Hexion Inc. Q1 2017 Earnings Call
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Corporate Speakers

- John Kompa; Hexion Inc.; VP, IR and Public Affairs
- Craig Morrison; Hexion Inc.; Chairman, President, and CEO
- George Knight; Hexion Inc.; EVP, CFO

Participants

- Tarek Hamid; JP Morgan; Analyst
- Chris Ryan; Bank of America Merrill Lynch; Analyst
- James Finnerty; Citigroup; Analyst
- Richard Kus; Jefferies; Analyst
- Tim Raeke; Alcentra; Analyst

PRESENTATION

Operator^ Good day, ladies and gentlemen, and welcome to Hexion Inc.'s first quarter 2017 earnings call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the call over to your host for today's conference, Mr. John Kompa, Investor Relations for Hexion. You may begin, sir.

John Kompa^ Thank you, Demetrius. Good morning, and welcome to the Hexion Inc. first quarter 2017 conference call. Leading today's call will be Craig Morrison, Chairman, President, and CEO; George Knight, Executive Vice President and Chief Financial 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. A replay of this call will be available for one week and a 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 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 our website. Our earnings release and our recent SEC filings are also available on the Internet at Hexion.com.

With that, I'll now turn the call over to Craig Morrison to discuss our financial results.

Craig Morrison^ Thanks, John. And turning to page 4, in the first quarter of 2017, we achieved revenue and volume gains of 6% and 8% adjusted for divestitures in the prior year. Due to the significant headwinds of raw material inflation, and the temporary destocking and volatility of the year-over-year results for specialty epoxy, our first quarter 2017 EBITDA declined 11%. Excluding specialty epoxy, the remaining portfolio of segment EBITDA grew 13% on a year-over-year basis. The lead lag impact from raw material and inflation, which we would expect to recover going forward, also negatively impacted our results by $5 million.

We also recently amended our ABL credit facility and refinanced our senior secured notes due 2018. As part of our cost saving initiatives, we continue to implement our chief operating officer structure designed to optimize our organizational efficiency. We are currently working to achieve $20 million of in-process cost savings, the majority of which we expect to achieve this year.

First quarter earnings reflected modest year-over-year improvement in our oilfield proppants in our [Berry] businesses. Our recently completed formaldehyde plants continued to perform well they contributed $4 million in EBITDA in the first quarter of 2017 and $12 million over the last 12 months. We remain on track to deliver approximately $30 million to $35 million in run rate EBITDA over the next few years representing significant upside opportunity.

Turning to slide 5. You can see an overview of our first quarter 2017 results. Reported revenue decreased 4% year-over-year to $870 million primarily reflecting the impact of divestitures. Adjusted for the impact of recent divestitures, revenue increased 6% year-over-year. Hexion posted a net loss of $42 million compared to a net loss of $44 million in the prior year. Reported segment EBITDA decreased 22% to $95 million primarily reflecting the impact of divestitures and the softening specialty epoxy market. When adjusted for the impact of our recent divestitures, segment EBITDA decreased 11% year-over-year.

Turning to slide 6 and our combined raw material index. Our total raw material cost increased 18% on a sequential basis. When considering our three major raw materials, the average price for phenol, methanol, and urea increased 30%, 65%, and 8%

respectively. This inflationary trend played significant pressure on our first quarter results, much of which we anticipate recovering over the remaining three quarters.

Turning to slide 7. We remain focused on achieving $20 million of in process structural cost savings. In the first quarter of 2017, we achieved $8 million of savings and identified another $4 million of manufacturing savings. As previously announced, the closure of our Norco site occurred in mid-2016, and we achieved $18 million of the $20 million incremental savings. In addition, our good optimization efforts for our German phenolic specialty resins business and specific SG&A actions related to our new chief operating officer structure are ongoing. You can see the projected splits for the balance of our in-process cost savings, and the majority of the savings are expected to be achieved in 2017. Our new North American formaldehyde plants continue to ramp up and a majority of the new capacity is contractually committed. First quarter volumes rose 22%, and we expect the new sites to continue to be strong contributors to the overall segment performance going forward.

Turning to slide 8. We've highlighted two of our key businesses, base epoxy resin and oilfield proppants, that are continuing to gradually recover. In our [Berry] business, expected improvement in the industry fundamentals over the next several years drives a positive outlook for profitability going forward. The structural savings from our Norco closure also supports continued earnings improvement in fiscal year 2017 and beyond. In the first quarter, we saw a significant year-over-year increase in [Berry] profitability driven by strong cost controls and gradually improving demand. Volumes increased approximately 15% on a sequential basis.

Turning to our oilfield proppants business. We continue to benefit from our market leading position where we hold the number one position in Canada and the number two position in the U.S. With a diversified portfolio and proprietary technology, we are well-positioned to take advantage of the cyclical recovery in oil and natural gas market. Finally, we benefited in the first quarter from a greater than 5% improvement in volumes on a year-over-year basis. Resin-coated proppants increased 33% as we exited the raw sand market since we are not a producer of that material.

Let me now turn the call over to George Knight to further discuss our financial results.

George Knight^ Thank you, Craig. Turning to page 10. In our Forest Product Resins segment, first quarter 2017 revenue totaled $378 million, a 13% increase from the prior year, reflecting higher volumes of 8% and positive price mix of 2%, and currency translation of 3%. Segment EBITDA increased by 9% due to higher segment volumes, cost efficiencies from the North American formaldehyde facilities, an improvement in our Latin American business. Margins were negatively impacted primarily due to the negative lag impact, which we are working to recover.

Turning to the next slide. In our Epoxy, Phenolic and Coating Resins segment, first quarter 2017 revenue totaled $490 million or a 14% decrease from the prior year, due to a 15% impact from our divestitures and negative currency translation of 1% partially offset by volume gains of 1% and positive price/mix of 1%. Adjusted for divestitures, revenue increased 1% year-over-year.

Segment EBITDA results decreased by $31 million compared to the prior year. Adjusted for divestitures, segment EBITDA declined by $16 million, reflecting destocking in specialty epoxy resins primarily from our China wind energy business and the negative lead lag from higher raw materials. Improved results in our oilfield proppants and base epoxy resins businesses partially offset the decline. Segment EBITDA margins declined due to product mix and lead lag.

Regarding our balance sheet, our cash plus borrowing availability under our credit facilities was $362 million at the end of the first quarter. We invested $30 million in capital expenditures in the first quarter of 2017, and continue to expect to invest between $100 million to $110 million for the full year. We continue to focus on appropriately managing our working capital. In the first quarter, we saw the normal seasonal increase from increased volumes as well as the impact from rising raw material prices. Net working capital remains a modest 13% of sales.

As Craig mentioned, we were pleased to successfully address our 2018 maturities. We issued $710 million of debt in February of 2017, and the proceeds, together with cash on hand were used to repay all of our outstanding 8.875% senior secured notes. We also satisfied the conditions to extend the revolving facility commitments under the ABL facility until 2020. We now have no material debt maturities before 2020 and our weighted average maturity of four years.

I'll now turn the call back to Craig.

Craig Morrison^ Thanks, George. We'll go ahead and open it up to any questions, operator, that may be on the line.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) And our first question comes from Tarek Hamid of JP Morgan.

Tarek Hamid^ I just want to, first, to start off just on the China wind energy business, can you maybe just talk a little bit about that destocking cycle. Are you kind of seeing a destocking cycle end, kind of any signs of green shoots yet? Sort of how do you think that's going to play out?

Craig Morrison^ Yes. That was something we had talked about in previous quarters that we anticipated in occurring through the first half of this year and it has occurred. I was in China last week, and its really being driven by demand capacity utilization. And as that has not reached the level that's targeted by the Chinese government, they are slowing down on the build of any new blades which they do periodically. We would anticipate that, that would continue to occur through the first half of the year. And you will see an adjustment towards the back half of the year as it starts to go back towards -- more towards growth. But we think it's more than a single quarter. I would say it might even extend through the third quarter, but it's always difficult to tell because if they can turn the faucet on fairly quickly.

Tarek Hamid^ Got it. And then on your, I think you said, resin-coated proppants volumes were up 33% year-over-year. Did I hear that correctly?

Craig Morrison^ Yes, the 5% reflected, we, in prior year, had uncoated sand sales as well, which we don't produce. But a major customer asked for us to be able to leverage our transload capability, et cetera. So when you look at actual resin-coated proppant, it was up 33%.

Tarek Hamid^ Got it. And then kind of any color on sort of what you are seeing in the second quarter continuation of that trend?

Craig Morrison^ Yes, I mean we think the market certainly is not -- on a relevant basis, obviously, those numbers are impressive, but all of us follow the oil market and it's certainly not a robust market as you see it bouncing around in the 40s to 50s on oil. And you see fits and starts in different basins. So I'd say, overall, it's improving. We believe that it would continue to improve, but I wouldn't call it robust market yet.

Tarek Hamid^ Got it. And just one last one from me. You announced a number of public price increases, I think, particularly in Europe, on the epoxy side. Kind of any color on how those price increases are going to expect to realize most of them during the second quarter? Or do you think there will be some lag into 3Q?

Craig Morrison^ Yes, those are going well, and we think those will largely be seen in the second quarter and moving into the third quarter. And so it weren't main drivers obviously in the first quarter but we do think you will see it in the second and third quarter.

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

Chris Ryan^ Hi, yes, this is Chris Ryan on for Roger, thank you for taking my questions. First question, qualitatively, how much did base epoxy's EBITDA do versus Q1 2016 and also versus Q4 2016? And how much of that was Norco epi shutdown versus underlying?

Craig Morrison^ It was a strong double digit relative to prior year. I should say double digit growth in the teens prior to prior year and very significantly versus prior quarter which has a turnaround so that's not unusual. Fourth quarter normally is heavily impacted by manufacturing costs. So very strong growth versus prior quarter and up nicely versus prior year. I'm sorry the second part of your question, Chris, was?

Chris Ryan^ If you just give how much generally was part of the Norco shutdown versus underlying growth?

Craig Morrison^ I would call it roughly 50/50.

Chris Ryan^ Okay. And did -- do you see epoxy margins get temporarily squeezed on the pass-through of higher raw material costs in Q1 ’17?

Craig Morrison^ Did base epoxy margins get squeezed?

Chris Ryan^ Right.

Craig Morrison^ No, I mean not the base because we generally had the increased prices going through. It affected specialty epoxy margins being squeezed, that's why I was kind of pausing because the base epoxy goes down stream into specialty, and there we felt the pressure, not so much at base epoxy.

Chris Ryan^ Got it. And did Versatic Acids and Derivatives margins get temporarily squeezed in the pass-through of higher raw material costs in Q1 2017?

Craig Morrison^ A minor impact but overall very strong quarter for them.

Operator^ And your next question comes from James Finnerty with Citi.

James Finnerty^ On the note that you made, the ex-specialty epoxy segment EBITDA would have increased 13% year-over-year. So doing the math, does that imply that this $25 million approximate hit from specialty epoxy when you think about it?

Craig Morrison^ On a year-over-year basis, no, but it is -- it wasn’t exactly that amount. It was less but it was significant obviously.

James Finnerty^ Okay. And then on the base epoxy, you said that there was -- the margin squeezed in the first quarter because prices went up. So that’s not contract pricing, that is just you raising pricing and actually having success in doing that in the first quarter?

Craig Morrison^ Yes.

James Finnerty^ And then on the proppant business, you said that there were some improvements there, I think, quarter-over-quarter or was it year-over-year?

Craig Morrison^ That was year-over-year. The volume growth on resin-coated was the year-over-year number.

James Finnerty^ Okay. And now -- was it profitable in the first quarter or is it still in the red?

Craig Morrison^ Yes, we don’t comment about the specific profitability. Overall, our overall oilfield businesses are profitable.

James Finnerty^ Okay.

Craig Morrison^ So we have other product lines like Triazines, et cetera.

James Finnerty^ And then on the volume on slide 8, just to make sure I understood it, that’s your volume of proppants that you are showing and included sand. But when excluding sand, your resin-coated business volumes were up 33%.

Craig Morrison^ Correct. That's correct.

Operator^ And our next question comes from Richard Kus with Jefferies.

Richard Kus^ Hey, guys, most of my questions have been answered but just on the epoxies business, specific to the base epoxy side, have you seen a reduction in competitive activity there that’s allowed you to successfully push through these price increases or how would you characterize the competitive conditions there?

Craig Morrison^ Yes, the place we have seen a change in the dynamics is coming out of Asia, where there has been less product. Some of it is due to plant shutdowns, some of it is just due to the pricing dynamics, and the lack of profitability we believe there. So, yes, the competitor dynamics have improved.

Richard Kus^ I see.

Craig Morrison^ And the biggest impact was in Europe.

Richard Kus^ Got it. Okay. And then just in terms of cash flow, are you still expecting an increase in networking capital for the year?

George Knight^ Yes, a slight increase. What you will see is, you know, similar to what we’ve had in prior years where we are using working capital in the first half, it becomes an inflow in the second half. And for the year, we expect a slight increase in working capital.

Operator^ (Operator Instructions). And our next question, we have a follow-up from Roger Spitz of Banc of America Merrill Lynch.

Chris Ryan^ Hi, yes, thank you for taking my follow-up. This is Chris Ryan again on for Roger. Can you give any indication or an indication of Versatic Acid and Derivatives volumes growth year-over-year and which particular end markets have been strong?

Craig Morrison^ Yes, Versatic Acid -- I mean, excuse me, Versatic Acids and Derivatives were up about 15%, so very, very strong growth, and was across the Cardura and the VeoVa applications. So you are looking at automotive finishing, you are looking at waterborne paint applications, you are looking at construction, et cetera. So very broad based as well as geographical growth.

Chris Ryan^ Thank you. And which of the various solvent businesses do you expect the greatest near-term improvement?

Craig Morrison^ You mean across all of our portfolios?

Chris Ryan^ Right.

Craig Morrison^ I think Versatic Acid will continue to do well. We think over the next few quarters, base epoxies will do very well. We think the forest products will continue to show well. We think PSR will see a benefit from a reversal because they were hit significantly by the phenolic increase which is very considerable which is coming aloft. So pretty broadly, across the portfolio, probably the one that will stay most under pressure is the specialty epoxy, like I had mentioned, for another quarter or two. But even on a comparative basis, we think they will show well versus the first quarter.

Chris Ryan^ Okay, thank you. That is all my questions.

Craig Morrison^ Thank you.

Operator^ And our next question comes from Tim Raeke with Alcentra.

Tim Raeke^ Yes, thanks for the call. Specifically, on slide 8, the volumes on proppants, I'm not sure if I you guys spoke to it, but could you talk about taking price there? Have you been -- has it been easy or hard? And are you kind of caught up on pricing as you are on the base epoxy business?

Craig Morrison^ Yes, I think pricing in the market, because capacity is long, has been challenged across the industry for OTG for the resin-coated proppants. I don’t think that is unique to us. I think it's an industry challenge. So we have not seen tremendous relief there. But, you know, I think as the industry comes back, you will see that dynamic change as well but I can't say we’re seeing it in full swing right now.

Tim Raeke^ And maybe, just generically, do you think that resin-coated is taking share from plain sand or do you have a sense?

Craig Morrison^ No, I don’t think resin-coated is taking market share from raw sand. I think raw sand benefited from the tight cash positions downstream. And it's a cheaper alternative in the short term. But you lose productivity in the longer term. So I think as the industry comes back, resin coated will disproportionately benefit because the basins that will come back and as the producer economics make it more advantageous to open up some basins that may not be particularly active right now, those will tend to disproportionately require resin-coated proppant as well as some producers that are currently using raw sand will go back because they are not as cash-constrained to resin coated. So I think the long-term outlook continues to look positive, but we are not seeing that benefit yet from a pricing standpoint.

Tim Raeke^ Not yet, okay. And then just a last one, just on the specialty epoxy business, you called out wind and you talked about wind as very important in that space. Can you talk about -- is there other segments that are sort of being with the inventory destocking? Or is really wind the biggest driver? Thank you.

Craig Morrison^ The driver of decrease in profitability and volume decreases are really purely wind. We actually have other segments like waterborne coatings that are growing very strongly and have a tremendous outlook over the next few years as well as some other composite applications in automotive. So it really is any sort of downturn right now that we are feeling is really driven by wind.

Operator^ And that is all the questions we have for today. I will now turn the call back over to Craig Morrison, President and CEO of Hexion. You may proceed.

Craig Morrison^ Thank you. I'd like to thank everybody for participating in today's call, and we look forward to updating you next quarter. Thank you very much.

Operator^ Ladies and gentlemen, thank you for participating in today's conference. That does conclude our program and you may all disconnect. Have a great day.