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KMG - Q3 2017 KMG Chemicals Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2017 KMG Chemicals Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to introduce your host for today's conference call, Mr. Eric Glover, Investor Relations Manager. You may begin.

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

Thank you, Kevin. Good morning, and welcome to the KMG Third 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'll 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.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Thank you, Eric. Good morning, and thank you, everyone, for joining us today. Our Q3 earnings release was issued this morning, and our 10-Q will be filed this afternoon. After my remarks, Marcelino will review the financials, and then we'll take your questions.

KMG delivered another quarter of strong results, generating sales growth of 9% year-over-year to $81.6 million, with increased sales in each of our businesses. GAAP operating income increased to $9.4 million, a 33% improvement over the same period last year. GAAP net income was down slightly compared to the same quarter last year, reflecting the $2.1 million bargain purchase gain for the acquisition of NFC that benefited GAAP earnings in last year's third quarter.

Adjusted EPS, which exclude acquisition-related expenses and other items, grew 29% year-over-year in the third quarter to $0.53. Adjusted EBITDA reached a record level of $14 million, up 24% over last year's third quarter, reflecting increases in all of our businesses. KMG has now achieved 13 consecutive quarters of double-digit year-over-year growth in adjusted EBITDA. KMG's strong results for the third quarter and for the fiscal year to date reflect our continued progress operationally, financially and strategically. Each of our businesses has continued to perform at a high level, driven by consistent focus on execution and the successful advancement of our growth strategy. Positive fundamentals in each of our end markets have also contributed favorably to our overall financial performance for this year.

From a strategic perspective, we've announced 3 acquisitions over the past 14 months, including 2 in the last 4 months. These acquisitions expand our market presence, our capabilities and our geographic reach in both the semiconductor manufacturing and energy services markets, providing new opportunities for growth while enabling us to more fully serve our customers throughout the world.

Now looking more specifically at performance in each of our segments. Third quarter sales in our Electronic Chemicals business increased 4% from the prior year, excluding a negative foreign currency impact, driven by product volume growth in all geographic regions. As expected, sales ticked down sequentially from the exceptionally strong levels seen in our second quarter, reflecting the timing of certain customer production ramps.

Global silicon wafer production trends remained favorable during the quarter, benefiting from rising demand for semiconductors across a wide range of applications and end markets, strategically capitalized on these positive industry fundamentals by aligning our product offerings to meet the demands of semiconductor manufacturers in a variety of market segments.

Looking forward, we see 3 trends supporting a continued positive outlook for our Electronic Chemicals business. First, following a period of consolidation and rationalization of production capacity, multinational semiconductor manufacturers are ramping up capital spending on advanced technology and tools that will enable the next generation of semiconductor devices. While semiconductor capital equipment spending doesn't immediately impact our Electronic Chemicals business, it is a leading indicator for future growth given our focus on supplying the highest-purity and highest-quality products for our customers' most advanced manufacturing processes.

Second, semiconductor unit production has increased to meet rising demand for numerous new applications in automotive, Internet of Things, artificial intelligence, cloud computing and more. KMG is strongly aligned with many global semiconductor manufacturers who are -- increasingly focus their product development efforts on these faster-growing end markets, which should provide a favorable tailwind for semiconductor unit production in the years ahead.

Third, as semiconductor devices continue to become more highly integrated and complex, chemical purity and quality requirements are increasingly -- increasing to enable production of these more advanced devices. Manufacturing process complexity is also increasing at new technology nodes, resulting in greater process chemical usage during the wafer production process. Given our investments in product quality, purity in our supply chain, KMG is well positioned to meet these challenges for our customers today and in the future.

In conjunction with our acquisition of NFC last year, we announced the capital investment in our Singapore operations, which will expand our manufacturing, packaging and purification capabilities. I'm pleased to say we're making good progress as this project remains on track and on budget, with construction expected to be completed in fiscal 2018. These investments will enable KMG to more comprehensively and efficiently serve our semiconductor customers in Singapore and throughout the region.

Following the recent conclusion of our 1-year tolling agreement with Nagase Singapore, we initiated restructuring of our Singapore operations to even further enhance our operational efficiency.

I'll shift now to our newly named Performance Materials segments, which includes our wood treating chemicals and industrial lubricants business. In light of the acquisition of Sealweld and the pending acquisition of Flowchem, our Chemicals -- our Other Chemicals segment was renamed the Performance Materials segment. This segment achieved sales of $13.5 million in this quarter and operating income of $4.2 million, a 48% gain from the prior period.

Our wood treating chemical business, which generates fairly predictable results in any given period, experienced a strong sequential and year-over-year increase in third quarter sales, driven by higher volume caused by severe storms that required increased utility pole replacement in the West and the South.

In spite of higher raw material costs compared to last year's third quarter, our wood treating chemicals business achieved higher profit this quarter. We expect the wood treating sales to remain strong in the fourth quarter due to seasonal trends and the impact from recent tornadoes in the South. However, increased raw material costs will limit the positive impact from improved sales on fourth quarter EBITDA for this business.

Our industrial lubricants business, which includes both Val-Tex and Sealweld, saw robust demand for our products, resulting in higher sales and profits in Q3. Increased capital and maintenance spending by North American pipelines and midstream customers has strengthened demand for our valve lubricants, sealants and application equipment. Additionally, as the U.S. rig count has risen from increased drilling activity, we have seen greater use of our products in the field.

Through our acquisition of Val-Tex in 2015 and Sealweld earlier this year, we've built a strong growth platform to serve the global pipeline and energy services market with a range of high-performance products and services. Sealweld was accretive to our results in the third quarter, and we're currently integrating Val-Tex and Sealweld to maximize the growth potential of these complementary businesses.

Our pending acquisition of Flowchem represents a unique and compelling opportunity that will allow us to further expand and strengthen this growth platform to serve the global pipeline and energy services market. We're progressing on this transaction, with expected closing in the middle of this month. Flowchem not only adds significant size, scale and diversity to our operation but also will be highly accretive to our EBITDA, our margins and our adjusted earnings per share. We're enthusiastically looking forward to joining with Flowchem's exceptional team.

In summary, this has been an exciting, productive and successful past 9 months this year, highlighted by continued strong financial results and key strategic acquisitions that position KMG for our next phase of growth. I'm pleased with the progress we've made as an organization, and I'm as confident as ever in our future potential.

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

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

Thank you, Chris, and good morning, 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'll reference are reconciled to the corresponding GAAP numbers in today's earnings release.

Third quarter sales grew 9% to $81.6 million, and year-to-date sales improved 7% to $237.2 million. GAAP diluted EPS was $0.49 per share compared to $0.53 per share in Q3 of 2016. As Chris noted, in last year's third quarter, we recorded a bargain purchase gain of $2.1 million related to the acquisition of NFC. This benefited GAAP earnings in that period by $0.17 per share.

Adjusted EPS for the third quarter of 2017 increased 29% year-over-year to $0.53. For the 9 months year-to-date, adjusted EPS grew 27% to $1.58. Our EBITDA growth in the third quarter was driven by volume growth in both our Electronic Chemicals and Performance Materials segments and contributions from the acquisition of NFC and Sealweld. Adjusted EBITDA margins improved to 17.1% in the third quarter versus 15% in the prior year period.

Third quarter cash flow from operations was $7.9 million compared to $8.5 million in the second quarter of fiscal 2017. The variance largely reflected the excess tax benefit realized in Q2 and the associated positive impact on net income in that period. For the 9-month period ending April 30, 2017, operating cash flow was $27.3 million compared to $29.4 million for the 9 months ending April 30, 2016.

Cash and cash equivalents were $14.1 million as of April 30, 2017. As you will recall, our cash balance was abnormally high at the end of the second quarter as it included the funds borrowed to finance the acquisition of Sealweld. With the Sealweld transaction having closed on February 1, the first day of our third quarter, our cash balance returned to a more normalized level.

Long-term debt was $34 million as of April 30 compared to $41 million as of January 31, 2017. During Q3, we repaid $7 million of debt, bringing our fiscal 2017 year-to-date debt reduction to $18.8 million. Supported by our strong cash generation, we have repaid long-term debt by $38.8 million over the past 7 quarters.

Capital expenditures in the third quarter was $3.3 million, up slightly from $2.7 million in the second quarter of fiscal '17. For the fiscal year-to-date, we've invested $8.6 million on CapEx. Due to the scheduling of payments for our major capital projects, we now anticipate that CapEx for the fiscal year will be approximately $16 million to $17 million compared to our prior forecast of approximately $21 million.

Turning now to our income statement. Third quarter gross profit margin of 39.9% increased 110 basis points from the same period last year, reflecting product mix and operating efficiencies. Distribution expense of $9.5 million increased by approximately $300,000 compared to the prior year due to the higher shipment volume. As a percentage of sales, distribution expense decreased to 11.6% compared to 12.2% in last year's third quarter. The decrease in distribution expense as a percentage of sales was primarily due to a shift in customer and product mix compared to the prior period.

SG&A increased $1 million from last year's third quarter, primarily reflecting expenses for the acquisition and integration of Sealweld and approximately $560,000 in expenses related to the proposed acquisition of Flowchem.

As we concluded our 1-year tolling agreement with our acquired assets from Nagase Singapore, we initiated a restructuring of our Singapore operations and have incurred approximately $226,000 of employee-related severance costs.

Our effective tax rate in the quarter was 34.1% compared to the 25.3% in the prior period. The increase in our effective rate was due to the nontaxable gain associated with the NFC bargain purchase in last year's third quarter. We anticipate an effective tax rate of 32% to 33% for the fiscal 2017 year, which is consistent with our previously stated guidance.

Now I'll briefly review our segment results. Our Electronic Chemicals business generated 4% sales growth on a constant currency basis compared to last year's third quarter, driven by product volume growth in all geographic regions. The acquisition of NFC also contributed positively to our results.

Electronic Chemicals segment adjusted EBITDA, excluding corporate allocation, increased 10% year-over-year to $14.8 million. And EC segment EBITDA margins, again, excluding corporate allocation, increased 21.7% from 20.3% in the prior period. The improvements in EBITDA and EBITDA margin were driven by volume growth and operating efficiencies.

Performance Materials segment adjusted EBITDA, again, excluding corporate allocation, increased to $5.6 million from $4.1 million in last year's third quarter. This increase was due to substantially stronger volume in our industrial lubricants business, higher penta sales and the contribution from Sealweld. Performance Materials segment EBITDA margins, excluding corporate allocation, were 41.9% in the third quarter compared to 48.6% in Q3 2016. The decrease primarily reflected product sales mix and higher raw material costs.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Rosemarie Morbelli with Gabelli & Company.

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

I was wondering, looking at Electronic Chemicals, the sequential growth of 3% was higher than you anticipated because if my memory serves me right, you thought that sequentially, the -- a down quarter in terms of revenues. What was the reason for the pickup?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So as I said, our sequential revenue in Electronic Chemicals was down. We had an exceptionally strong Q2, where we had some of our customers doing some fab modifications and ramping for technology. And so we benefited from that in Q2. But having said that, the overall electronic -- I mean, the overall semiconductor industry continues to do well and seems to be doing each quarter a little bit better than what everybody expected. And we experienced that with -- we saw volume in every region grow, which we benefited from. From 1 quarter to the next, you might have some product mix and some customer mix. But overall, we saw good volume across all fronts, all regions, all products, and we benefited from that in the quarter. So sequentially, it was a little better than we expected. Year-over-year, 4% growth, which is a little bit better than we expected. But overall, from a full year standpoint, year-to-date, if I look at it from that standpoint, we've got over 5% growth from total revenue in Electronic Chemicals versus prior year. So we're feeling pretty good at that. And if you adjust that number with currency, it gets up to closer to 6%, which is outpacing what the industry is performing right now.

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

And looking at the ramp-up by the semiconductors manufacturers, how long is the lag before you see it?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes, that's a good question. So it depends on the customer. So with some customers, we've got a longer lag period of when they buy our product to when they consume it and shorter for others. But if you use a 3 -- a quarter or so, in some cases, a little bit longer than that, a 4-month period, it gives you a good perspective on what kind of lag from when they buy our product to when they actually consume it and manufacture the chip with it.

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

Okay. And then looking at the Performance Materials, could you touch on what is behind -- I mean, the type of growth rate in the market in the oil and gas market, could you touch on the trend that you are seeing? Is the growth rate that you have experienced over the past couple of quarters increasing? Or is it -- has it stabilized at current level?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So actually -- so this quarter was stronger than we saw it last quarter. You had 2 things going on. One is there's a seasonal element to it, right? As we -- as you get into the spring and then into summer, there's more maintenance being done. So we saw the benefit from that. And specifically, with some of the operations in Canada, pipeline services in Canada, you get into the breakup in the thaw. Once you get through that, they're able to do some of the maintenance that had been put off for some time. So we saw a benefit of that seasonally. But in addition, we are seeing an increasing maintenance spending, and the rig count is going up for 23 weeks now. And so oilfield services are performing well, and we're getting the benefit of that. So we've got several things that are helping us. Year-over-year, it's pretty significant. From 1 quarter to the next, we saw not only a seasonal pickup, but we also saw the rig count going up and increased oilfield and drilling activity.

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

And Chris, during the quarter, you had the contribution from the Sealweld acquisition. Can you give us the top line and operating income contribution from Sealweld?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So we don't really -- we don't get into that in specifics. It's all part of our Performance Materials segment. But if you think about, Rosemarie, when we announced the acquisition, the Sealweld organization had approximately $12 million of trailing revenue with an EBITDA approximately $2.5 million. So if you use those numbers, they can give you some kind of thoughts around the perspective and the impact of Sealweld. We're delighted on how Sealweld is performing. We believe the assets in the business is even going to be better than we had anticipated. So -- and we think the timing of our acquisition, given some of the market fundamentals I just talked about, was very good. So we're pleased with the performance of Sealweld, and the future looks very bright, especially when you consider it as part of the combination with Val-Tex, but in addition, even the greater impact as we build out this pipeline performance area with the addition of Flowchem, and you think about the breadth of products and services and equipment, that we are going to offer into that market segment, is really exciting for us in building out the capabilities for our customers and the breadth of products and services that we can offer.

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

And lastly, if I may, looking at the pending acquisition of Flowchem, you said that deleveraging down to 3, 3.5x versus about 5.5x at the time of closing. How long do you think that is going to take? And then related to that, well, acquisitions obviously are not going to be priority until you deleverage. What would you do if an attractive property becomes available on the EC side of the operation?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So let me first handle the deleveraging question. So yes, our target level is to get down to a more reasonable level, 3.5 leverage. We feel very good about the cash flow generation of the business. We'll be giving guidance in October after we announce our fourth quarter of what we project out the financials with the combination of Flowchem and, at that time, be able to give you some -- a better line of sight into the cash flow generation and expected deleveraging. But let's just say, we're very comfortable and confident of the projections on the cash flow and how quickly we'll be able to delever with the existing business. In addition, we have that universal shelf that we registered that we have those capabilities and the optionality to use that if we deem appropriate given market conditions and everything else that we could use that could provide us that flexibility to deleverage even quicker in addition to the generation of cash flow. As far as the impact on other acquisitions, when we were looking at Flowchem, we wanted to make sure that we were not going to miss out on other opportunities strategically that could benefit us. So we looked at, from our perspective, what the acquisition pipeline looked at -- looked like going forward and felt that there was opportunities out there, but none of them were near term enough that we felt would be -- that we would lose out on the opportunity if we made the Flowchem acquisition and then forward thinking around our deleveraging. So our interest in acquisitions will not be delayed, so to speak, from what we think the opportunities that they will present themselves and the timing of them. But I would have to say that you've heard me in the past talk about a multipronged acquisition strategy. It was building out industrials lubricants platform, it was building out Electronic Chemicals and specifically looking for growth in Asia and was looking for a new platform. What I would have to say now is going forward, after the Flowchem acquisition, our focus will be on the 2 fronts. We won't be looking for an additional platform for any near-term acquisition. We'll be looking at building out that platform that I talk about with pipeline performance, which we think has tremendous bandwidth and geographic capabilities, not only industrial lubricants but other products and services that we can build out, utilizing the Flowchem and industrial lubricants products and markets and, in addition, continuing our pursuit of growth in Electronic Chemicals strategically to even broaden our strength and geographic reach. So it will be more of a two-pronged approach, if you will, rather than what we had before as we think we've got plenty of room and plenty of ideas and opportunities in those 2 platforms to build those out from where they are today.

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

And just following up on one of your comments just now, are you now thinking that you may use the shelf to -- in order to use stock here given the valuation of the stock as opposed to borrowing the entire amount?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

No. We will not be using the shelf prior to closing. We expect the closing to happen actually fairly soon, mid this month, so we're a week or 2 out. But I would say after the closing, so we'll do the debt financing as we'd outlined. And that's going very well, by the way. The syndication and all the financing and everything is progressing very well. We're very pleased with that. And so the shelf, though, would be something we would consider after closing. And it's out there for us to consider and use that optionality and flexibility we have, but it will not be done before closing.

Operator

Our next question comes from Jacob Schowalter with Seaport Global.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

It's actually Mike Harrison sitting in for Jacob. Was hoping that we could start at something higher level. I noticed that you guys didn't update the guidance that you had previously provided. Presumably that's because of uncertainty around the exact closing date for Flowchem. But relative to your prior guidance and to your expectations, did the April quarter come in ahead of those expectations? And would you have -- absent any acquisition contribution, would you have raised guidance?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes, that's a great question, Mike. So we had previously guided EBITDA from $51 million to $53 million. And this quarter did perform well. We saw good progress on all fronts. So we expect to come in on the high end of our guidance. We really -- we don't update guidance outside of midyear, so we didn't want to get into that even though -- and with the Flowchem acquisition, as you said, the timing of that can move numbers quite a bit. So we thought rather than trying to -- try and pin that date down exactly, we kept away from that. But having said that, our existing business, without including any acquisitions, for the high end of our range where we think we'll come in and feel comfortable with that level right now.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

All right, that's helpful. And then I was also hoping, it sounded like you said that the Electronic Chemicals growth was pretty even across all regions. I was wondering if you could just comment on the mix in Electronic Chemicals and how that may have affected your margin in the quarter.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So the margin in the quarter, if you look at it from -- against Q2, you'll see that it was the -- operating margin was down slightly from Q2 but up from Q3 of last year and trending year-to-date above last year. So we're pleased with the progress we're making there. But for 1 quarter to the next, depending on customer, region and product mix, it can vary from 1 quarter to the next. So we saw growth in all regions. And because of this mix and some of the geographic mix and the product mix and customer mix, we did see a little bit lower margin this quarter than last. Last quarter, we benefited from, as I said, some of the technology ramps and fab ramps. And some of those, as you can imagine, are some of the higher-end fabs. So some of those products and -- blends and products have some higher margins. So that helped our Q2 mix effect that drove the higher margin at the operating level.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

Got it. And then also in the Electronic Chemicals business, can you talk at all about what you're seeing in terms of customer inventory levels and order patterns? It sounds like you're fairly bullish on the capital equipment spend and some of the ramp in the higher-end nodes and advanced technologies. But I'm thinking really more in terms of legacy nodes and maybe some of the lower-end applications. Are you seeing any kind of inventory build that could limit growth as you look over the next couple quarters?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes, Mike. Actually, we're not. We're seeing a pretty steady, consistent order pattern across almost all fronts and various different customers. I think the projections are for 2017, from a calendar year, from the industry to have growth upwards of 5% to 6%. Some projections are even higher than that. If you look at the wafer production and millions of square inch and you put some of the projections running anywhere from 5% to 7%. So -- and we're seeing that as we layer out the next couple quarters as it continues in 2017. So we're not seeing an inventory build. We're seeing consistent order pattern that's continuing. We're getting into the kind of the best quarters, if you will, the summer months and getting into the fall, and we're seeing a good steady pace on orders.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

All right. And then I was also hoping, if you could comment on the CapEx guidance. It sounds like you reduced that number fairly substantially. Can you talk about why that number is coming down? And is that a pushout of projects? Or is it some things that are coming in at lower cost? Or what's going on there?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes, it's just a timing element. The biggest part of our -- so our maintenance capital is kind of on target. We've got some other strategic investments that we're making. The biggest one is our investment in Singapore. As I said, it's on schedule and on budget, but we're right in the kind of peak period where we are ordering a lot of equipment, tanks and whatnot, that we're placing orders for that will be delivered here in the coming future. But with that, you get into negotiating terms and when actual payments are going to be made. And so when we just took a very granular look at it with the knowledge now of when we're actually placing orders and the orders we placed and just layer that in on top of our fiscal year and saw what the cash flow of those were going to be, it came in lower than we had expected. And when you -- if you think about a $10 million to $12 million capital project, there's some pretty heavy months there at a period of time when a lot of equipment is being delivered. So the movement from 1 month to the next can actually significantly impact the cash flow. So we just looked at it more granularly. It's not a delay, and it's not a reduction of any projects. It's more about just timing of cash flow. And you -- I think you should expect to see that. We'll see in our Q1 since we're only a couple months short of finishing out our fiscal year. If you think about the timing for our Q1 in 2018, which starts in August, we would expect to see probably higher capital spending than we might have normally seen just because of movement from Q4 into Q1 of some of these larger spends that we're doing out in Samsung -- at -- in Singapore.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

Understood. And then I believe you referred to the distribution cost number being down year-on-year related to mix. Was just wondering if you can give a little more detail on that. And I guess in particular, is that improvement sustainable? Or is that mix something that's going to fluctuate over time and could lead distribution costs higher over time?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So clearly, we focus on the cost of distribution, and we're looking at it from a per-unit standpoint or a lane standpoint. And with oil prices where they are, obviously, we benefit from lower fuel costs. There's -- but so overall, transportation costs are running on par. We expect a little bit of an increase next year. But having said that, from 1 quarter to the next, we're going to get a movement on our distribution expenses. So some products are sold with more freight than others. Some customers purchase from an -- on an ex work standpoint where others are more on a delivered basis, and then you've got the geographic mix as well. So you got a product mix, you got a customer mix, and you've got a geographic mix that can impact it from quarter-to-quarter. So we're obviously pleased with the progress we've made over a period of time. But from 1 quarter to the next, it could flex. And at this point, I'm not willing to say that next quarter is going to be at the level that it was this quarter because of the mix impact. We like the overall trend around efficiencies, but it's not something I would just take this quarter and assume that that's going to be at that level going forward.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD and Senior Chemicals Analyst*

Okay. And then the last question I have is around the Flowchem business. Just wondering if -- since you've had a couple months now to work on the integration plan, is there any change to your synergy expectations related to Flowchem either on the cost side or on the revenue side?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So no, we have not changed anything, Mike. We talked about we think there's a decent amount of synergy, some of them immediate, and some of them are longer term. So we've not really changed our thoughts about that. But having said that, I would tell you that as we get to know this business more and more and the capabilities, not only the people and the physical assets, but we really like the combination. We have not built into any of our synergies the opportunities of cross-selling and adding expanded products and services to our customers. And as we bring both industrial lubricants and the DRA customer products to bear and as we approach customers, we think there's tremendous cross-selling opportunities as we just provide more and more services and products. So I would say if there's anything, we've not changed our synergy numbers. But having said that, I'm more confident about those numbers and the ability to deliver even more products and cross-selling to our customers and the opportunity that this new platform is really going to present for us in -- both from a growth standpoint but as well as just the existing businesses and how they're going to come together very nicely.

Operator

Our next question comes from Lucian Tira with HPS Partners.

Lucian Tira

We're in -- close to mid-June now. And I was wondering if you guys had any update on the Flowchem performance itself and how it's done relative to when you guys announced the deal.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes, sure. So we have not seen anything that would change from our perspective. Obviously, the last numbers that we saw officially were through the March quarter. But as we watched the business progress since that time period, we've not seen anything that changes our projections or thoughts about the business or the financial strength of it. They're continuing to perform well, and they continue to operate as they have as a stand-alone entity. And we're just excited about them becoming part of KMG and working with them here in the next couple of weeks and then them being part of our growth. And as I said earlier, we're excited not only about the business side of things and strategy side of things. It's going to be significantly accretive to our EBITDA, our revenue and our margins as well as they are a well-run business.

Operator

Our next question comes from Mack Fuller with GSO Capital.

Mack Fuller - *The Blackstone Group L.P. - Principal of GSO*

Just a question, on the Performance Materials side, can you just talk a little bit about the mix shift that led to the decline in operating margin?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Sure. So in that segment, we have both industrial lubricants and wood treating. And in industrial lubricants, we have both Val-Tex and Sealweld. As the industrial lubricants business became a bigger percentage of the overall EBITDA and overall revenue of that business, we saw a mix impact that drove our margin percentage lower. So it's nothing -- I mean, each one of the businesses, I was happy with the progress they made on margins. The wood treating business, as I've said in prior quarters and said in this quarter, we continue to see increasing raw material costs, which is putting pressure on the margin there. The industrial lubricants side made very nice margin improvements and progression. But it's more of just a weighting and a mix impact that when you look at the overall segment that drove the lower-margin percentage from 1 quarter to the next and year-over-year.

Mack Fuller - *The Blackstone Group L.P. - Principal of GSO*

That makes sense. I got it. Just a follow-up on that, wood treating side, do you see -- I guess, any sort of really -- are there pass-throughs in that business in terms of getting relief on the raw material price pressure?

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Yes. So we're obviously -- we pay close attention to that. We're 100% of the production of penta in North America. And we feel very comfortable to the extent that the -- if there were significant improvements or increases in raw materials, we would be looking to pass those on. So it's something we monitor, something we look at every month and quarter. And so we also want to remain competitive for our customers and provide good product and quality and value to our customers. So we'll be -- we're monitoring that continuously. And to the extent that it's necessary, we'll do the appropriate thing and pass on price increases to the extent we need to cover continued operating and raw material cost expenses.

Mack Fuller - *The Blackstone Group L.P. - Principal of GSO*

Got it. But it sounds like it's more of a mix thing than that. So I appreciate that color.

Operator

And I'm not showing any further question at this time. I'd like to turn the call back over to our host.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Great. Well, we appreciate your appreciation today and your interest in KMG. We look forward to speaking with you in October when we provide our fourth quarter and fiscal year-end results and provide our financial guidance for fiscal 2018. Thank you.

Operator

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.

Christopher T. Fraser - *KMG Chemicals, Inc. - Chairman, CEO and President*

Thank you.