THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

KMG - Q2 2017 KMG Chemicals Inc Earnings Call

EVENT DATE/TIME: MARCH 13, 2017 / 9:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Eric Glover *KMG Chemicals - IR Manager*

Chris Fraser *KMG Chemicals - Chairman and CEO*

Marcelino Rodriguez *KMG Chemicals - CFO*

CONFERENCE CALL PARTICIPANTS

Mike Harrison *Seaport Global Securities LLC - Analyst*

Rosemarie Morbelli *G. Research, LLC - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the KMG Q2 2017 Earnings Conference Call. (Operator Instructions) I would now like to turn the call over to Eric Glover, Investor Relations Manager. Please go ahead.

Eric Glover - *KMG Chemicals - IR Manager*

Thank you, Ayla. Good afternoon, and welcome to the KMG's second quarter fiscal 2017 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 then 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 - Chairman and CEO*

Thank you, Eric. Good afternoon, and thank you, everyone, for joining us today. Our Q2 earnings release was issued today after the market close, and our 10-Q will be filed shortly. After my remarks, Marcelino will review the financials, and then we'll take your questions.

KMG delivered outstanding results for the second quarter, generating a 12% year-over-year increase in sales to $79.1 million and a 63% increase in GAAP net income to a record $6.5 million, resulting in GAAP diluted earnings per share of $0.53. Adjusted EBITDA reached a record level of $13.1 million, an 18% gain over last year's second quarter. KMG has now reached 12 consecutive quarters of double-digit year-over-year growth in adjusted EBITDA. Our adjusted EPS of $0.57 was also a quarterly record, benefiting from our strong performance and a lower tax rate. This result eclipsed the prior record of $0.48 per share on an adjusted basis reported in the first quarter of fiscal 2017.

This was an unusually strong performance in what is typically a slower seasonal period for our business, while we often experience a temporary softening in demand in both our Electronic Chemicals and our Other Chemicals segment during the winter months. In the second quarter this fiscal year, we experienced the opposite, a strengthening in demand driven by positive fundamentals both in the semiconductor and energy markets.

According to the data from SEMI, worldwide silicon wafer shipments increased 1% sequentially and 10% year-over-year in the calendar fourth quarter. This growth reflected broad-based demand strength in virtually all segments of the market, including memory, Internet of Things, automotive, cloud computing and others. In this environment, our second quarter Electronic Chemicals sales grew 4% sequentially and nearly 12% year-over-year, outpacing the growth of the overall market. Our performance speaks to the investments we had made in quality and reliability over the past several years to support our customers' growth and to our enhanced market position that has diversified our exposure to faster-growing semiconductor end markets.

During the second quarter, our volume growth increased to meet rising demands from some of our key global customers who ramped production in new or recently expanded fabrication facilities. These customer fab expansions and additions remain an important contributor to our organic growth, and we work continually with our customers to ensure that our product road map is closely aligned with our current and future needs. By collaborating closely with our customers and making the necessary capital investments in purity and quality, we strengthened our long-term value proposition and position our business to capitalize on future growth opportunities when they arise.

In the Logic segment, we benefited from our focus on supply in the [high-purity] products for our customers' most advanced manufacturing processes. For example, certain of our customers are moving aggressively to shift production to a 10-nanometer manufacturing process from 14-nanometer, a trend which drove incremental demand for our high-purity products.

In addition to this favorable technology shift which enhanced our Q2 results, we also benefited from enhanced end market positioning that has increased our exposure to faster-growing end markets like automotive, Internet of Things, cloud computing and mobility. By aligning our product offerings to meet the demands of semiconductor manufacturing in these markets, we've been able to more fully participate in our customers' growth, which is increasingly broad-based across multiple end applications and markets.

In our Other Chemicals segment, second quarter sales decreased 3% from Q1 and increased 12% from the prior year period, an exceptional result given that we typically see much softer demand in the winter months due to a lower maintenance spending in the energy industry and lower levels of utility pole replacement demand due to cold weather. This significant increase in sales was primarily driven by higher sales volume in our industrial lubricants segment, as fundamentals within the energy industry are improving.

For example, our pipeline and midstream customers are ramping up capital spending in North America following significant CapEx cutbacks in 2016. There's growing demand for pipeline valve. There are corresponding increase in customer demand for our valve lubricants, sealants and application equipment. Additionally, the U.S. oil rig count continues to increase with increased investment in new equipment and rising demand for frac valves. This trend is similarly positive for our industrial lubricants business, and strong drilling activity stimulates demand for new valves and requires greater use of our products in the field.

Our recent acquisition of Sealweld, a premier supplier of high-performance products and services for global pipeline operators is especially compelling in this environment. Pipeline construction continues to expand, while pipeline maintenance and integrity remains a critical area of focus for the industry. Sealweld significantly expands our presence and customer reach in the global industrial valve maintenance market and also broadens our participation in key growth areas such as valve maintenance services and training.

We're excited about the organic growth opportunities we can pursue, given Sealweld's strong position in the pipeline services market, and we're currently identifying and implementing best practice from both Sealweld and Val-Tex to maximize our growth potential and best serve our customer.

Now turning to our fiscal 2017 outlook. Given our strong performance in the first half and our expectations for continued year-over-year growth in the second half in both Electronic Chemicals and industrial lubricants, we are raising our sales and adjusted EBITDA forecast for the year. We forecast fiscal 2017 sales of $315 million to $320 million, up from our prior guidance of $300 million to $305 million. We continue to anticipate a negative foreign currency impact to sales of approximately $4.5 million, which is included in our revised guidance of $315 million to $320 million. In the Electronic Chemicals segment, we project the full year fiscal 2017 sales will increase at a mid-single-digit rate compared to the prior year.

Looking more closely at the second half of fiscal 2017. We expect Electronic Chemicals sales will grow on a year-over-year basis in both the third and fourth quarters. However, we anticipate a sequential tick downward in our Electronic Chemicals sales in the third quarter compared to the exceptionally strong level reported in the second quarter. This expectation is consistent with the calendar Q1 sequential revenue forecast guidance by major semiconductor manufacturers. In our fourth quarter, we anticipate Electronic Chemicals sales will resume sequential revenue growth compared to the third quarter.

In the Other Chemicals segment, we project fiscal 2017 sales will increase strongly compared to the prior year, driven primarily by improved demand in the industrial lubricants business as well as the contribution from Sealweld. As we indicated this past October, we anticipate the rising raw material cost in our penta business will act as a headwind on EBITDA in the second half of fiscal 2017. Additionally, we expect higher stock-based compensation expense of $6.5 million in fiscal 2017 compared to our prior estimate of approximately $5 million.

Given this outlook, we increased our fiscal 2017 consolidated adjusted EBITDA forecast to $51 million to $53 million, up from our prior guidance of $47 million to $49 million and a 15% improvement over the $45.4 million that we reported in fiscal 2016. Our increased guidance reflects higher growth expectations on Electronic Chemicals segment as well as improved demand in industrial lubricants business and the contribution from Sealweld.

From a strategic standpoint, we continue to remain active in pursuing acquisitions to drive growth and expand our geographic reach. With our acquisition of NFC last year, we strengthened our Electronic Chemicals capability and market presence in Singapore and Southeast Asia. Looking forward, our objective is to further extend and enhance our presence in Asia, the largest region of the world for semiconductor production.

The industrial lubricants space remains a key area of M&A focus for us as well. We believe there are attractive opportunities to expand and build this platform through acquisitions that would provide complementary or adjacent products primarily serving the pipeline and energy distribution markets. Finally, we're continuing to evaluate acquisition opportunities that would constitute an additional growth platform.

In summary, I'm very pleased by our strong performance in the first half of this year and with the growth trajectory that we're on. With the investments we've made in our people, our systems and our capabilities, we've made significant progress as an organization, enabling KMG to deliver high level of financial performance and create long-term value for our shareholders.

I'll now turn the call over to Marcelino for a review of the financials.

Marcelino Rodriguez - *KMG Chemicals - 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.

Second quarter sales grew 12% to $79.1 million from $70.9 million in the second quarter of last year. Operating profit improved 47% to $9 million, and GAAP EPS increased 61% to $0.53 per share. Adjusted EPS, which excluded approximately $800,000 in acquisition and integration expenses and corporate relocation expense, increased 43% year-over-year to $0.57. Our EBITDA growth in the second quarter was driven by volume growth in both our Electronic Chemicals and Other Chemicals segment, a positive contribution from the acquisition of NFC and reduced corporate expense.

Second quarter cash flow from operations increased 39% year-over-year to $8.5 million, reflecting growth in the net income as well as improved working capital management. We continue to benefit from the investments we've made in our ERP system which helped us enable to improve our cash conversion cycle.

Capital expenditures were $2.7 million in the second quarter, essentially flat compared to the level in the first quarter. We anticipate total CapEx of approximately $21 million in fiscal 2017, which includes a portion of our planned capital investment in Singapore.

Now I'd like to discuss a couple of items on our balance sheet. Cash and cash equivalents were $30.6 million as of January, 31, 2017. This amount included a $17 million borrowed to finance the acquisition of Sealweld. Although the Sealweld transaction closed on February 1, the first day of our third quarter, we borrowed funds to finance the acquisition on January 31, the last day of our second quarter, to allow for the time needed to convert U.S. dollars into foreign currency. As a result, our cash and cash equivalents were abnormally high at the end of the second quarter. Long-term debt was $41 million as of January 31, and included the debt incurred to finance the acquisition of Sealweld, partially offset by the $9.3 million in debt that we paid down during the second quarter. As a result, our long-term debt as of January 31 increased only $7.7 million from the first fiscal quarter ended October 31, 2016.

Now turning to our income statement. While second quarter sales increased 12% from the prior year period, gross profit margin of 39.5% was essentially unchanged from 39.8% in the second quarter of fiscal 2016. The variance was due to regional sales mix.

Distribution expense of $9.8 million increased by approximately $1 million compared to the prior year due to higher shipment volume. As a percentage of sales, distribution expense was unchanged on a year-over-year basis at 12.4%.

SG&A expense decreased $330,000 from last year's second quarter, primarily reflecting lower [audit] expenses, partially offset by increased stock-based compensation expense. As Chris noted in our updated guidance for the year, we anticipate stock-based comp expense will be approximately $6.5 million in fiscal 2017, up from approximately $5 million in fiscal 2016, reflecting our continued strong financial performance and higher stock price.

Our effective tax rate in the quarter was 24.4%, down from 34.1% in the prior period. The decrease in our effective tax rate was due to improved earnings in our international operations, coupled with stock-based compensation excess tax benefits of $700,000 realized as a result of the adoption of an updated accounting standard to account for employee share-based compensation. Given the positive adjustment to our second quarter tax rate, we now anticipate an effective tax rate of 32% to 33% for the fiscal 2017 year compared to our prior expectation of approximately 35%.

Now I'll review our segment results. Our Electronic Chemicals business generated 12% sales growth compared to last year's second quarter, driven by broad-based product volume growth across our global operations. The acquisition of NFC also contributed positively to our results. Electronic Chemicals segment adjusted EBITDA, excluding corporate allocation, increased 11% year-over-year to $15.6 million; and EC segment EBITDA margins, excluding corporate allocations, were essentially unchanged from Q2 2016.

Our Other Chemicals segment, which includes our penta and industrial lubricants businesses, reported a 12% sales increase from the second quarter of fiscal 2016. This improvement was driven by substantially stronger volume in our industrial lubricants business as well as an uptick in penta sales. Despite the strong increase in Other Chemicals segment sales from the prior year, segment adjusted EBITDA margins, excluding corporate allocation, were 43.8% in the second quarter compared to 46.2% in Q2 2016. The decrease primarily reflected product sales mix and higher raw material costs.

[Iyana], now let's open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mike Harrison with Seaport Global. Your line is now open.

Mike Harrison - *Seaport Global Securities LLC - Analyst*

Just wanted to ask a couple of questions on the industrial lubricants business. First of all, the Sealweld acquisition, it sounds like they have kind of a different service approach in the way that they do business. Can you share any early color on how the integration process is going, how the two teams are coming together, where there may be kind of a different culture between the two teams?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Sure, Mike. So first of all, let me just say we're -- after the acquisition, obviously, we had spent a lot of time in due diligence trying to understand Sealweld. But since the acquisition, I'm more enthusiastic and excited about the opportunities that it brings. They've got a good team of people, that we're really excited them joining KMG. And the opportunities that are presenting themselves are meaningful.

So their approach to the market had a service segment, much more than a Val-Tex had. So they use the service as a way to facilitate additional lubricant sales in support of the revenue generation. And so what that has provided for us as we look at it with Val-Tex is an even broader-based application in customers. They have service relationships with global pipeline companies, which allow us to expand our geographic reach with both Sealweld products and Val-Tex products. And the service element also provides some training revenue that we provide to various pipeline operators to have their maintenance people understand valve maintenance and provide various good information for them to utilize our products in that.

So it's a -- very complementary. They were competitors but approach the market slightly different than each other, which, in the complementary aspects, are something that we're really excited about both from a geographic and a product breadth.

So again, we're really excited about it. The integration has begun. The teams have been spending quite a bit of time together looking for those opportunities and everything from manufacturing to market approach and ways that we can work best together. And again, I'm excited about what those opportunities look like.

Mike Harrison - *Seaport Global Securities LLC - Analyst*

And then in terms of the pickup that you saw in industrial lubricants demand, is it fair to assume that the year-on-year growth in the Other Chemicals segment is primarily industrial lubricants and that penta was pretty flattish year-on-year?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes, that's a good way looking of it, Mike. Yes, the growth driver year-over-year was primarily industrial lubricants. What we saw on wood treating was basically flat from year-over-year, and the drive was around industrial lubricants. We've seen some really nice pickup. This past quarter was the highest quarter that Val-Tex has had in the history of the company which was exceptional, given it's usually a slow quarter. So it's the -- their highest Q2 ever and actually was on par with Q1. So usually, it dips down pretty significantly and it didn't. So that's really encouraging for the rest of the year, which we've included in our guidance.

Mike Harrison - *Seaport Global Securities LLC - Analyst*

Got it. And then the last question, on the Other Chemicals business, it's just -- it sounds like the slight year-on-year margin decline in Other Chemicals was partially raw material related and partially mix related. But I was just curious, in terms of the raw material pressure in penta, can you comment on the magnitude there? And can you also discuss whether there are pricing actions in place to help offset that margin pressure?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. That's a good question, Mike. So yes, we did see raw material pressure year-over-year and also sequentially in wood treating. So the volume is holding up as we would hope, but the raw material costs have driven that EBITDA impact down for wood treating. So we're -- we anticipate that continuing as the year builds, specifically in phenol and solvents. We think their -- the chlorine pricing seems to be leveling out, but we do think they will continue to pressure on phenols and solvents as we go into the rest of the year.

So we had put a price increase in earlier in the year in wood treating, which has offset some of that, but here we are with the increasing raw materials as they go through the rest of the year. So we do expect that affects us in the second half. I don't really want to give the specifics about how big a dollar, how much of an impact that was, but it was meaningful in Q2 and as we expect it to be in the remainder part of the year.

Mike Harrison - *Seaport Global Securities LLC - Analyst*

All right. And then on the Electronic Chemicals side, you mentioned the expectation that Q3 is going to see a little bit of a sequential slowdown. Obviously, we heard some of the commentary from the industry players that there was some inventory drawdown going on. But I'm just curious, as we think about kind of the bottom line and think about that inventory drawdown taking place in maybe some more commodity-type areas, should we still see pretty good growth on the advanced logic and advanced memory applications and maybe see mix drive some better margin performance in the third quarter relative to the fiscal second quarter?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So the margin impact we're expecting will be somewhat in line with Q2. There could be some product or regional mix that impacts our Q3 results, but we saw a really nice pickup in volume, actually, year-over-year in Q2. And we expect -- as you said, there was some inventory drawdown we're seeing now. So we expect Q3 to be slightly lower than Q2 but still year-over-year good growth, and then we factored that into our guidance for the rest of the year. The fourth quarter, we expect it to pick back up, again, good year-over-year growth.

As we look at our full year 2016 versus full year 2017, now as I said, mid-single digits. The industry is projecting 4% to 5% growth. We're expecting to outperform that slightly, which gives us these revenue targets that we put out.

So from a margin standpoint, the assumption is continuing the same margins where we've been. We don't expect any kind of change in that unless there is a regional or product sales mix. But our assumption, we've assumed it to be pretty consistent but yet expect the volume to be increasing year-over-year as we've outlined.

Mike Harrison - *Seaport Global Securities LLC - Analyst*

All right. And then last question for me is just on the NFC acquisition. Can you comment on the progress you're seeing in integrating that business? It sounds like it was a nice contributor to revenue growth in the quarter. Can you comment -- quantify that revenue number? And then, are we getting closer on another Asia acquisition in Electronic Chemicals? I think you've commented in the past that Taiwan would be an attractive region for you.

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So the NFC acquisition, you remember we've got a toll arrangement that lasts through the beginning of April, so we're continuing to see that toll arrangement playing out both in revenue and EBITDA contribution. So as we have said before, revenue was approximately $4 million to $5 million a year. So you can kind of figure out on a quarterly basis how much of an impact that is.

But having said that, we're effectively transitioning from a toll arrangement to, in April, we'll take over those sales directly. We've made good contact with customers in transitioning that. We expect the revenue to continue. As you know, we're making a sizable investment there, and that's proceeding on schedule. Capital estimates are coming in as we anticipated. We're, again, looking at other opportunities that could potentially avail themselves in that facility.

But right now, we're on what we'll call Phase 1 with what we'd outlined before, this 10-plus -- $10-ish million capital investment. And it's going well. We're working down the progress of permitting, ordering equipment to the extent we can. We've got a good team there working on it, and I'm really happy with the expectations and what's going on there. So that's going to be a great platform for us to build off of. As we expand those capabilities as well as we could potentially have other capabilities there, it gives us a very good presence in Southeast Asia and Singapore, particularly the Malaysian market obviously.

So as we look outside of that, we're not slowing down our efforts to proceed in other regions. We're being very disciplined in our approach. So we're looking for those opportunities that might present themselves, but yet we're not going to chase revenue or chase acquisitions that don't make sense. So we continue to pursue them. I don't have anything really definitive to say about that, but [outside] to say that we're continuing to work our M&A strategy and our desire to expand our presence in Asia.

Operator

(Operator Instructions) Our next question comes from Rosemarie Morbelli with Gabelli & Company. Your line is now open.

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

However, I do have a little bit. Could you talk about Sealweld? And in terms of the geographic expansion, where are they bringing you that you weren't before?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes, it's a good question. So they have -- obviously, they're a Canadian company, so they had a larger presence in Canada than Val-Tex had. In fact, we had identified the Canadian market a year or so ago was an area that we wanted to move into and actually held off as we started on this discussion with Sealweld of executing our geographic expansion in Canada. So this has really helped us there.

But in addition, they have sales globally, much more global than Val-Tex was. For example, they have office in the U.A.E., which allows us to have business in the Middle East. And obviously, there's lots of pipelines and customer potentials there. So they've got established sales, are conducting business today there. So that allows us to expand there. In addition, they have other regions in the world, like Australia, for example, is a region that they have business that at Val-Tex we had limited sales as well.

So I would say that the big growth -- the geographic growth areas for us is Canada that we didn't previously have, the Middle East and then Australia. And then, obviously, they do sell like Val-Tex into some of these other regions, but those are the big areas that we're going to see a significant step-up in our geographic reach.

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

That is helpful. And if we look at the customers, at this particular stage, are you solely selling into the pipeline in oil and gas industry? Or are you making inroad for other industrial applications?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes, so it's primarily focused on pipeline and oil and gas. There are some very small sales into other industrial lubricants, but it's primarily those markets. Those are the market areas that both Val-Tex and Sealweld focused on.

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

And do you find -- do you think that you can extend into other markets? And if you can, would the margin be similar to that of the revenues going into the oil and gas?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So when I think -- as we look at that segment and we think about the expansions and growth that we can see, not only do we see potential opportunities in other lubricants, for lack of a better word so I'll use that, but we also see this geographic expansion in the markets that we serve today, utilizing the end markets that we're in today. But also, it gives us this window into other opportunities within pipeline area, for example, whether it's products or services they have. So there's both a horizontal, there's a geographic as well as a vertical opportunity that we see with this platform that Sealweld just provides us one more step in the potential for that.

So my -- I mentioned before the enthusiasm I have after the acquisition of Sealweld is the obvious benefits we get but also the other doors that it's beginning to open as well. So this is a platform or segment that we are really excited about what the growth could be in.

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

And when you look at that platform, Chris, can you -- are there many -- I mean, I understand it is a $200 million market. But within that $200 million, are there -- given the fact that the oil and gas have hit bottom, do you find that potential candidates to be acquired are now thinking that, well, they don't want to miss the upside after having suffered for several years?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So I mean, I think the industry is seeing an improvement. The industry is seeing some benefit, like we did, but there's still quite long ways to go before it gets to a level that it once was. In oil, as we saw, it hit mid-50s and then it's pulled back to low 50s. So I think it's stabilized to some degree, but it's still not where it was. So having said that, we still think there are plenty of opportunities in that segment to further consolidate and absorb some competitors that are in that space. We still think there's opportunities there, but again, we're going to be disciplined in our approach.

To the extent it makes sense financially, provides us some additional benefits that we just don't have now or consolidate would be a benefit, we'll pursue them. But again, we're going to be disciplined and not be overly aggressive in that space, just look for the right opportunities and take advantage of them when they present themselves. But I still think there are plenty for us to look at.

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

Okay. And looking at EC, when we look at the volume, at the -- well, revenues were up 12%, and you said strong volume. What is the definition of strong volume? Did you get any pricing? Or was volume more or less in line with sales?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So when I speak volume, it's really -- it's unit increase. So we saw good volume increases in all three regions, North America, Europe and Asia, the second quarter of last year and second quarter of this year. In fact, we saw some volume increases from Q1 to Q2. So that's what we're talking about when I talk about volume, and thus, leading to the higher revenue.

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

And so pricing, did that contribute? Or was that pricing actually down and, therefore, the unit growth was higher than the [world]?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes, so we didn't see any erosion on pricing. There was some product mix that we did see. And again, if you remember, different regions have different pricing and different margins. So we've got both the product mix and a region mix. But having said that, again, we saw volume across all good -- all three areas. And I don't want to give specific volume numbers out, but let's just say the volume growth was good. We didn't see pricing erosion per se, but more so, we saw some mix impact regionally as well as product wise.

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

Okay. And when we look at that strong volume growth, was it a question of inventory buildup at the new fab and, therefore, this is the main reason why Q3 is going to be down versus Q2? Or is it a question of really substantially stronger demand, and that would then be the reason for the increase in Q4?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes. So if you look at wafer shipments in Q4 -- calendar Q4 2016 versus calendar Q4 2017, the wafer shipments were up a little over 10%. So if you use that as a surrogate for volume, that will give you some indications. And the Q4 versus Q3, again this is industry-wide, was flat, up a little bit but basically flat from Q4 -- from Q3 to Q4.

So if you were to use that as a surrogate for volume and then look at how the industry was building, our indications for Q3 are not a reflection of, that we think the industry is going to slow down. Most of the customers gave guidance that their Q1 versus their Q4 will be down slightly, and we saw that kind of across analog as well as digital customers, some 2%, some 3%, 4% down from their Q4 to Q1. So whether it's inventory -- but there's an overall industry perception that it will slow down again, which is our Q3.

Having said that, we think year-over-year, the volume growth will hold and we're reflective in that in Q3. So when I said a slight downtick in Q3 versus Q2, I don't want to be too much an alarmist. All we want to say is that we saw exceptionally strong revenue and volume in Q2, and we expect it to be slightly down.

As Mike mentioned, there are some inventory things that we think are going on. In addition, there's been some ramps that occurred as some of our customers have ramped up their fab as they move to new technology. We saw some benefit of that. So when you put all that together and think about what's going on in the industry, we think our Q3 will be down slightly, still year-over-year very solid, and then we see Q4 ramping back up after Q3. But again, it's on the heels of a very good Q2.

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

Okay. And then my last question regarding Nagase, the fact that you will be no longer tolling for your, well, the company --

---

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Right.

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

Do you think that it is going to have a negative impact on the [market] going forward?

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Yes, we're not saying it's going to be a negative impact. We're assuming it's going to be consistent to where it is. We don't see a large increase after the tolling. We've been working hard to transition those relationships. So when the tolling arrangement ends, we'll be stepping in their shoes. So we don't anticipate any large impacts either positive or negative, as we transition away from the tolling arrangement. That will end in April. So our Q3 has basically got two-thirds of it under the toll arrangement, February, March and April will be where we see ourselves in after the toll arrangement. But again, we expect it to be pretty similar to what we've been experiencing up to this point.

Operator

And I'm showing no further questions. I will now like to turn the call back over to Chris Fraser for any further remarks.

Chris Fraser - *KMG Chemicals - Chairman and CEO*

Thank you very much, everybody. We look forward to talking to you after our Q3 results. Thank you.

Operator

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