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KMG - Q4 2017 KMG Chemicals Inc Earnings Call

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen. I would now like to turn the call over to Eric Glover, Investor Relations Manager. You may begin.

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

Thank you, Sonia. Good afternoon, and welcome to the KMG Fourth Quarter and Full Year 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 a 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 from the Investors section of our website at kmgchemicals.com 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 as to the future performance of the company. I'll now turn the call over to Chris Fraser, our Chairman and CEO. Please go ahead, Chris.

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

Thank you, Eric. Good afternoon, and thank you everyone for joining us today. Our Q4 and full year 2017 earnings release was issued today after the market closed, and we will file our 10-K this evening. After my remarks, I'll turn the call over to Marcelino for a review of the financials. After Marcelino's comments, we'll take your questions.

After market closed today, we issued a press release announcing the launch of a primary 2.6 million share equity offering pursuant to an effective shelf registration statement on Form S-3 previously filed with the SEC. We have also granted the underwriters an option to purchase up to an additional 390,000 shares of common stock from us. Proceeds from this offering will allow us to make significant progress towards achieving our target net leverage which, you may recall from our June 2017 earnings call, was 3.5x. Going forward, we expect to achieve additional deleveraging through organic EBITDA growth as well as ongoing cash flow generation. In light of the securities laws and the pending offering, we'll not comment on the offering or address any questions about it.

Fiscal 2017 was an outstanding year for KMG, highlighted by continued record financial performance and key acquisitions that advanced our growth strategy and significantly expanded our capabilities in the global pipeline and energy markets. Adjusted EBITDA grew 33% from the prior year to $60.2 million, marking our third consecutive year of record adjusted EBITDA and third straight year of adjusted EBITDA growth exceeding 20%.

GAAP earnings per share of $1.92 was also a record and represented a 22% increase over the prior year. Adjusted EPS of $2.27 increased 41% and represented an all-time high for KMG. I'm proud of our accomplishments, not only in 2017 but also over the past several years and of the substantial progress we have achieved operationally, strategically and financially. KMG today stands stronger and more capable than any time in our history, underpinned by 3 strong and diverse business platforms that provide essential products and services for our customers on a global basis.

Acquisitions are a fundamental component of our growth strategy, and we completed 2 significant transactions in 2017. Our purchases of Sealweld and Flowchem, 2 premier businesses serving a global pipeline market, complement our existing industrial lubricants business and establish KMG as a leading global provider of performance products and services for improving pipeline operations and optimizing pipeline throughput.

We've been pleased to join forces with the dedicated and talented teams of both Sealweld and Flowchem to better serve our pipeline customers across the world. The integration of both businesses is proceeding smoothly, and we've made progress integrating back-office functions, and we are beginning to leverage our operational supply chain knowledge to optimize business processes. With the additions of Sealweld and Flowchem, our Performance Materials segment now represents more than half of our EBITDA on an annual basis, providing diversification and balance to our overall business.

Sealweld effectively doubled the size of our existing industrial lubricants business and opened up new growth opportunities in pipeline services such as valve maintenance, education and training. Sealweld is immediately accretive to our financial results on an adjusted basis, starting in the third quarter this year and contributed meaningfully to our growth in fiscal 2017.

On June 15, we completed the acquisition of Flowchem, a leading DRA solution provider serving major pipeline and midstream operators worldwide. DRAs, or drag reducing agents, provide tremendous value to pipeline operators through improved pipeline performance, reducing operating costs, and enhance safety. This was a transformative acquisition for KMG, substantially increasing our size and scale as a company and nearly doubling our annual cash flow.

Flowchem was a compelling and synergistic addition to our existing industrial lubricants business, and the acquisition was consistent with our long-standing strategy requiring established, well-managed businesses with strong cash flow, high barriers-to-entry and value-added products that provide essential performance enhancements for our customers.

From a strategic standpoint, Flowchem strengthened our product offering for pipeline operators, expanding our technology capability and further extended our international reach to all of the world's key oil-producing regions. We've been pleased with Flowchem's financial performance since we closed the acquisition in mid-June. Flowchem was immediately accretive to our results on an adjusted basis in the fourth quarter, benefiting from demand both domestically and internationally, and the business has continued to experience solid growth in the first quarter of fiscal 2018.

As we look forward, we're excited about the opportunity that Flowchem's leading technology and products address on a global basis. Aging global pipeline infrastructure, heightened safety and environmental regulations and rising oil production and pipeline capacity-constrained regions are driving growing usage of DRAs which are a proven cost-effective and efficient solution to improve pipeline operators and enhance safety.

Our Performance Materials segment, which consists of our pipeline performance and Wood Treating Chemicals businesses, generated record 2017 sales on EBITDA, driven by increased volume in our industrial lubricants business and higher sales in our Wood Treating Chemicals business as well as a 6-month contribution for Sealweld and a 6-week contribution from Flowchem.

Our industrial lubricants business had a very strong year, benefiting from increased capital and maintenance spending by North American pipeline and midstream customers. This higher level of spending strengthened demand for our valve lubricants, sealants and application equipment, while increased oil and natural gas production in North America led to greater use of our products in the field.

Despite higher raw material costs, our Wood Treating Chemicals business had another solid year, benefiting in part from increased pole replacements due to storm-related damage. In addition to the significant progress we achieved in building our pipeline performance business last year, we continued to expand and grow our Electronic Chemicals business, serving the global semiconductor manufacturing market. Electronic Chemical sales grew 7% in 2017 to a record $280 million, excluding a foreign currency impact, representing our most robust sales growth in this segment over the past 3 years. Adjusted EBITDA of $49 million was also a record high for this segment.

We experienced product volume growth in all geographic regions, benefiting from improving global silicon wafer production and also from our continued efforts to serve dynamic growth markets like cloud computing, automotive and advanced logic. The rising complexity of semiconductor device architectures and advances in semiconductor processing technology remain important trends, driving demand for high-purity products on a global basis. And we, continue to collaborate closely with our customers to ensure that our products meet their evolving needs for purity and quality.

In Asia, we completed our integration of Nagase FineChem, a Singapore-based manufacturer of electronic chemicals, into our existing operations in Singapore. We also made further progress with respect to our capital investment project in Singapore that will broaden and enhance our product offering to our semiconductor customers in this important region for semiconductor production. This product remains on track for completion in 2018. And we expect product qualification to begin in 2019. By 2020, we will -- which will be our fourth year of ownership of these assets, we anticipate an EBITDA contribution in excess of $5 million per year.

Turning now to our fourth quarter financial results. Adjusted EBITDA reached a record level of $20.6 million, reflecting increases in each of our businesses. KMG has now achieved 14 consecutive quarters of double-digit year-over-year growth in adjusted EBITDA. Fourth quarter adjusted earnings per share of $0.69 increased 82% from the same quarter last year and represented a quarterly record for KMG. Our performance in the fourth quarter reflected strong continued fundamentals across all our global businesses, further improvements on our operational efficiency and a deferred tax benefit related to the acquisition of Flowchem.

Production within the global semiconductor manufacturing market remains robust during the fourth quarter, driven by continued strength in silicon wafer shipments for a variety of applications and end markets. Our Electronic Chemicals segment performed exceptionally well, generating 9% sales growth from the prior year, excluding foreign currency translation impact. This met -- marked our highest rate of year-over-year growth in Electronic Chemicals sales in more than 2 years. Product volume growth in all region was the primary driver of the Q4 sales increase.

Fourth quarter sales on our Performance Materials segment increased to $24.5 million from $9 million in the same quarter of last year. Growth in this segment reflected contributions from Sealweld and Flowchem as well as increased product volume in industrial lubricants, driven primarily by higher maintenance and capital spending in the energy industry. We also experienced higher sales of Wood Treating Chemicals.

Looking ahead to fiscal 2018, we're planning for continued sales and EBITDA growth and margin improvement, supported by solid fundamentals and favorable outlooks in each of our 3 business platforms. As stated in our earnings release today, we project fiscal 2018 sales of $435 million to $450 million, an increase from the prior year of approximately $109 million, at the midpoint of our guidance. This forecast assumes continued organic sales growth in our Electronic Chemicals segment, which should benefit from the increased global silicon wafer production to meet continued demand for semiconductors in a variety of end markets.

We remain very positive about the healthy fundamentals in the Electronic Chemicals market, which are being driven in part by increasing demand for semiconductors to process and store increasing quantity of data.

We also project significant sales growth in our Performance Materials segment, reflecting a full year contribution of Sealweld and Flowchem, as well as organic sales growth from our industrial lubricants and Wood Treating Chemicals business. More specifically, we believe maintenance and capital spending in the energy industry remain healthy given stabilization in energy prices, supporting increased demand for our products and services.

In our Wood Treating Chemicals business, we expect to see a moderate improvement in demand aided by replacement of storm-damaged utility poles and from an uptick in utility spending on pole maintenance and replacement programs. Our adjusted EBITDA guide for fiscal 2018 is a range of $110 million to $115 million, an increase from the prior year of approximately $52 million at the midpoint of our guidance. This forecast reflects our expectations for growth in both our Electronic Chemicals and Performance Materials segments as well as our continued focus on enhancing efficiencies.

Including in our -- included in our guided EBITDA are our expectations for higher raw material cost in our Wood Treating Chemicals segment, which we expect to somewhat dampen the profitability of this business within our Performance Materials segment.

In closing, our record results in fiscal 2017 reflect the successful advancement of our growth strategy and our continued focus on execution and driving efficiencies throughout our global operation. We've made significant progress over the past several years. And as we enter our next phase of growth, we remain committed to enhancing long-term shareholder value through the smart, efficient management of our operations and cash flow and the optimization of our acquired assets. And now Marcelino, please go ahead with the review of the financials.

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

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

To begin, I'd like to highlight that our reported GAAP results include a $3.7 million negative impact from the step-up in basis related to the valuation of acquired inventories as required under purchase price accounting. This valuation adjustment on acquired inventories is reflected in our reported GAAP results on a consolidated basis and in our Performance Materials segment's results. As a result, GAAP diluted earnings per share was reduced by $0.22 per share in the fiscal fourth quarter and for the fiscal 2017 year.

Fourth quarter consolidated net sales increased 27% to $96.3 million from $75.9 million in last year's fourth quarter, reflecting organic growth in the Electronic Chemicals and Performance Materials segments as well as contributions from the acquisitions of Sealweld and Flowchem.

Adjusted EBITDA in the fourth quarter was a record $20.6 million, up 76% compared to the fourth quarter of fiscal 2016. The improvement in adjusted EBITDA from the prior year reflected strong growth in the Performance Materials segment aided by contributions from acquisitions as well as continued growth in the Electronic Chemicals segment. Adjusted EBITDA margins increased to 21.1% in the fourth quarter from 15.5% in the same quarter a year ago.

Adjusted EPS in the fourth quarter was $0.69 compared to $0.38 in last year's fourth quarter. In Q4 of 2017, our effective tax rate was 9.8% as compared to our typical 35%, primarily due to a one-time tax benefit of $1.7 million realized from the reorganization of legal entities related to the Flowchem acquisition. This tax benefit was equivalent to approximately $0.14 per diluted share.

Our effective tax rate for fiscal 2017 year was 27.2%, below our expectation of approximately 33%, reflecting the tax benefit realized in Q4. For fiscal 2018, we anticipate an effective income tax rate of approximately 32% to 33%.

Fourth quarter cash flow from operations was $17.6 million, representing the highest quarterly level in KMG's history. Operating cash flow benefited primarily from increased volume globally across our 3 business platforms, continued realization of manufacturing efficiencies, earnings contributions of recent acquisitions within the Performance Materials segment and a full year of earnings from NFC business acquired in the third quarter of fiscal year 2016. Supported by the strong cash flow of our business, we repaid $10 million of new debt during the fourth quarter of 2017, and we repaid $31.8 million in total debt during the fiscal 2017 year.

Capital expenditures in the fourth quarter were $4.5 million, and CapEx for fiscal 2017 totaled $13 million. Fiscal 2017 CapEx came in below our prior guidance of approximately $16 million to $17 million due to the scheduling of payments for major projects, including our capital investment project in Singapore.

With a portion of these capital investments having shifted into 2018, we project CapEx this fiscal year will be approximately $29 million, which includes investments for manufacturing expansion in Asia, continued ERP system implementation and investments in our global operations to support future growth. Our corporate expenses increased by only $1.3 million over the last year, driven primarily by increased stock-based compensation. As you will see on our earnings release and 10-K, we modified our corporate allocation methodology, resulting in higher allocations to the business segments. This has no impact on our corporate EBITDA.

Turning briefly now to our segment results for the fourth quarter. Performance Materials segment adjusted EBITDA, excluding corporate allocations, was $11.1 million compared to $4.2 million in the prior period, reflecting organic growth in our industrial lubricants and Wood Treating Chemicals businesses as well as contributions from Sealweld and Flowchem.

Performance Materials' adjusted EBITDA margins, excluding corporate allocation, were 45.3% compared to 47.1% in last year's fourth quarter. The decrease was due to higher raw material costs in our Wood Treating Chemicals business and a less favorable sales mix. Electronic Chemicals segment adjusted EBITDA, excluding corporate allocation, was $16.8 million, an increase of 21% from $13.9 million in last year's fourth quarter. Product volume growth and operating efficiencies were the key drivers of EBITDA growth.

Electronic Chemicals segment adjusted EBITDA margins, excluding corporate allocation, improved to 23.4% from 20.1% in the same period last year. The increase was due to product volume growth, a favorable sales mix and operational efficiencies, partially offset by higher distribution expense due to increased shipment volume.

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

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from Mike Harrison of Seaport Global Securities.

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

Chris, was wondering if you could talk a little bit about the Electronic Chemicals growth outlook for 2017. I'm curious in part to hear what your outlook is for kind of the mix going forward and the pricing environment. And given that we're seeing this nice ramp-up in some of the more advanced or complex chips, are you seeing any change in behavior from your competitors trying to position themselves to capture more of this growth going forward?

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

Yes. So I think you're referring to our outlook for 2018, Mike?

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

That's correct.

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

Yes. So yes, I mean there's some really good fundamental drivers that are going on right now that we're experiencing now and we expect to continue into 2018. And if you look at the equipment orders for the semiconductor producers, it continues to be at a very strong pace into 2018, which is somewhat of a leading indicator for us. We're hearing from our customers obviously, there's real positive growth perspectives from them. They're getting increased revenue not only from volume but also on pricing specifically around memory. So across-the-board, we are seeing good growth in both memory and logic. Our products go more heavily into logic. There's more consumption of our products in logic manufacturing than memory. But again, there's good volume in both. The really thing -- an interesting thing for us is the fact of this application of technology to more and more of our daily lives, whether it's in wearables or it's in other computing: appliances, HVAC, what's being done in the automobile, even before we get to autonomous vehicle, just the amount of sensors, the amount of data that's being accumulated is requiring more storage, more memory and then more logic to manage that data that's being put together. Even in the business world, with Business Intelligence and all of the data that's being driven, whether it's up into the cloud through servers is just driving this explosion of data and, therefore, the memory and storage capabilities that are required to handle it and then all the logic that is required to compute with it and analyze it. So we're just seeing this broad-based, fundamental growth that we're seeing that we expect to continue through 2018 and beyond. There's indications of a potential inflection in outer years like we haven't seen. You go back 30 years to the PCs and the inflection that happened and the real -- and the amount of data that was being processed and what that meant for semiconductors and then with mobile phones 10 years ago and with artificial intelligence and all the fundamentals that I just talked about, the projections out for the next 5-plus years are very strong around that. So again, we see real strong demand. How it pertains specifically to us, the more process steps -- as the chips get smaller, the number of process steps go up, which require more chemicals, each one of the process steps requires more cleaning, etching, in the manufacturing of the chip, the cleaning and etching of the wafer, so we see good growth there from the number of process steps, shrinkage of the chips as well as the number of chips going up and the end markets for those chips being more diverse than they've ever been before. So we see real good growth, Mike. And it's -- we experienced that in '17, we're projecting that into '18. We look at global silicon volume to give us some guidance, and the projections are 5% to 6% growth of wafer volume going into 2018, which is the numbers we're reflecting in our guidance for 2018 in our business. We'll continue to drive for opportunities to improve the margin inside of that. Some of the -- some products more than others are growing faster than others which may provide us opportunities to provide some price improvement. But that's something we're continually focused on, whether it's operating efficiency or price improvement, to the extent it's appropriate around the globe. As I mentioned earlier, our Singapore investment we expect to yield benefits out in 2019 and beyond as we get that facility built, which will tap us into -- further into the Asian market, which is one of the fastest-growing markets. So we feel good about keeping pace with the global growth and driving for margin improvement as we can through operations as well as pricing.

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

Chris, you mentioned with that NFC acquisition and the expectation that it would contribute about $5 million in EBITDA by 2020, I believe that's the same number that you guys had initially put out there and I was wondering if you've had any change in terms of scope of the capabilities that you're adding there. Is there any optionality around some of those projects to expand them if you see additional opportunities for growth?

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

Sure. Yes, Mike, that's exactly the same number we put out before, we've not modified that. But having said that, as we get further into the project, we are building in some, let's call it, some engineering capabilities to do more. We have not finalized the investment return on those to move them further from just an engineering concept. So we're creating some optionality, and to use your word, some opportunities, to do more than that, which we'll call second or third phase beyond that. Right now, we're not building that into any of our models. But we like the asset, we like the footprint it has, and we're doing the engineering to make sure we keep those doors open to do even more. The Singapore market is a strong one as well as overall Asia. And with the -- this asset just gives us a really nice platform and foundation to do even more. So we hope to, in 6, 12 months from now, be able to give further perspective on what those next steps could be. There's nothing included in our capital plan in 2018 to do anything more than what we've identified here. But hopefully, when we're looking into 2019, we'll have some clarity around some other opportunities that we could talk with much more specifics at that time.

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

Got it. And then on the wood treating business, obviously we've had some hurricanes come through. Just curious for what kind of benefits you're expecting from pole replacement related to the storms that came through. And then also I believe you commented that your expectation was that raw materials were going to be a headwind next year. Just wondering if you can -- can we quantify that? Or give us other details on that.

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

Yes, sure. So Irma and Harvey obviously had large impacts; Irma more so on poles in affecting Florida and Georgia and the storms there related to the impact that it had on utility poles. There was damage done, and poles are being replaced. In fact, there's poles being replaced out in the

Caribbean as well where some of our U.S. treaters ship poles out there. So we are seeing uptick in the first quarter that our first quarter will benefit from it. Depending on the region and the type of wood being treated, that will impact penta, it may impact some of our competitors as well if they have alternative products to use. In the Southeast, penta does compete with CCA and creosote in Texas primarily. So we'll get some of the benefit of that. We won't get all of the benefit of that. In addition, I would point to the West. These fires that are going on in the West, PG&E is a -- uses 100% penta poles because of the Douglas fir that is used in the poles out there. So we're anticipating and seeing some things right now that we'll see some pole replacements going on because of all the fires out West. So that will impact this year somewhat in the first quarter. That is almost ended now at the end of October, but we anticipate that going into the second quarter. As you know, our -- there is seasonality to it. There was some -- we saw a little bit of prebuying in anticipation of some of these storms that helped us in the fourth quarter and were trickled into our first quarter results. But typically, our second quarter is a slower period for us for wood treating, so we'll see how much of a surge we get as we finish out the first quarter. As far as the full year 2018 goes, we've got -- expecting chlorine price increases as well as phenol, which is the key raw materials for our wood -- for our wood treating business, and we anticipate and are seeing already some cost increases there. We have put forth a price increase on penta already, but we expect the cost increases to exceed our price increase here in 2018. So it's a little bit of a headwind. We factor that into our 2018 guidance.

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

And then last question for now is just on the Flowchem business and kind of the outlook for DRAs. You mentioned that your view, at least on the industrial lubricants side, is that CapEx is going to be a good driver. Just wondering if on the DRA side of the business, if existing pipeline converting to DRA is the bigger driver? Or is it that new pipeline CapEx that we need to pay the most attention to? And are there specific regions that you expect to grow faster for that business.

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

Yes. So thanks, Mike. Good question. So DRAs has a lot of applications as you know, so existing pipelines that are trying to move more product through it. So an example of that domestically here is the Permian Basin that continues to see production increasing there. There's an increasing demand to drive the product out of there and get it to the refineries. There are limited capacity for pipelines, takeaway capacity from that region, so we're seeing enhanced DRA consumption in that area in order to expand the takeaway capabilities. There's also, as you can probably read, over the next year to 2 years, there's a number of new pipelines being put in place to help on the takeaway of Permian, for example, and bring the product flowing to the refineries. So we're seeing existing pipelines increasing their demand of DRA. In addition, we're anticipating new pipelines being added as the shift of oil production occurs, whether it's in the U.S. or whether it's happening around the world. The really nice thing about the DRA business, it's really driven by oil demand. And so depending on pricing of oil, it can determine which regions will produce more relative to another. So globally, it's -- 2018, global demand for oil is up and expected to be up. It was up in 2017. So overall, we expect DRA consumption to increase from that perspective. In addition, the -- as I've talked about before, the aging pipelines and the pressure restrictions that are put on some of the older pipelines are also enhancing the use of DRA. So Mike, we see a good balance of new pipelines, older pipelines wanting to reduce pressure, therefore, using DRA; and then, in addition, the increased penetration of DRA around the global pipeline infrastructure that we see continued demand driving in different areas of the world. So again, I -- another good fundamental perspective of our growth going forward in that business, it's solid. We're really pleased with what we've seen so far. Projections for '18 are solid. We've built those into our guidance and continue to be really excited about the Flowchem assets that are now part of KMG, and then what that -- what can then that business can do for us going forward. On the industrial lubricants side, as you mentioned, the capital spending has been good, maintenance spending has been good. We've seen an increase in volume across that business. Oil production again drives drilling, it drives additional valve maintenance. And as people add pipelines as well as the safety regulations go in and around valves and in the pipeline, especially in the U.S., there's more maintenance required on the existing valves. So all good fundamental tailwinds for those businesses going forward.

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**Operator**

(Operator Instructions) And our next question comes from Rosemarie Morbelli of Gabelli & Company.

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

I was wondering, what was the contribution from both Sealweld and Flowchem in both the fourth quarter and the year? Can you pull it out?

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

Yes. So Rosemarie, we're not going to break that out. We've got the segment reporting that has both industrial lubricants and Flowchem in it. Flowchem, as you know, we had it first 6 weeks. Sealweld, we had it for the full quarter. And Sealweld, we had it for the second half of the year. So yes, we don't break out those specifics. But -- let me just say this, both businesses performed at or above expectations, which allowed us to exceed expectations for this fourth quarter. We're really happy with the margin contribution as well as the adjusted EBITDA contribution.

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

So if I look at the Performance Materials, my understanding is that penta has the highest margin. And if we adjust the margin for the fourth quarter for that particular overall business and eliminate the step-up in inventory cost, is that a good overall margin for the whole segment? Or as you get more of the Flowchem business in it, will it be higher or lower? Can you give us a sense?

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

Yes, let me give you some perspective. So Flowchem has a very respectable margin. We had 6 weeks of that business. The contribution from Flowchem will drive our overall margin on that business in 2018 as we have a full -- a benefit of a full quarter and full year going forward. So I think in the past, we have said that we expect, with the contribution of all the businesses, that we'll have a greater than 25% overall company margin from an EBITDA standpoint, from an adjusted EBITDA. And with our guidance that we put out, we're reflecting slightly better than 25% depending on which end of the range you look at. So yes, so you could expect a higher margin in that segment going forward into 2018.

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

Okay. And what was -- what is behind the pickup in penta? Is it already from the hurricanes? Or is it something else, and those hurricanes will come mostly into the first quarter?

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

Yes. So we saw some increased purchasing in our fourth quarter, which we can tie to some prebuying, if you will. And people -- there were treaters anticipating a storm season that we haven't seen in a number of years. There were forecasts for a heavy storm season. So we saw some increased sales that happened in June, more particularly in July, that drove the fourth quarter from a volume standpoint. In addition, if you remember, a year or so ago, some of our -- I made mention of some of our customers reducing some maintenance spending which reduced their pole replacement program. So that's kind of worked its way out. And in the fourth quarter, we saw some increased maintenance spending that reflected in increased penta sales. So a combination of both helped our fourth quarter. But the major impact, to the extent there is some, will be in the first quarter relative to the hurricanes and the storms. And I do expect some to move into the second quarter as well as I talked about from the fires out West. And again, I don't want to build too much of a high expectation on that. I mean, it's -- relatively speaking, when you think of the number of poles in the U.S. and how many really were affected in the storms, it's not a dramatic percentage. However, it has helped our business slightly in the first quarter and we expect slightly in the second quarter. But again, it's not dramatic. And we've -- as we look into our 2018 guidance, we took that into perspective as well as the higher raw material cost. So it's already reflected in our full year guidance.

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

Can you -- I seem to recall that the maintenance program from all of the utilities, especially on the West Coast, were going to generate demand growth of about 10% a year for multiyears. Do I have that number right? Or is it different, and lower?

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

Yes, that's much higher. So I think what we said, Rosemarie, is you could expect 1% to 2% growth per year in our penta business, reflecting pole replacement programs and maintenance of that. And we said from time to time, it could move slightly up or slightly down depending on storms. As you know, in the past several years, there haven't been many storms. We've seen quite a few this year, so you could expect some increase in demand there. But overall, a good number to use is 1% to 2% of demand increase and, therefore, revenue increase for us in the penta business.

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

Okay, that is very helpful. Yes, I didn't think I had it right but -- and still staying on penta, regarding your price increases, do you -- are you going to be able to raise your prices sometime during the year in response to the higher raw material cost or what you have gotten so far is just about it?

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

Yes. So we announced a price increase in the beginning of October that we -- that reflected our -- the cost increases that we're seeing in our raw materials. So we saw a cost increase in the fourth quarter and then moved into the first quarter, and it's continuing. So we put in forth a price increase. I don't want to really comment on future price increases. But what I would say is we have built into our 2018 guidance a continued increasing of raw material costs around chlorine and phenol, to the extent they don't occur and we have slight improvement from where we have guided to.

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

Okay. And lastly if I may, how much more can you get in terms of efficiencies out of your electronics business? And then if you could talk of the potential synergies from the -- from Flowchem and Sealweld potentially?

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

Sure. So as you know, we basically doubled the margins in our EC business over the last several years, and we've done that through a keen focus on operating efficiency, consolidating our operations, as well as some price improvement and driving efficiencies through supply chain. So we've gotten a significant improvement already, it's a continued focus for us. There are still opportunities for us to pursue. It's a never-ending pursuit that we have. And so as we look forward, we do anticipate getting further margin improvements. With regards to Flowchem and Sealweld, when we announced the acquisition, we had said there will be $2 million to $3 million of immediate synergies on an annual basis. So -- and we are getting those. So they'll play out here in 2018 since we, again, just owned the business for just a really short period in 2017. And we expected a $1 million to $2 million of additional synergies operationally that we would get over time. We're optimistic about those, there's no reason to think that we can't. We have been working with the Flowchem team and looking at where those opportunities are and beginning to outline a plan to get those. As far as Sealweld goes, what we had said at Sealweld was that the opportunities were really not much around -- much around operational synergy. We thought maybe $0.5 million. But it was more about bringing those 2 businesses together and the complement that they bring to each other. They have complementary products, complementary customers. Geographically, it was very complementary. So we are really excited about our breadth of product offering across that region. So that's an ongoing process. It's ongoing into 2018 that the team has been working on. We have seen some benefit of that already, but expectations are continued -- continue to be into 2018 and beyond that we'll get those as we look to bring those businesses even closer together. And then I would have to say, as we look at it from an overall pipeline performance business that the benefit of looking across the pipeline and thinking about the value creation with a DRA, with a lubricant or a sealant and maintaining the valve that allow those pipelines to run more efficiently, effectively and more safely, you bring those together, and we're really excited about the complementary aspects of the go-to-market capabilities of those teams. And those -- again, those discussions and plans are being sorted out as we speak, in sharing of information and go-to-market approaches. So those are some of the things we have built into 2018 but also will benefit us even beyond that.

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**Operator**

And we do have a follow-up question from Mike Harrison of Seaport Global Securities.

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

A couple more for you. On the Flowchem business, I know that one of the competitors in that business appears to be adding capacity. Was just wondering if you can comment on whether the Flowchem team had seen any meaningful change in the competitive dynamics in that business, either in the U.S. or abroad?

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

Yes. It's a good question, Mike. So we are not seeing any additional competitive activity, I guess, specifically around that. I mean, it is a market where there's lots of potential growth. I think all of us are looking for opportunities to expand our capacity, to meet the growing demand around the globe. And so I don't want to talk specifically about any one competitor and what their capabilities are, but we're not seeing any increased competitive activity that impacts our plan and our design and our plan for the future. So I think you'll see from time to time, there'll be additional capacity expansions by any one of us to meet the growing demand. It's a great product with great applications where I think the future market is really robust when you think about the potential application for this that we've only begun to scratch the surface on. And when you think about the penetration only being globally, 30%, 35% of all the pipelines that exist today that could get benefit from DRA, and you multiply that out, I mean it's more than almost a tripling of the market size. If those were to play out then, obviously, there's going to be a needed expansion capabilities by the market. So again, nothing specific to talk about. From a competitive standpoint, we're not seeing any additional competitive activity.

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

Okay. And then a couple of housekeeping questions for Marcelino. The corporate expense, it sounded like there was a reclassification, and you're putting more into the segments. So I'm just wondering kind of from the $11 million corporate expense level we saw in fiscal '17, what kind of number should we be modeling for next year?

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

Yes. I think it's probably the same cadence that we had this year in terms of corporate expenses and then overall SG&A. When I -- when we compare this year to last year's, the most variable number has always been stock-based comp, and then we've had some issues in the past regarding external, internal audit. But I think those have -- I think the external, internal audit numbers are starting to normalize. And then the only issue that kind of is a little bit variable is obviously the stock-based compensation and bonus. So very, very similar to this year's cadence.

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

Okay. And then the D&A guidance, $21 million for next year is roughly $5 million a quarter. This quarter was $6.1 million. So was that just accelerating the depreciation that was in there? Help me understand the difference there.

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

Yes, exactly.

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

Okay. And then in terms of the CapEx, you mentioned that the $29 million for next year includes some additional spend in Singapore. How should we think about the normal level of CapEx going forward, including the Flowchem and Sealweld businesses?

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

Yes. So the $29 million that we put out has got about $7 million of the Singapore spending in there, to give you some perspective, and that's part of the benefit we saw in '17 when we -- Marcelino commented, we expected originally $15 million to $16 million, ended up with $13 million. What really has occurred is some of that capital spending that was anticipated to happen in Q4 slid into Q1. That is not because we're not executing on the project, it was more about just timing of invoices and work being done. So that inflated our 2018 number, leading to the $29 million. So if you think of the $7 million coming out of the $29 million, that gets us down to $22 million. We have some growth CapEx in there around -- in Electronic Chemicals, which is around increasing our capabilities in purification, filtration technology in order to keep abreast of the market demands as well as some demand growth. So we're seeing investments in our supply chain and other elements to continue to meet the growing demand that we're seeing. Now we've given a number in the past about maintenance CapEx. So in the past, we've used $8 million to $10 million of standard maintenance CapEx on an annual basis. Now when you add in Sealweld and you add in Flowchem, probably a more prudent number is $10 million to $12 million. But having said that, with the growth projections that we're seeing in the business and anticipate in the outer years and the continued growth in the fundamentals in the business, it would not be appropriate to assume $10 million to $12 million because I think it's our job to find good growth CapEx that has a good return on investment on it. So if you want to utilize the $29 million less $7 million, down to $22 million. But a number kind of in the $20 million to $25 million kind of range would be an appropriate range to use, including growth CapEx and maintenance CapEx on our business going forward. And obviously, if we were to do another phase in Singapore or any major expansion of any one of our facilities, that will be on top of that. But that's a good surrogate to use going forward, Mike.

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

Great. And then last one from me. You had mentioned, with the leverage, you expected to be closer to 5x EBITDA but you were probably out of the M&A market for a while. Now that we're looking at a leverage being more like 3, 3.5x, does that mean you're back in market for bolt-on acquisitions near-term?

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

Yes. Well, so I think what it means is we're going to continue on our strategy around acquisitions. And with a reduced leverage, obviously, that gives us optionality that if we're remaining at 5x that, that wouldn't provide. If I think about our growth strategy around acquisitions and you -- and of what I've spoken about in the past, is our desire to expand our capabilities in Asia for EC. It's to expand our pipeline performance platform, whether it's tuck-ins around lubricants or other additive complementary product or services that can expand on the value-add that we have for those customers is our 2 primary focus going forward. I think adding an additional platform at this point is further down the list. I don't want to say that it's impossible, but it's less of a focus and a priority for us. Obviously, if there's a really tremendous opportunity for us that makes a lot of sense, we'll do what we need to. But having said that, our real focus is around building out the platforms that we have. We think there are plenty of opportunities in there, and we'll remain disciplined, look for those opportunities when they exist. When they meet our criteria, both strategically and financially, we will act upon them. And the fact that we'll now have a lower leverage ratio gives us that optionality that obviously you wouldn't have at 5x. So I'm excited about this shelf takedown and the opportunity that it gives us from a leverage standpoint.

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**Operator**

And our next question comes from Jay Harris of Axiom Capital Management.

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**Jay Richard Harris** - *Axiom Capital Management Inc., Research Division*

I'm wondering if you can give us a little color on, when you've completed this equity financing, what your -- is there going to be a change in your debt structure? And what would be the kind of interest expense that we should expect?

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

Yes, so the -- obviously, we'll have a lower interest expense, and we're not going to get into those specifics. As I mentioned before, we're launching this equity offering of, as I commented before, 2.6 million shares with a follow-on of potentially 390,000 shares. Obviously, depending on the offering price and the net, that will determine what our interest expense is after that. So I think it's more prudent to say let's wait to see what -- how all that plays out, and then we'll -- after possibly when we announce Q1, we'll be able to give a clearer perspective on our interest expense going forward in 2018.

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**Jay Richard Harris** - *Axiom Capital Management Inc., Research Division*

What about the level of interest on the debt? Do you -- can you share -- give us a range of what to expect.

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

When you say level of interest, you mean interest rates or total interest?

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**Jay Richard Harris** - *Axiom Capital Management Inc., Research Division*

Interest rate.

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

Yes. So Marcelino, maybe you want to talk about what our current term loan is?

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

I mean, right now, the -- we have LIBOR plus 4.25%, and that will -- and then within our agreement, we do have some step-downs if we certainly achieve certain leverage ratios, but it's essentially LIBOR plus 4.25%. And as we had previously announced, we did do a -- we did execute a trade effective August 31 on a swap, and so that's going to have -- that will certainly favorably impact if rates go up.

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**Operator**

And I am showing no further questions at this time. I would now like to turn the call back over to Chris Fraser for any further remarks.

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

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

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**Operator**

This does conclude today's program, you may all disconnect. Everyone, have a great day.

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