Hexion Inc(Q2 2018 Earnings)

August 07, 2018

Corporate Speakers:

- John Kompa; Hexion; Investor Relations
- Craig Rogerson, Hexion; Chairman, President, and CEO
- George Knight; Hexion; Executive Vice President and CEO
- Joseph Bevilaqua; Hexion; COO
- Mark Bidstrup; Hexion; Senior Vice President and Treasurer

Participants:

- Nathan Schubert; JP Morgan Chase; Research Analyst
- Roger Spitz; Bank of America, Merrill Lynch; Research Analyst
- James Finnerty; Citigroup Inc; Director of High Yield Research
- Karl Blunden; Goldman Sachs Group Inc.; Senior Analyst
- Brian Lalli, Barclays Bank PLC; Senior Analyst
- Richard Kus, Jefferies LLC; Analyst
- Juliano Torii, Descartes Trading; High Yield and Distressed Analyst

PRESENTATION

Operator: Good day, ladies and gentlemen, and welcome to the Second Quarter 2018 Hexion Earnings Conference Call.

(Operator Instructions)

As a reminder, this call will be recorded. I would now like to turn introduce your host for today's conference, Mr. John Kompa, Investor Relations for Hexion. You may begin.

John Kompa: Thank you, (Catherine). Good morning, and welcome to the Hexion Inc.'s Second Quarter 2018 Conference Call. Leading today's call will be Craig Rogerson, Chairman, President and CEO, George Knight, Executive Vice President and Chief Financial Officer, Joseph Bevilaqua, Chief Operating Officer, and Mark Bidstrup, Senior Vice President and Treasurer.

As a reminder, this call is also being webcast and the slides referenced in today's conference call are available through the hexion.com website, under the Investor Relations section of Hexion Inc. The replay of this call will be available for 1 week, and the replay dial-in information is contained in our latest earnings release.

Before we start, I'd like to read information about forward-looking statements and the use of non-GAAP information as part of this call. As you know, some of our comments today may include statements for our expectations for the future.

Those expectations are subject to known and unknown risks, uncertainties and other factors that may cause the company's actual results and performance to be materially different from any future results or performance suggested by these expectations.

The slide you now see gives you more information on the assumptions and factors we consider in making those forward-looking statements. We can't guarantee the accuracy of any forecast or estimates and we undertake no obligation to update any forward-looking statements during the quarter, except as otherwise required by law.

For more information on our risk factors, please see our earnings press release and our SEC filings. In addition, some of our comments may reference non-GAAP financial measures. A reconciliation of the most directly comparable GAAP financial measure and other associated disclosures are contained in our earnings release and in our website.

Our earnings release and our recent SEC filings are available on the Internet at hexion.com. With that, I'll now turn the call over to Craig Rogerson to discuss our quarterly results.

Craig Rogerson: Thanks, John. Good morning, everyone and thank you for joining our call today. I'm pleased to report another strong quarter and the third consecutive quarter of year-on-year sequential growth in our segment EBITDA, reflecting the hard work of our global teams and solid demand from our diversified customers.

In the second quarter 2018, we drove a strong top line segment EBITDA gains of 9% and 28%, respectively. Strong results in our base epoxy resins and forest products businesses drove year-over-year segment EBITDA gains as well as a positive impact of our recent structural cost reduction initiatives.

Adjusted for the sale of our Additives Technology Group business earlier this year, our segment EBITDA increased year-over-year by 29%. We continue to reduce cost throughout the organization as part of our latest structural savings initiative and are on pace to achieve run rate savings of $53 million in 2018 versus 2017.

Following a strong first-half, our outlook remains positive and we expect the cost-savings, along with the continued strength across the product portfolio, continue to drive strong segment EBITDA growth in 2018.

Turning to Slide 5, I've highlighted several of our growth drivers. First, our next generation waterborne coating system drove solid growth and specialty epoxy business this quarter. As we've talked about on past calls, much of the recent growth is from Chinese regulations mandating the use of waterborne coatings for shipping containers.

We continue to believe that additional regulations will drive new coating applications into other end markets. Our outlook is very positive for waterborne coatings business and we expect to add more capacity in the third quarter this year.

In our Epoxy business, the industry is expected to remain balanced as now known significantly announced plant capacity is expected to come online.

Within the next few years, we see continued strength in ECH and BPA, supporting positive liquid epoxy resin pricing trends. In our forest products business, we continue to see good growth in North America from residential construction as well as in formaldehyde, which goes downstream into our own resins and into customers for a variety of applications.

Our forest products business is well positioned due to operating leverage from our low-cost manufacturing network, strong customer relationships and sustainable product solutions.

We are pleased with the underlying trends in this business in the second quarter of 2018, which included improved volumes in Latin America, solid demand for a variety of products, such as our NDI and BDO, drove steady increases in a global formaldehyde volumes.

Our (battery) integration position also provides a competitive advantage for our resins business. We continue to leverage new capacity and saw volumes increase 7%.

Turning to Slide 6 in our combined raw material index, our total raw material cost were essentially flat on the sequential basis compared to first quarter as raw material stabilized. On a year-to-date basis, we've seen inflation for two of our major raw materials as the average price of methanol and urea increased by 13% and 12%, respectively.

The average price for (phenol) was flat in the first six months of this year versus the prior-year period. We'll continue to closely monitor raw material trends, implement any strategic pricing actions as needed throughout the year. I'll now turn the call over the George Knight to further discuss our financial results.

George Knight: Thank you, Craig. In our Forest Products Resins segment, second quarter 2018 revenues totaled $431 million, a 9% increase from the prior year, reflecting positive price mix of 7%, volume increases of 2% and favorable currency translation of 1%, partially offset by the impact of divestitures.

Revenue increased in all regions where we operate. Segment EBITDA grew by 12% due to higher volumes and cost efficiencies from the new North American formaldehyde facilities. Adjusted for divestitures, segment EBITDA rose 13%.

Turning to the next slide, in our Epoxy, Phenolic and Coating Resins segment, second quarter 2018 revenues totaled $564 million or a 9% increase from the prior year, reflecting positive price mix of 10% and favorable currency translation of 5%, partially offset by volume declines of 6%.

Segment EBITDA improved significantly year-over-year, and totaled $72 million, reflecting a strong increase in base epoxy resins, improved specialty epoxy results supported by continued growth in our waterborne coatings and ongoing improvements in phenolic specialty resins due to higher volumes and cost actions.

Turning to the next slide, we continue to drive our structural costs reduction initiative and realized $25 million in savings in the first half of the year. As of 6/30/18, we had $28 million of in process savings, the majority of which are expected to be realized by year-end 2018, which we expect to further support our improving segment EBITDA margin.

Regarding our balance sheet, we generated $41 million in cash flow from operations in Q2 '18, driven by improved segment EBITDA and networking capital reductions. Our cash plus borrowing availability under our credit facilities was $322 million as of June 30, 2018.

Second quarter liquidity improved sequentially by $40 million and was essentially flat with the prior-year period. In terms of portfolio optimization efforts, we previously announced that we are pursuing the sale of a portion of our Epoxy, Phenolic and Coating Resin segment, and that process is moving forward, although we are not commenting further at this time.

We invested $43 million in capital expenditures in the first 6 months and continue to expect to invest between $80 million to $90 million in 2018. We continue to focus on managing our working capital.

We expect working capital increase only modestly in 2018 as we expect decreases in the second half of the year, consistent with historical trends. I'll now hand the call back to Craig.

Craig Rogerson: Thanks, George. In summary, we are pleased with our strong second quarter results. Our outlook remains positive for the second half of the year, we expect continued gains in our segment EBITDA in 2018 compared to the prior year. Thank you.

John Kompa: Operator, we would now like to open the line for questions.

QUESTIONS AND ANSWERS

Operator: Thank you. Ladies and gentlemen if you have a question at this time, please press the star then the one key on your touchtone telephone. Again, that’s the star then the one key on the touchtone telephone. Our first question comes from Nathan Schubert with JPMorgan. Your line is open.

Nathan Schubert: So just first on base epoxies. It looks like pricing backed up a bit subsequent to quarter end. Can you substantiate that? And kind of just give us an update on where margins are in base relative to the second quarter?

Craig Rogerson: Jody, you'll comment.

Joseph Bevilaqua: This is Jody. Yes. As you know, there's been a tight supply situation in many of the feed stocks that has been favorable for us for the past six or so months, so we've been able to push price a bit better than we did in the prior year.

Nathan Schubert: Okay. And then can you kind of give us an update on wind andproppant, how did they perform in 2Q '18 versus 2Q '17? And if they're down, do you expect them to improve in the back half?

Craig Rogerson: Overall, the amount of gigawatts to be installed in 2018 are disappointing. We thought there was going to be a bit of better demand, particularly in Asia; that's not appearing to come forth so our wind energy business continues to be at roughly the same level as prior year, give or take a bit.

On the proppant side, we've been talking with you all regularly around the shift towards uncoated sand. And we continue to see completion strategies focused around uncoated sand.

So our volume year-over-year is roughly flat, with the exception of Canada, where you probably also see there's been a difficult ability to get gas out of Canada with significant natural gas in the system. So this second quarter didn't have a volume we thought primarily due to our inability to get gas out of Canada.

George Knight: So the positive side relative to Canada, which is a very important market for us, and we do expect that the market data shows an improvement in the second part of 2019, we have maintained our strong leading share there. So we're well-positioned for a rebound when that occurs in '19.

Operator: And our next question comes from Roger Spitz with Bank of America Merrill Lynch.

Roger Spitz: In proppants, maybe bring you a little bit more on the spot, can you say if proppant's EBITDA is still slightly negative as it was last quarter -- you told us, it was last quarter? Was it slightly down from last quarter?

Craig Rogerson: Yes. It continues to be negative.

Roger Spitz: Okay. And you called out formaldehyde strength. It felt like more than Phenolic Resins strength. I guess, when I look at the markets, the Phenolic Resins, always strong, always be prices and demand on the one hand, whereas on formaldehyde, I guess there’s been some NDI industry outages.

Maybe formaldehyde is still doing better as all on the new North America cost plans, the fill out on demand side, maybe the Phenolic Resins might've been doing better than formaldehyde?

Craig Rogerson: No, you had it correct. Overall, the Forest Products is slightly up based on housing starts and remodeling, but it's really been the global disruption within the BDO and NDI market where there -- it's allowed the U.S. producers to run pretty hard in the second quarter, actually back into February's. So just enough to share a volume basis, that's really driving the volume and skewing at the formaldehyde.

George Knight: Yes. I think, last year, we did have some outages in some of our customers. So this year in the quarter, we saw -- actually saw double-digit volume growth in the formaldehyde side.

Roger Spitz: Okay, got it. So it's a year-over-year outages?

Craig Rogerson: Yes.

Roger Spitz: All right, I see. And when you give a sense of whether sales are EBITDA, the split between formaldehyde and resins to give a sense of it, how that might've changed?

Craig Rogerson: I’m sorry Roger, can you repeat the question?

Roger Spitz: Within the segment, that split between sales and/or EBITDA split between formaldehyde and Forest Product resins, just to give a sense of the size of them?

Craig Rogerson: No, we don't break that out.

Roger Spitz: Okay. And then, epoxies volumes are down 6% overall. Can you talk about where you were presumably more down than 6%, since presumably, in specialty epoxies, phenolic specialty resins and perhaps even base epoxies, maybe you were volumes was up.

It sounds like proppants was down, but 6% down was a little surprising given the strength of the business as you were calling out within that segment?

George Knight: Yes, I think Jody talked about some of the softness we saw on the oilfield volumes, especially on the uncoated sand piece, we were down in that segment. We saw growth in our very volumes. Jody spoke about some of the continued weakness we're seeing on the wind side.

So while waterborne volumes were up overall, our specialty epoxy volumes were down year-on-year. We saw strong growth on the resins and formaldehyde side from a volume perspective.

Roger Spitz: And lastly for me, you haven't spoken about Versatic. Can you comment on that business, either how it’s the performance and/or volumes this quarter or this half-year, year-over-year?

Craig Rogerson: Yes, volumes up for Versatic slightly for the quarter there. We continue to see pressure on raw materials on the pricing side, but we have been trying to price and continue to take advantage of where we can on the Versatic side.

Operator: And our next question comes from James Finnerty with Citi.

James Finnerty: Going to the formaldehyde capacity, just can you give us an update in terms of where you are in terms of profitability versus the guidance of the $30 million to $35 million?

Craig Rogerson: Oh, you mean on the new plants?

James Finnerty: Yes, sir.

Craig Rogerson: Yes. Our North American plants were tracking slightly ahead of what we expected there. As we talked about in Brazil, with some of the challenges that we've seen in the economy there, we're behind from where we wanted to be, but we're starting to see the economy pick up there and we expect to start up some of the capacity that we had in Brazil later this year.

From an efficiency standpoint, we have seen some benefits down in Brazil, so we probably gotten about $2 million to $3 million of efficiency savings just from our manufacturing footprint in Brazil resin plants.

James Finnerty: Okay. And in terms of the waterborne coatings where you've seen these great ramp up in volumes, where do you produce that product? Is it produced in Asia? Or is it imported into Asia? Just trying to think of that in terms of tariffs and potential impact.

Craig Rogerson: We produce it in all three regions in the world, and we're putting in new capacity in China as we speak. So in Europe, the U.S. as well as China.

James Finnerty: Great. Thanks. And lastly, one of your competitors on the epoxy side referenced challenging raw material environment in the second half and just sort of guiding to potential margin impacts, how do you think about margins in the base epoxy business in the second half?

Craig Rogerson: Well, I think we're all aware of some of the back-half pressures that appeared to possibly be occurring. We're in a wait-and-see mode right now to see it manifest at the level that it could. But we don't -- in our current plan, we don't foresee significant increases in the back half.

Operator: Our next question comes from Karl Blunden with Goldman Sachs.

Karl Blunden: From a corporate overhead side, it looks to be about up about $6 million year-over-year. Could you comment on what some of those drivers are and whether those are one time in nature?

George Knight: Yes. A lot of the difference is timing just based on things like incentive accruals. That's really the biggest driver of that year-on-year increase.

Karl Blunden: Got you. On epoxy, just on the planned downtime that you have in your plans, could you refresh us on the timing size of that and then your views on overall market supply-demand, I know that one of your competitors had some outage in the first half as planned, but now that capacity is fully back online, what are you observing in terms of supply-demand when you talk to customers?

Craig Rogerson: The demand still continues to be strong and we're very happy with what we see at the customer level, not withstanding tariff impact, which is in everybody's mind. So we continue to see relatively good volumes on a historical basis in the bulk epoxy resin business.

We don't see that really backing off unless something really significant happens to the economy. So our shutdowns are by normal standards, fairly small. We've got a short turnaround in the back half of the year; we had 1 in the front.

So we're on plan but these are -- take less than 18 to 19 days for these, so they're relatively short and we have been building inventory in different parts of the business to be prepared for that this fall.

Karl Blunden: Got you. And you mentioned in the fall, is there any more specific timing than that?

Craig Rogerson: October, November.

Operator: Our next question comes from Brian Lalli with Barclays.

Brian Lalli: Can you hear me?

Craig Rogerson: Yes.

Brian Lalli: Sorry. Maybe first on just the EPCR segment. Quarter-over-quarter, it looks like margins were down a bit. I mean, I think we've touched on a few of these different pieces, but is it fair to say that the epoxy margin with better pricing would've been up and it's just offset by some of the other pieces you talked in proppants and wind, is that the way to think about the 1Q to 2Q sequential move?

Craig Rogerson: Yes, that's right.

Brian Lalli: Okay. And then maybe second on the cost saves. Is it possible to breakout, maybe, George, how much of the $25 million cost saves that you realized year-to-date are actually in the first half EBITDA, just help us maybe model what would be having already been spent but is not yet in our numbers for the second half in addition to what you have left in the other $28 million?

George Knight: Sure. So we saved $25 million in the first half of the year, so those are in our numbers there. From a spend standpoint, we spent about $11 million of onetime cost.

We have about $14 million of cost, mostly related to severance that will be flowing through in the second half of the year, primarily. The $28 million of savings again, the majority of that, we should realize in the second half of the year.

Brian Lalli: Got it. All right, I apologize, I guess, I was in the opinion -- understanding, that the $25 maybe that some of that was maybe achieved by the second quarter, but had not yet formed the numbers but it sounds like that's not the case?

George Knight: No, no those are the numbers, yes.

Brian Lalli: Those are in the numbers? Okay, great. And then, last one from me, more of a housekeeping item, it looks like in the slide, the ABL balance went down the $40 million, but it doesn't appear that there are any material cash flows, outflows relative for that being reduced with the cash payment. Is it possible to walk through kind of what changed relative to the $160 million that you have outstanding last quarter?

George Knight: Yes, I mean, just with cash that was generated last quarter, we paid down the revolver.

Brian Lalli: Yes, I guess, what I'm saying is as we walk through -- for the numbers into our model, the cash flow from the financing was only down like $1 million in the second quarter. So I was wondering what, I guess, offset that $40 million reduction?

George Knight: Okay. We did do a sale leaseback of about $20 million in April. I think we've talked about that in the last call. So that increased the debt. The rest of it would have just been miscellaneous working capital increases in some of our international locations.

Operator: Our next question comes from Richard Kus with Jefferies.

Richard Kus: So first one for me on waterborne coatings, are you guys reaching a point where you end up getting capacity constrained in that business, or can we expect to continue to see that type of growth you've seen so far this year?

Craig Rogerson: I'll let Jody make more specific comments. I made a comment in my remarks that we're planning to add capacity -- additional capacity in the third quarter. Jody mentioned it's in China, that's to relieve that situation you just talked about.

Yes, we're very tight and we need additional capacity to come online. And we'll need more as we phase into '19 and '20 as well. But we're trying to be systematic about adding capacity so we do that as the demand increases, so that we can run near full. So Jody, do you have any other comments?

Joseph Bevilaqua: That's the plan.

Richard Kus: Okay, and how big is the capacity coming on in China?

Craig Rogerson: I'm sorry?

Richard Kus: How much capacity is coming in…

Craig Rogerson: We didn't comment this morning. Large enough to handle the demand for the next 1.5 year to 2 years.

Richard Kus: Okay, very good. And on then on the resin coated proppants side of things, I believe I've heard some rumblings about guys thinking about exiting that business.

Can you comment a little bit on your long-term outlook for that business and whether or not you think that, that thing can rebound to levels where it's actually contributing meaningfully and profitability again?

Craig Rogerson: I think overall, resin coated proppants is been marginalized into really a completion strategy around the wellbore and multistage fracking. We don't believe that our plan is going to rebound of the levels needed to pre-drop to 14 or 13. It's a new level, and that's significantly lower.

So as you all know, we've been closing plants by many of our competitors as the activity kinds of shifts around, we've been putting that bulk of our activity around the mobile coating unit that we've announced, and we see a fair competition for the use of that, the structure around that, but we believe that resin coating is going to be a significantly lower than historical and not rebounding.

Operator^ Our next question comes from Juliano Torii with Descartes.

Juliano Torii: I think that one of the previous questions raised the fact -- the risk of tariffs for some of the segments of your business. So just maybe, if you could help us understand, if you haven't done before, is what kind of exports and imports flows does it come from into China into other geographies for your business?

Craig Rogerson: Maybe Jody or George can give you more specifics again, but generally, one of the advantages that we have is as specialty chemical producer, we tend to produce and source raw materials in those markets that we serve.

So, as Jody is talking about waterborne as an example, we produce in all the three major geographies, so in China, in Europe and in North America. And so we have some ability to move the sourcing around the grid to try to mitigate the effects of tariffs.

Clearly, as they expand potentially, and our customers are impacted, that can have same impact on us but we're flexible enough that we can mitigate, at least, with the current expectations of the list that we've seen, mitigate the vast majority impact on that by, again, using our grid effectively.

Juliano Torii: Okay, right. Can I ask another question?

Craig Rogerson: Sure, sure.

Juliano Torii: Okay. So when you mentioned adjustment for disposals, you are taking just $1 million out of your EBITDA. Just trying to understand because you sold the unit for $49 million during the year, and I was wondering why this adjustment for disposal includes in your EBITDA, maybe in your other revenue segment or CapEx?

George Knight: Yes. So as we disclosed last quarter, we sold our ADG business. The impact -- the quarterly impact was about $1 million or $2 million each quarter. So that's where -- for comparative purposes, we take it out when we do our comparisons.

Craig Rogerson: That's the difference between 28% and 29% as far as the improvement, with or without that.

Operator: (Operator Instructions). And we have a question from (Inaudible) with Cyrus Capital.

Unidentified Analyst: On the forest product business give a little bit more detail around the EBITDA growth. I know you mentioned customers had outages last year, so that explains some of it, but as the new level of EBITDA relative to history, and I'm just wondering how much of it is, I guess, one-time price versus raw?

And how much of it is sustainable in your run rate going forward because of your new plants and so forth that we can expect to see reoccur in future quarters?

Craig Rogerson: There's no one timers in the quarter for Forest Products. In the formaldehyde business, as I mentioned, is strong. We see some upside as we restart some of the facilities -- the newer facilities in Brazil in that business, so we did see some improvement of the Brazilian economy and we expected that in earnings but there's nothing special in 2018.

As mentioned, there were some outages in '17, but from a baseline perspective, nothing unusual in the second quarter.

George Knight: As Jody talked about, housing starts are continuing to drive volume growth in our North American residence business; again, nothing unusual there. Yes.

Operator: And I'm showing no further questions at this time. I would like to turn it back to Craig Rogerson for any closing remarks.

Craig Rogerson: I just want to thank everybody for taking the time this morning. I know it's early, and again, thanks for your interest in Hexion. We look forward to reporting for the third quarter results. So thank you very much.

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