to Marcelino for a review of the financials.

Marcelino Rodriguez - *KMG Chemicals, Inc. - CFO*

Thank you, Chris, and good afternoon, everyone. In my remarks, I will reference 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.

While first quarter sales were essentially flat on a year-over-year basis, at $76.5 million, operating profit grew 19% to $8.7 million and GAAP EPS increased 21% to $0.47 per share. Adjusted EPS, which exclude approximately $130,000 in acquisition expenses and corporate relocation expense, improved 14% year-over-year to $0.48 per share.

Our financial performance in the first quarter was driven by one, volume growth in our electronic chemicals segment and a positive contribution from recently acquired NFC; two, improved operational efficiencies and a positive geographic and product mix in our electronic chemicals segment; and three, improved pricing and a favorable product mix in our other chemicals segment.

We are pleased with the growth in our first quarter operating cash flow, which totaled $10.9 million, a 36% improvement compared to the first quarter of last year. The increase in operating cash flow was primarily due to higher net income, coupled with improvements in working capital. The investments we've made in our ERP system continue to enhance our working capital management, enabling us to improve our cash conversion cycle to 61 days in the first quarter, compared to 70 days in first quarter of last year.

Capital expenditures were $2.6 million in the first quarter. We continue to anticipate total CapEx spend of approximately $20 million in FY17, which includes a portion of our planned capital investment in Singapore.

Turning now to our income statement. Gross profit margin improved 60 basis points year-over-year to 38.8%, reflecting higher sales volume in electronic, chemicals, manufacturing efficiencies, and improved margins in our other chemicals segment. Distribution expense declined $1 million year-over-year to $9.1 million, primarily due to favorable changes in customer and product mixes.

SG&A expense increased $700,000 from last year's first quarter, reflecting annual salary and wage adjustments, an increase of about $400,000 in stock-based compensation expense, and the addition of NFC, partially offset by lower audit fees. We anticipate stock-based compensation will be higher in FY17 compared to the prior year, due to our continued strong financial performance and higher stock price.

Although we reduced debt by $2.5 million in the first quarter, interest expense ticked up to $177,000 due to an increase in the LIBOR rate. Our effective tax rate in the quarter was 34.3%, down from 35.8% in the prior period. The decrease was due to improved earnings in our international operations. We continue to anticipate an effective tax rate of 35% for FY17.

Turning now to our segment results. Excluding a foreign currency impact of approximately $420,000, our electronic chemicals business generated 2% sales growth compared to last year's first quarter. Overall volume improved from last year's first quarter, driven by stronger volume in Europe and Asia. The acquisition of NFC also contributed to our results. Electronic chemicals segment adjusted EBITDA margins expanded to 16.8%, an increase of 115 basis points from Q1 2016. The increase was due primarily to improved operating efficiencies and a more favorable customer and product mix.

Our other chemical segment, which includes our penta and industrial lubricants businesses, reported a 9% sales decline from the first quarter of FY16, as a moderation in the rate of utility pole replacements in the western US, reduced customer demand for penta. Additionally, penta sales were unusually strong in last year's first quarter, creating a challenging year-over-year comparison.

Our industrial lubricants business continues to contribute positively to our results in the first quarter, with sales volume for valve maintenance related products holding up well, despite the continued challenges in the energy industry. Other chemicals segment adjusted EBITDA margins increased to 41.2% in the first quarter from 37.9% in Q1 2016, reflecting improved pricing and favorable product mix. Grace, now let's open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And our first question comes from Mike Harrison from Seaport Global Securities.

Mike Harrison - *Seaport Global Securities - Analyst*

Hi. Good evening.

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

Good evening, Mike.

Mike Harrison - *Seaport Global Securities - Analyst*

Chris, I was wondering if could you talk a little bit about the trends that you're seeing in the electronic chemicals business. It looks like, based on the semiconductor industry data, that wafer shipments were actually pretty good in calendar Q3. So I guess I'm a little bit surprised that the volume growth wasn't a little bit stronger. Can you talk about the overall demand trend that you were seeing in that business and as you went through the quarter, and now that we've probably at least got a few weeks of November under your belt, was there any noticeable acceleration that took place?

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

Yes, as we said, Mike, our volume was up year-over-year, as well as sequential, so we're pleased to see that. As you know, we have sales in all of the three major regions and we saw a growth in each of the regions. As you know, a bigger portion of our sales are in North America versus Asia. So I think some of the global rates that you're referring to might have been referencing a higher growth in Asia; and as you know, our business is more heavily weighted to North America.

But building off of that, we did see sequential growth. We did see year-over-year growth. We're optimistic about our second quarter. I think there's a lot of good data out there that is demonstrating that the semiconductor industry is picking up and is expecting a fairly good second half and a fairly decent 2017. So we're optimistic about that. So again, we did see those trends and we feel good about the path going forward.

Mike Harrison - *Seaport Global Securities - Analyst*

And then looking at the advanced logic and I think you referred to some of the advanced memory, the 3D NAND bit and the like, some of those more complex applications, can you talk about your growth expectations for calendar 2017 in those applications and also whether you expect to see any additional competition in the high 3D process chemical space or do you think your share can remain pretty steady?

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

Yes, so a couple things. We do see higher growth in some of those areas, as we mentioned, positioning ourselves to take advantage of those more complex chips and then more advanced semiconductor chips. So we feel good about our position there. That's something we have been working on over the last several years and not only positioning in those segments, but also with the customers that we see or the best position for that growth. So we do see some of that and we feel confident about some of the development, some of the new nodes and the fabs that will be getting those newer technologies and how we're positioned with them.

So then the other thing I would say, Mike, a lot of the growth that you see projections are around semiconductors and a lot of the talk is about revenue numbers. And there has been some pricing increase in the memory space, so we're looking at volume of whether price of memory goes up or not really doesn't affect our volume. What we look at is the wafer shipments, and we have seen an increase in wafer shipments in Q3 year-over-year and that's kind of a leading indicator of what we expect in future quarters, because of the wafer shipments obviously lead to higher volume of chips. So we're again optimistic about that. We see increasing wafer shipments, which we think are good indications for the remainder of this year and into next year. Overall, the market is projecting a 3.5% to 4% growth 2017 over 2016 on a calendar year basis, and that's what we're looking at right now as we project out into 2017.

Mike Harrison - *Seaport Global Securities - Analyst*

And then looking at the other chemicals business, was hoping to get your thoughts on calendar 2017 as your penta customers are looking at their maintenance budgets for the year, and obviously, calendar 2016 had a [refurb] replacement cycle. Could we see some rebound in that business in 2017?

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

We're optimistically looking forward to 2017 on that basis. As you said, calendar 2016 was a tough year. A lot of maintenance spending was curtailed. We saw it specifically in some of the areas of fittings and metal products that we sell, as well as our industrial lubricants. So we are anticipating some of that coming back in 2017. And with the recent move in oil prices, that only bodes well for us in that segment. So we did see a little pick up in this quarter versus last quarter, which gives us some good indication, we believe, for next year. There is some seasonality, so as you know, our Q2, we do have a lower expectation around maintenance spending and lubricant sales. But overall, 2016 versus 2017, we are expecting an uptick in that spending and our revenue in that area.

Mike Harrison - *Seaport Global Securities - Analyst*

And then a little bit of a political question for you. Obviously, you have a very important facility down in Mexico for the penta business. Any thoughts on what the Trump presidency could mean, any concerns about being able to get that product from Mexico into the US, given some discussion about changing NAFTA and some other trade policies?

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

No, we don't really have any concerns. Obviously, we're watching very closely and paying attention, but we don't really have any concerns. Penta is such a critical product for poles in the US, and so we see that it won't be a problem getting product in to be able to treat poles. And in addition, as you can think about infrastructure investments in 2017 and beyond, which a lot of the political discussions around that can only lead to possibly enhance the use of penta and poles being put in the US. So obviously, we pay attention to that, but we're really not concerned about being able to bring penta into the US out of our plant in Mexico.

Mike Harrison - *Seaport Global Securities - Analyst*

And then the last question I have is, as I think about the M&A environment and the financing, I know you mentioned that increasing LIBOR was going to be hitting your interest expense a little bit. In the future, if you guys are doing a bigger deal, are you going to continue to be relying on those floating rate vehicles or is it possible that we could see you issue some fixed cost debt or even maybe do a stock issue, under [refinance laws]?

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

Yes, that's a good question, Mike. So we look at whether it's utilization of our stock or it's our existing revolver or if it required a different line of financing. All of those are options available to us. And we'll pursue which ones make sense and reflect the cost of capital as we pursue each one of those acquisitions. I really like the way our balance sheet is now positioned. The progress we've made over the last couple years and where we are now, whether it's using our existing revolver, which has a floating rate, or some other structured finance in order to make an acquisition, at the time we'll look at what's best positioned and what provides us the best cost of capital. So again, having our improved balance sheet only helps to give us those options to pursue the right acquisitions.

Mike Harrison - *Seaport Global Securities - Analyst*

All right. Thanks very much. I'll turn it back.

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

Great. Thanks, Mike.

Operator

Thank you.

(Operator Instructions)

And our next question comes from Rosemarie Morbelli from Gabelli and Company.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Thank you. Good afternoon, everyone, and congratulations on the strong first quarter.

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

Thank you, Rosemarie.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Chris, when we looked at the margins you had in this quarter, is this really safe to assume that they are going to be similar for the balance of the year?

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

Yes, Rosemarie, in anticipation of that question, we know you're going to ask that question, so it's a great question.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

You are prepared.

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

So we had very good margins in the first quarter and year-over-year, as well as sequentially. So we're really proud of that. And we continue, as Marcelino said, make good progress on running our facilities as efficiently as possible and we continue to look for opportunities to do that. So our margins are a reflection of that. And as our volumes go up and we put more volume through our facilities, it's a natural improvement of our margins.

Having said that, the margins are also impacted by the mix of products, the mix of customers, the mix of regions. We have different margins for each product. We have different margins by regions around the world, as well, and customers, as well. So there's a mix element that we look at, as well, and the first quarter we had a very favorable mix. We saw that in some of our distribution costs and we saw that resulting in our higher margins than we had projected into 2017.

So I would say the direction is correct. I don't want to, at this point, say that we should expect those same margins all the way through 2017. But again, as we continue to strive for becoming more and more efficient and as we put more volume through our facilities, we do expect that we'll continue to see a rise in margin and it may move from one quarter to the next. I think it's fairly safe to say, though, that 2017 margins we expect to be higher than 2016 margins.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And when you looked at the positive mix in the first quarter and now you look at however many weeks you have in the second, can you see a shift in terms of either customers or product lines that would imply a substantially lower mix in the upcoming quarter, for example?

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

So we don't really get into projecting quarter to quarter. We project it for the year with our range in guidance that we have given before. So I really don't want to comment specifically about Q2. But at this point, we are not adjusting our guidance, just because we only do it in the middle of the year and we'll be doing that after our Q2. And yes, as Mike said, we're partially the way through Q2 already, but we're not at any point ready to discuss adjusting our guidance or any specifics around margins for Q2 or the quarters beyond.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Okay. And you talked about the demand increasing on wafers. My understanding was that you can grow in that particular area faster than the market, and yet you said that you're growing at the same rate, and you grow faster because you are taking into a new area and new applications. So why shouldn't you be growing faster than the market, than the 3% to 4%?

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

Yes, so as we've said in the past quarters, in the past years, we have performed better than the markets. And the indications are that we'll continue to perform better than the markets. And as you know, some customers from time to time perform better than markets than others. But we think on a macro basis, if you look at the customers we're with, the fabs we're supplying, we do expect it will outperform the market. Whether it's 3.5% or 4% or 4.5%, those are general guidance on relative market, and so we use them as such. But we do expect when all numbers are tabulated and the facts are known versus what maybe be projected on the markets, that we will outperform it. And the hard thing, as I said, when people talk about semiconductor numbers, they often refer to revenue, which is very misleading because of the price component of it. So we work pretty hard to try and dissect that out, but some of the numbers can be challenging.

But overall, we still believe we will outperform the market from a volume standpoint. As I said, wafer shipments are a good indicator of the future. There's some projections that that will grow 4% to 5% next year, which is again optimistic. Overall, semiconductors projected to grow, as I said earlier, 3.5% to 4%. So I think again, not trying to get too much into guidance, and we'll be looking at that after Q2 to provide any update as we can on revenue, and I think we'll be much more apt to be able to speak specifically to the market trends, because at that point, 2016 will have been completed and we'll be into 2017 and will give us even better visibility in how we expect our full year 2017 comes together.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

So Chris -- and I apologize, there is going to be background noise now -- but when you talked about the different regions growing at different rates, so even though you are smaller in Asia Pacific, could you touch upon how your volume growth there, which is where most of the demand is?

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

Yes, so we don't give out our breakdown of our revenue or sales in any one region. But having said that, the Asian market is continued to be projected to be the fastest growing market. Europe has been relatively flat, which is we've seen some growth there, which provides us a good optimism for the future. North America continues to grow, but not as fast as Asia. So having said that, we were pleased to see our volume grow, in particularly in Europe, which it has not done for a number of quarters. We are pleased to see that.

In addition, we did see the growth in Asia, as expected, as the biggest growth area because of what I talk about, the market dynamics. So when we look at each of our areas and the growth in each one of the areas, we're pleased with what we're seeing relative to the overall market. But as I said, when you take our relative regional mix compared to the overall semiconductors, we are less of our fortune in Asia, which obviously negatively impacts our overall growth.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Regarding Nagase, are you doing what you accomplished to do, any surprises in terms of the potential demand, has that slowed down, have you gotten the customers you were looking for? Could you give us a little more on that?

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

Actually, we continue to be more and more positive about the progress there. We're really pleased with the design that we're looking at for that facility. We think the opportunities could actually be even better than what we originally laid out when we outlined this acquisition and the opportunities that it presents. So we're eagerly pursuing the design and construction. We're working through the permitting process, as we expected. But I would say at this point, Rosemarie, I don't really have any update to provide you, outside to say that we are more positive than we were when we first made this acquisition.

We think the market is going to accept our products. The customers are enthusiastic about the investment we're making, and we're very confident about the capabilities we'll be building out there, and all that coming together for us as we had outlined, and potentially even better than what we had outlined.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

That is very helpful. Thank you. And looking at penta, the comparison was difficult quarter-over-quarter -- I mean, year-over-year. Are we going to see a similar type of a trend, comparison year-over-year over the next three quarters, or did penta, did the demand slow down some time in the second or maybe the third quarter and then it is more of a flat line as opposed to a decline?

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

Yes, so we had a very strong first quarter of 2016 that we're now comparing against. So as 2016 progressed, we did see a slowdown in pole replacement. And so we're seeing the continuation of that into our first quarter. So year-over-year we expect volume to be slightly less than it was in 2016. And we'll see as the year plays out and we don't believe it will be as dramatic as it was Q1 versus Q1, but we do anticipate the volume being slightly less in 2017 versus 2016.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And you did suggest, confirming that I heard probably, you did say that on the lubricant, you did say that you are seeing some pick up in demand in terms of maintenance, and is that directly related to the higher price of oil?

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

Well, you know, it's been such a extended period that with the uncertainty around oil prices, that we saw a continuation of delayed maintenance. And I say delayed, because we do anticipate it coming back. So we were encouraged by the latter part of our first quarter, where we saw some increases occurring which were encouraging to us as we projected out for the rest of our year. So I think with oil prices stabilizing around $50, and now more recently going above $50, is giving people a little bit more confidence that the downside is relatively low and there is some upside. So we believe, at this point anyway, it looks like people could be freeing up some maintenance spending and some of the delayed spending that is going on, so we're again optimistic that that could play out very favorably for us for the remainder of 2017.

Now I will remind you that there is a seasonality to maintenance. Our Q2 is typically a slower quarter because of maintenance spending over the more winter months slow down and then we do see a pick up in the spring months.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

And then lastly, if I may, and you are going to argue that I always ask it one, but what if you were to give a percentage, what is the likelihood that we could see your closing an acquisition between now and the end of your fiscal year?

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

(Laughter) Well, you didn't disappoint me, Rosemarie, by asking. So I'm not going to give probabilities out, but as I said, I'm encouraged by the pipeline. I think the team is doing a great job of bringing opportunities to the forefront for us to look at. The challenge for us continues to be to not overpay and to pay an appropriate price, so we're very disciplined in our approach. We've got our strategic and financial criteria that we look at very closely.

But it doesn't say that because of that, there's no acquisition opportunities. We just have to work harder to find those. And as I said, I'm pleased with the progress and I'm confident that we will make some acquisitions over the coming year, as the team is doing a really good job of keeping the pipeline robust and we just have to continue to be diligent with it. So hopefully that gives you some perspective that we believe we'll get some done, but I can't give you any more specifics than that.

Rosemarie Morbelli - *Gabelli & Co. - Analyst*

Sure, I appreciate it. Thank you very much.

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

Thank you, Rosemarie.

Operator

Thank you. I am showing no further questions. I would like now to turn the call back to Eric Glover for any further remarks.

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

This is Chris. I'll just say, we appreciate your participation today and your interest in KMG. We look forward to speaking with you on our second quarter conference call in March. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.