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# EDITED TRANSCRIPT

Q3 2018 Hexion Inc Earnings Call

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## CORPORATE PARTICIPANTS

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**George F. Knight** *Hexion Inc. - Executive VP, CFO & Director*  
**John Kompa** *Hexion Inc. - VP of IR & Public Affairs*  
**Joseph P. Bevilaqua** *Hexion Inc. - Executive VP & COO*

## CONFERENCE CALL PARTICIPANTS

**Andrew Sherman**  
**Brian J Lalli** *Barclays Bank PLC, Research Division - Director & Senior Analyst*  
**James Peter Finnerty** *Citigroup Inc, Research Division - Director*  
**Juliano Torii**  
**Nathan Edward Schubert** *JP Morgan Chase & Co, Research Division - Research Analyst*  
**Roger Neil Spitz** *BofA Merrill Lynch, Research Division - Director and High Yield Research Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2018 Hexion Inc. Earnings Conference Call. (Operator Instructions)

As a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference, Mr. John Kompa, Investor Relations with Hexion. Sir, you may begin.

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### **John Kompa** *Hexion Inc. - VP of IR & Public Affairs*

Thank you, Lauren. Good morning, and welcome to the Hexion Inc. Third 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, Hexion Inc.

A 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 about our expectations for the future. Those expectations are subject to known and unknown risk, 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 forward-looking statements 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 most directly comparable GAAP financial measure and other associated disclosures are contained in our earnings release and on 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.

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### **Craig A. Rogerson** *Hexion Inc. - Chairman, President & CEO*

Thanks, John. Good morning, everyone, and thank you for joining our call today. I'm pleased to report that our positive momentum continued in the third quarter of 2018 as we posted our fourth consecutive quarter of year-over-year segment EBITDA growth. In the third quarter of 2018, we drove strong top line and segment EBITDA gains of 4% and 33%, respectively. Strong results in the phenolic



specialty resins, global forest products and base epoxy resins, primarily drove our year-over-year segment EBITDA gains. Third quarter results also reflect the positive impact of our recent structural cost reduction initiatives. When adjusted for the sale of our Additives Technology Group business in January, segment EBITDA increased by 35%. As part of our latest structural saving initiative, we continue to reduce costs throughout the organization. We remain on pace to achieve run rate savings of \$53 million in 2018 versus 2017. Our outlook remains positive, and we continue to expect solid demand in our global forest products business, and ongoing strength in market fundamentals in basic epoxy resins, which are expected to persist for the foreseeable future. These trends and our productivity at (inaudible) support strong EBITDA growth in 2018.

Turning to Slide 5. I've highlighted 2 key specialty product lines. First, our next-generation waterborne coating systems drove solid year-to-date growth as we benefited from Chinese regulations mandating the use of waterborne coatings in shipping containers. We continue to believe that additional regulations will eventually drive new coating applications in other end markets. We successfully brought on additional capacity during the quarter to serve our customers. In our forest products business, we continue to see volume growth in the third quarter, particularly in North America and Latin America as our formaldehyde volumes increased by about 6%. Continue to leverage our new capacity to meet customer demand for a variety of products, such as our MDI and BDO, which have driven steady increases in our global formaldehyde and resins volume.

Now turning to Slide 6. We continue to maintain a steady focus on our research and development initiatives and strategically invest in our network. I'm pleased to announce today that we are building a new application development setup in Shanghai to strengthen our presence in the Asia-Pacific region. We expect to occupy this space in the second half of 2019. The new site is intended to support product development and customer responsiveness to drive growth in waterborne coatings and other specialty epoxy applications. Developing strategic partners like the one we've just renewed with the Fraunhofer Project Center is part of our innovative approach towards new product development. This particular partnership is focused on developing lightweight composite technologies and high-performing systems designed to meet the demand of mass-produced automobiles. These materials and technologies enable automakers to fabricate lighter-weight, higher-strength parts, reducing overall vehicle weight and improving gas mileage and performance. We've been partners since 2013 and are pleased to renew our agreement. With key innovation centers spread across the globe and strategic partnerships in place, approximately 20% of our sales were from new products developed over the last 5 years.

Turning to Slide 7 and our combined raw material index. Our total raw material costs increased approximately 3% on a sequential basis compared to the second quarter. On a year-to-date basis, we've seen inflation of our major raw materials as the average price for phenol, methanol and urea increased 3%, 19%, and 19%, respectively, in the first 9 months of 2018 versus the prior year period. We'll continue to closely monitor raw material trends and implement any strategic pricing actions as needed throughout the year.

I'll now turn the call over to George Knight to further discuss our financial results. George?

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**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Thank you, Craig. In our Forest Products Resins segment, third quarter 2018 revenue totaled \$431 million, a 12% increase from the prior year, reflecting positive price mix of 16% and volume increases of 1%, partially offset by the negative currency translation of 4% and the impact of dispositions. Segment EBITDA grew by 15%, reflecting higher volumes in the Americas and cost efficiencies from our new formaldehyde facilities. Adjusted for divestitures, segment EBITDA rose 17%.

Turning to the next slide. In our Epoxy, Phenolic and Coating Resins segment, third quarter 2018 revenue totaled \$521 million, a slight decrease from the prior year, reflecting positive price mix of 12%, offset by volume declines of 12% and negative currency translation of 1%. Segment EBITDA improved significantly year-over-year and totaled \$67 million, primarily reflecting higher margins in our base epoxy resins and phenolic specialty resins as well as the positive impact of our cost actions.

Turning to the next slide, we continue to drive our structural cost reduction initiatives and realized \$37 million in savings in the first 9 months of the year. The majority of the savings are expected to be realized by year-end 2018, which we expect to further support our improving segment EBITDA margins.

Regarding our balance sheet, our year-to-date cash flow from operations improved by \$156 million compared to the prior year. Our cash

plus borrowing availability under our credit facilities was \$306 million as of September 30, 2018. Third quarter liquidity was essentially flat from the third quarter of 2017. In terms of portfolio optimization efforts, we previously announced that we were pursuing the sale of a portion of our Epoxy, Phenolic and Coating Resins segment, and that process is moving forward. The company continues to evaluate its options and review potential transactions to maximize value creation although we are not commenting further at this time. We invested \$62 million in capital expenditures in the first 9 months and continue to expect to invest between \$80 million to \$90 million in 2018. We continue to focus on managing our working capital, which remains a modest 12% of total sales. We expect working capital to increase only modestly in 2018 as we expect additional decreases in the fourth quarter, consistent with historical trends.

I'll now turn the call back to Craig.

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**Craig A. Rogerson *Hexion Inc. - Chairman, President & CEO***

Thanks, George. In summary, we are pleased with our strong third quarter results. Our outlook remains positive for the fourth quarter, and we expect continued gains in our segment EBITDA in 2018 compared to the prior year.

Operator, that concludes our prepared remarks. We'd now like to open the line for questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question comes from Nate Schubert with JP Morgan.

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**Nathan Edward Schubert *JP Morgan Chase & Co, Research Division - Research Analyst***

Just first, can you elaborate a bit more on the China win guidance. It's my understanding that business peaked in 2016. Now where are you at right now relative to then? And then where do you expect to be in 2019?

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**Joseph P. Bevilaqua *Hexion Inc. - Executive VP & COO***

Yes, this is Jody. Yes, we have a loss of better share in -- primarily in China. Our market shares in the rest of the world remain as they have been. It's a very competitive market in Asia. And we believe we'll regain the position in 2019 from where we were. We'll be a bit more aggressing on the pricing piece. As you know, raw materials were fairly buoyant this past year, and we were pretty close to the pricing side. So we expect that to improve in 2019.

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**Nathan Edward Schubert *JP Morgan Chase & Co, Research Division - Research Analyst***

Okay. And then just on overall China exposure. Just what portion of your China sales are affected by exports?

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**Joseph P. Bevilaqua *Hexion Inc. - Executive VP & COO***

Very little. I think if you look at the -- specifically the tariffs, as we've reported to you before, we've added a number of facilities and total arrangements in China. And we were able to really minimize any impact of the tariffs at this point in the process.

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**Operator**

And our next question comes from Roger Spitz with Bank of America.

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**Roger Neil Spitz *BofA Merrill Lynch, Research Division - Director and High Yield Research Analyst***

In base epoxies in Q3 '18, can you give a sense -- I know you don't want to give the EBITDA, but can you give a sense of -- sort of where you are versus the last peak and trough. I mean, are we halfway up? 3 quarters of the way up? Is there any -- thinking you can provide...

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**Craig A. Rogerson *Hexion Inc. - Chairman, President & CEO***

You're right. We don't give numbers. The -- we reported 2017 was a significant improvement over a bad 2016. We've continued to see improvement in 2018. So we're not at that top level, but we are closer than we've been in a long time and see -- and continue to see strength. So clearly, the base epoxy resin business has been a part of the -- a significant part of the improvement year-over-year in our overall performance.



**Roger Neil Spitz BofA Merrill Lynch, Research Division - Director and High Yield Research Analyst**

Would it be fair to say base epoxies EBITDA in Q3 was up sequentially from Q2?

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

Yes.

**Roger Neil Spitz BofA Merrill Lynch, Research Division - Director and High Yield Research Analyst**

And proppants. Was that -- is that breakeven or slightly negative in Q3? Or can you give some sense there?

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

It's -- Q3 '18 was slightly better than Q3 '17.

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Still negative.

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

Still negative, and still -- we're still working to get that closer to where it needs to be, not to where it was at one point, but we've got some good technologies that we're banking on going forward, both (inaudible) that we've talked about in the prop shield product line that we've talked about. And so we're starting to get in a position where through cost reduction and kind of maximizing our overall capabilities and technologies to get where we can do no harm until we see some of the benefits that we've got kind of baked in going forward. So we still have some hope for that business and well know that it will be back to where it was in its heyday but just because of changes in the overall technology used in that marketplace, but we think it can be valuable contributor, and we're seeing quarter-over-quarter and sequential improvements.

**Roger Neil Spitz BofA Merrill Lynch, Research Division - Director and High Yield Research Analyst**

And lastly, the forest products division. The increase in the EBITDA. I mean, prices -- raw materials probably pushed a lot of their pricing. And then you had some cost savings you talked about in North American formaldehyde. Is that the greatest increase -- explaining the increase of the \$10 million year-over-year increase was the cost efficiencies as well as some buying gains? And I guess, I'm trying to get at is it mainly in formaldehyde? Or is it also some benefit in the forest products part of that division?

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

It's both. It's both. Formaldehyde is doing better, and forest products is doing better as well. You talked about little bit of volume. These housing starts are up a little bit. Again, if you look, we're on that positive trend, and we expect to see more of that in 2019. 2019, we would expect some new products to start contributing that we've been developing and introducing in 2018, should be more of a contributor to 2019. So we expect further gains on that business as we go forward as well. But it's both sides. Both the forest products, the resins business and the formaldehyde side.

**Operator**

And our next question comes from James Finnerty with Citi.

**James Peter Finnerty Citigroup Inc, Research Division - Director**

On the new formaldehyde capacity, just looking for an update in terms of how far you've gotten to your \$30 million to \$35 million guidance for those 3 new facilities.

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

George want to do that one?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, the North American formaldehyde plants are exceeding our initial estimates there. And Latin America, we're seeing -- starting to see slight benefits, but we're not at the \$10 million to \$11 million level that we expected from Latin America yet. But it is starting to contribute, and we expect that to continue into 2019.



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**James Peter Finnerty Citigroup Inc, Research Division - Director**

So single-digit EBITDA for the facility down there? Would be then safe to say on LTM basis?

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**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, yes.

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**James Peter Finnerty Citigroup Inc, Research Division - Director**

Okay, great. And then on the Epoxy, Phenolic and Coating Resins segment. Volume decline of 12%. You highlighted proppants in China. Which one is the bigger contributor to the volume decline?

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**Joseph P. Bevilaqua Hexion Inc. - Executive VP & COO**

Proppants.

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**James Peter Finnerty Citigroup Inc, Research Division - Director**

Proppants, great. And lastly, on the working capital front. I'm not sure if you touched on it. I know in the slides you expect a fourth quarter seasonal decline. What would that mean for like a -- on a year-over-year basis to full year? Is it going to be a slight increase in working capital versus the last year?

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**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, we expect working capital to be slightly up for the year compared to last year, really driven by our growth and rising raw material prices.

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**Operator**

(Operator Instructions) And our next question comes from Juliano Torii with Descartes.

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**Juliano Torii**

Well, I was just wondering if you could give a bit of an update on the oil field proppants business in terms of the plans of the company for that business considering that since they remain weak -- that would be my first question.

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**Joseph P. Bevilaqua Hexion Inc. - Executive VP & COO**

I'm not sure I understood all the question, but our proppants, large number of our facilities have been closed. We've been public in those closures, and we're operating out of a couple of facilities on skeleton crews as Craig indicated, looking for technology change to go back to resin coat, but it's pretty obvious that they're doing quite well in the U.S. shell fracking area without resin coated proppants, and that's going to have an impact for some time.

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**Juliano Torii**

Okay, sounds good. Second question that I have is could you please remind me of and also give an update on your restructuring charge that you expect for the year for your cost savings? And also if you have any views on what you expect for next year?

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**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, the restructuring actions have all been taken for 2018. We expect to see about \$17 million of additional savings rolled through, majority of which will hit in 2018. We've got still onetime costs related to severance and some costs related to shutting down a portion of our manufacturing facility, and that totals about \$18 million. It will be paid over the rest of '18 and the beginning of 2019.

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**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

Relative to future restructurings or cost savings initiatives, we will continue to look at ways to be more efficient and more effective. And so as we go through our planning processes, both from a business process perspective and our operating processes, we're always looking at opportunities. So could there be more restructuring in 2019? Could be. And again, it will be dependent on how these evaluation studies go.

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**Operator**

Our next question comes from Brian Lalli with Barclays.

**Brian J Lalli Barclays Bank PLC, Research Division - Director & Senior Analyst**

Most of my questions have been asked. So just maybe a housekeeping. Could -- In addition to the last question around some of the restructuring expenses, could you remind us, I guess, for this year and also next year pension and environmental, some of the other cash flow items just to make sure we have our models in the right spot?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, I mean, our pension and environmental costs are pretty negligible for company our size. On the environmental side, we have remediation costs, \$5 million to \$10 million per year. On the pension side, we have no required contributions in the U.S, either this year or next year. Our pension contributions mostly relate to international plans. And that's about \$15 million of cash spend per year.

**Brian J Lalli Barclays Bank PLC, Research Division - Director & Senior Analyst**

Okay, cool. That's helpful. And then my second one. Is there anything is different or is it similar to last year in terms of seasonality in the fourth quarter? Again, just sort of directionally I want to make sure we're thinking about volumes the right way as we move into the end of the year?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, we'll see the normal seasonality. The other thing that we had this year is we had a large shutdown in our Deer Park facility that we do, fairly large shutdown, every couple of years. So that was in October and the beginning of November. So that's going to impact when you look year-to-year as far as the results.

**Operator**

And our next question is a follow-up from Nate Schubert with JP Morgan.

**Nathan Edward Schubert JP Morgan Chase & Co, Research Division - Research Analyst**

Just a quick question on the intercompany note. Is that collateral for the first lien bonds?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

I'm sorry, Nate. It was -- can you repeat the question?

**Nathan Edward Schubert JP Morgan Chase & Co, Research Division - Research Analyst**

The interco note from the COOP. Is that a -- is that collateral for the -- the first liens?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, I mean, that would be governed by our indentures and the same priority that you would see on the rest of our assets.

**Nathan Edward Schubert JP Morgan Chase & Co, Research Division - Research Analyst**

So in the event of an asset sale, would repayment of that interco note satisfy your asset sale covenant? Or would that not?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

We're not going to comment on actual interpretation of the indentures today.

**Operator**

Our next question is from Andrew Sherman with Latigo.

**Andrew Sherman**

I understand you guys don't want to comment any further on potential asset sale. But was hoping if you'd give a little bit of color around refinancing opportunities given significant maturities coming up in early 2020. To the effect you're not able to sell any assets in this environment, would love to hear what your plan B sounds like?



**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, I mean, our strategy is to continue to move forward with the asset sales as far as any other type of refinancing, really depend on market conditions and the results of our asset sales.

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

I think the only other thing I'd add to that is clearly, continuing to drive improved earnings performance is going to be critical relative to the -- any kind of -- whether we sell or not, any kind of refining we do or restructuring our debt. So continued focus on -- and continued improvement in earnings is critical as we look at our actions going forward in addition to the continued push on the asset sale side.

**Andrew Sherman**

Understood. And in terms of timing given that those maturities come up, they begin really in early 2020, can you give us some sense for what your time frame is for coming either to the market or to the bondholders?

**George F. Knight Hexion Inc. - Executive VP, CFO & Director**

Yes, we can't comment on that right now.

**Operator**

And I'm not showing any further questions at this time. I would now like to turn the call back over to Mr. Craig Rogerson, Chairman, President and CEO, for closing remarks.

**Craig A. Rogerson Hexion Inc. - Chairman, President & CEO**

I appreciate everybody's attention and everybody's interest in the company, and we look forward to reporting our fourth quarter and full year results in the spring. So thank you, everybody, and we'll talk soon.

**Operator**

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

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