

Hexion Inc. (Q3 2019 Earnings)

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Corporate Speakers:

- John Kompa; Hexion Inc.; VP of IR & Public Affairs
- Craig Rogerson; Hexion Inc.; Chairman, President & CEO
- George Knight; Hexion Inc.; Executive VP & CFO

Participants:

- Nathan Schubert; JP Morgan Chase & Co; Research Division, Senior Analyst

PRESENTATION

Operator^ Ladies and gentlemen, thank you for standing by, and welcome to the Hexion Third Quarter 2019 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, John Kompa, Investor Relations with Hexion. Please go ahead, sir.

John Kompa^ Thank you, Sidney. Good morning, and welcome to the Hexion Inc. Third Quarter 2019 Call. Leading today's call will be Craig Rogerson, 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 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 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 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.

Craig Rogerson^ Thanks, John. Good morning, everybody, and thank you for joining our call today. I'm pleased to resume our quarterly earnings calls to update you on our new company and our latest financial results.

With a new capital structure, leading market positions, strong underlying technology and talented global team of associates, I'm confident in our ability to drive long-term growth and create shareholder value.

I'll provide an overview of our business on Slide 4. We are the global leader in thermoset resins to leading positions representing 80% of sales. With a broad range of products, we serve approximately 3,100 customers globally. We have a diversified portfolio that is aligned around serving the adhesive and binder markets through a pioneering Forest Products Resins segment.

Our Epoxy, Phenolic and Coating Resins focuses on our innovative coatings and composite solutions. With 47 production sites globally and a balanced geographic footprint serving customers at approximately 85 countries, you can also see that we are not overly relying on any particular end market.

Turning to Slide 5, I'd like to review the positive outcomes of our balance sheet restructuring -- significantly improved our financial and operational flexibility.

Throughout the restructuring, we continue to operate in normal course, which had no operational disruptions, no asset sales, no headcount reductions or modifications employee benefits associated with the restructuring. Our trade creditors also received 100% recovery on their claims.

We emerged with a healthy balance sheet, significant liquidity and a structurally enhanced free cash flow profile. The restructuring reduced our debt by more than \$2 billion, and the company received a new equity infusion of \$300 million, while raising approximately \$2 billion in exit financing. Our annual cash interest expense also declined by more than \$200 million.

As of September 30, 2019, our net leverage and liquidity was about 4.1x and \$442 million, respectively. We are now positioned with enhanced flexibility to further delever and invest in our businesses through a variety of operational initiatives, innovation and growth opportunities.

I want to thank our lenders, customers, suppliers, and most of all, employees for their support throughout the process.

Now turning to Slide 6. With the restructuring fully behind us, I've outlined a few key elements of our strategy going forward, as we are laser-focused on improving our profitability and EBITDA margins, and we have a clear path to do so through a number of key drivers.

The first is our self-help capital projects, which we consider to be strategic investments with minimal market risk, such as debottlenecking projects, bringing tolling operations in-house or operational CapEx that improves our process efficiencies, which ultimately creates a lower cost to serve our customers.

Second, we expect organic growth due to our leading market positions and diversified portfolio going forward. Third, our commitment to accelerating new product development should drive greater top line growth over time. Fourth, we continue to drive our cost reduction initiatives as planned. We're looking for additional opportunities to adjust our manufacturing network and also improve our business processes to become more efficient.

Next, as we plan for future growth, we also want to have a portfolio that puts us clearly in a position to compete and win. And we continue to actively explore potential portfolio optimization moves.

Finally, we anticipate benefiting from our strong cash flow metrics going forward. The lower interest burden, modest tax expenses and best-in-class net working capital, we anticipate generating significant free cash flow in the fourth quarter of 2019 and over the longer term. As we said in our earnings release, we are focused on deleveraging going forward, as we drive toward an achievable debt-to-EBITDA leverage ratio of less than 3x.

Turning to the next slide. As part of our efforts to drive both growth and greater operating efficiencies, we are reviewing our reporting segments to align around our adhesives and binders and coatings and composites segments.

These are all growth platforms. We expect to change our operating segments to reflect how we'll be organized, make operating decisions and assess business performance, which we anticipate will impact our segment reporting in the first quarter of 2020.

Strategically, the new structure would also align with key megatrends that support our long-term growth. We consider these sector megatrends to be significant and transformative trends that define the present and are shaping the future by impacting on our businesses, on the economy, industries and society.

For example, our specialty coatings and wood adhesives means the growing needs of sustainable building and construction solutions. Our composite applications are making cars lighter, while our coating applications are making mass transportation, like rail and buses, more durable.

Our specialty resins are meeting the needs of wind energy turbine manufacturers, as the blades become increasingly longer to drive efficiencies higher and generation cost lower. Finally, our waterborne coatings are replacing solvent-borne coatings in a variety of applications, which reduces volatile organic compound emissions or VOCs.

Turning to Slide 8. We continue to strategically invest in our R&D effort to support our product development and improved customer responsiveness, as we focus on accelerating growth in waterborne coatings and composite applications.

I'm pleased to announce that we've successfully completed construction of our new Application Development Center in Shanghai. By locating our commercial and R&D leaders in one location, we expect that the new ADC will foster increased innovation, which will ultimately benefit our customers.

The investment is also in line with our ongoing commitment to incorporate sustainability principles through our R&D and product development initiatives, as customers are increasingly looking for environmentally-preferred solutions, such as our next generation wind energy solutions based on our EPIKOTE and EPIKURE epoxy systems.

With 24 global R&D sites, Hexion is uniquely positioned to develop the coatings, composites and adhesives solutions of tomorrow and build on our strong track record of new product development.

Turning to the next slide. We're also excited to have announced last week that we'll add phenolic resins capacity as a latest expansion within our adhesives and binders business at our Brimbank, Australia site.

The expansion is intended to meet the growing demand for phenolic resins in a variety of applications, including as a component in fire-resistant cladding material for commercial, institutional and residential applications. Construction of the new reactor and associated infrastructure is expected to begin in early 2020 and come on line in the first quarter of 2021.

As the main phenolic producer with manufacturing operations in Australia, our regional locations include Brisbane and Brimbank, and our joint venture in Perth as well as Hornby and Mountview in New Zealand.

We expect that this investment will further strengthen our regional customer relationships and meet the need for phenolic resins that are fire-resistant and meet the National Construction Code in Australia. I'll now turn the call over to George Knight to discuss our financial results. George?

George Knight^ Thank you, Craig. In the third quarter of 2019, sales totaled \$836 million, while segment EBITDA declined 9% to \$117 million. While on a run rate basis, we're essentially on track relative to our 2019 target, our third quarter results reflected

increased headwinds in our base epoxy resins and North American Forest Products Resins businesses. To address these trends, we recently initiated our previously announced \$20 million of productivity actions in the third quarter.

Through the first 9 months of 2019, we realized \$13 million in structural savings and have \$18 million in annualized pro forma cost savings that we expect to fully achieve over the next 12 months. We were also pleased to drive positive cash flow from operations, which totaled \$25 million in the successor period after paying \$56 million of pre-petition claims.

Regarding our near-term outlook, we expect year-over-year gains in our fourth quarter segment EBITDA, although we don't anticipate achieving the \$470 million in fiscal year 2019, as previously forecasted in the restructuring support agreement due to the challenging trends impacting certain of our end markets.

Finally, as disclosed in our earnings release issued earlier today, our third quarter 2019 results include the impact of fresh start accounting. Fresh start accounting results in the creation of a new entity for financial reporting purposes.

Therefore, due to the application of the fresh start accounting as well as the effects of the implementation of the Chapter 11 plan of reorganization, the condensed, consolidated financial statements on and after July 1, 2019, are not comparable with the condensed consolidated financial statements prior to that date.

Turning to the next slide. I've highlighted the main impact of fresh start accounting on our financials. First, as disclosed in our earnings release, we presented our financial statements as the predecessor company through July 1, 2019, and as the successor company starting July 2, 2019.

Looking at our balance sheet, our overall assets increased by approximately \$2.2 billion, as a result of fresh start accounting. Our intangible assets increased by \$1.2 billion, and our property, plant and equipment increased by \$380 million (sic) [\$780 million], while goodwill of \$178 million was established.

On our income statement, we recorded a large gain in the predecessor financial statements, reflecting the impacts of the bankruptcy on debt and equity amounts and the impacts of the fresh start accounting.

Depreciation and amortization in the successor financial statements also increased significantly due to the step-up of property, plant and equipment and intangible assets. Finally, deferred revenue was accelerated in the third quarter of 2019. The impact of fresh start accounting will be outlined in greater detail in our 10-Q filing.

Turning to the next slide and our segment performance. In Forest Products Resins, our third quarter 2019 totaled \$367 million, a 15% decrease from the prior year, reflecting volume declines of 8%, negative price/mix of 6% and currency headwinds of 1%.

Segment EBITDA grew by 11%, reflecting slight gains in Latin America and cost actions as well as an \$18 million impact from our acceleration of deferred revenue, which was partially offset by lower volumes.

Turning to the next slide and our Epoxy, Phenolic and Coating Resins segment, third quarter 2019 revenue declined by -- to \$469 million, which reflected a volume decrease of 4%, negative price/mix of 4%, currency headwinds of 2%.

This was partially offset by price actions in certain businesses. Segment EBITDA declined primarily due to the volume weakness and pricing headwinds in base epoxy resins, partially offset by cost reduction actions.

Turning to the next slide and our combined raw material index. Our total raw material cost decreased approximately 3% on a sequential basis compared to the second quarter. On a year-to-date basis, we've seen phenol and urea increased 3% and 1%, respectively, while methanol declined 18% in the first 9 months of 2018 -- I'm sorry, for the first 9 months of 2019 versus the prior year period.

The significant contractual pass-through of raw material cost, both increases and decreases, supports our consistent margin over material dollars but is also reflected in our changes in revenue, which we saw in the third quarter 2019 top line results. We will continue to closely monitor raw material trends and work to successfully implement pricing actions as appropriate going forward.

On Slide 16, we've provided an overview of where we stand with our previously announced cost reductions. In the first 9 months of 2019, we achieved \$13 million of cost savings.

Taking a slightly longer view, since the fourth quarter of 2017, we have realized \$56 million of cost savings related to headcount and manufacturing rationalizations. As of September 30, we had \$18 million of structural cost savings remaining, and we've taken 75% of headcount actions related to these savings. We expect the majority of the remaining savings to be realized over the next 12 months.

Our balance sheet restructuring bolstered our liquidity, which stands at \$442 million at September 30. Year-to-date, we've invested \$65 million in capital expenditures and expect to invest between \$90 million to \$100 million in total this year.

We continue to focus on managing our working capital, which remains a modest 15% sales. While we saw a contraction of our terms during our restructuring, we expect continued structural improvements in vendor terms going forward, particularly as it relates to normalizing our contractual terms with our suppliers based on our strengthened balance sheet and improved liquidity and cash flow profile.

We also anticipate working capital to decrease in the fourth quarter of 2019, consistent with historical trends. Supporting our strong cash flow profile, we would also expect our annualized cash interest expense to be approximately \$107 million. Finally, with no material debt maturities before 2026, we benefit from a long-dated maturity schedule. I'll now turn the call back to Craig.

Craig Rogerson^ Thanks, George. In summary, while our third quarter results were challenged by the general macroeconomic volatility, we expect to continue generating solid free cash flow going forward, and that will be a major focus.

This will allow us to further invest in our businesses, further deleverage and also optimize our portfolio, as we refocus the company on accelerating growth. With that, operator, that concludes our prepared remarks. Would you please open the line up for questions?

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) And our first question comes from Nathan Schubert with JPMorgan.

Nathan Schubert^ So, I guess, just first one for me is on kind of the full year outlook this year, and then maybe you can touch on 2020 as well.

You already said that you don't expect to hit your targets outlined in the RSA. Can you kind of talk about how we should be thinking about the remainder of this year? And maybe touch on which markets you're finding the most challenging. And then I'll stop right there.

Craig Rogerson^ Let me comment, and then George can put some color on it. We would expect the fourth quarter this year to be better than the fourth quarter last year.

I don't think it will be sequentially better than the third quarter just because of the normal issues we see in December around inventory adjustments and the uncertainty, as we sit here right now looking at December caused me some concerns around comparisons to the third quarter on a sequential basis.

As we go into 2020, we assumed, based on our projections, that the market will look more like it did in the second half of this year through next year. Hopefully, that that's wrong, and it'll be better. But again, as we sit here right now, I see no signs other than hope that the second half will be better next year. But again, no indications of why that would be.

With that being the case, we continue to expect to see some improvement in earnings through these things that we can control, so the projects I mentioned relative to improving our efficiency or our energy efficiencies or bringing tolling in-house relative to the projects that we have around cost reduction that George alluded to that have a full

year effect in 2020 and some of our new products that we are expecting to impact next year.

Some of them, we are expecting to be more impactful in 2019. But because of some of the slowdown we've seen, some of that will push into 2020, but it should have a material impact on our top line and bottom line growth in 2020.

Areas that we see softness in -- I mean, housing starts in the U.S. market are relatively stagnant. The latest number, annualized [1.256]. Now there was a talk it was going to be [1.3 or 1.35].

It's not -- next year, we're presuming similar type of numbers. So again, we have some new products in that area that we think we can gain some new applications, expand the pie a little bit, maybe take a little bit of share in some areas.

But it's a very competitive market. Board prices are low, and that causes mill shutdowns. And as they try to rationalize the supply-demand dynamics in the oriented strand board or plywood, and so that impacts us because of the large market share we have.

In the resins, the epoxy resins area, wind continues to look strong. And that's been a positive surprise this year, which we -- as we are getting the contracts in place for next year, look to be continuing into 2020.

Margins are a concern. The BPA margins are still under stress, which leads to liquid epoxy resin margins being under stress. Some of it due to effects of the soft automotive market, especially in China, and how that flows back to partly carbonate to BPA and then in liquid epoxy resin.

But volumes seem okay. We're still relatively pessimistic, presuming dampened margins in BPA and liquid epoxy resins into 2020. So again, I think 2020 would be better than '19, but mostly through things that are under our control around the cost side that our improved balance sheet allows us to really execute on that we couldn't have prior to the restructuring.

George Knight^ Yes, I think the biggest change probably, Nate, between when we put the RSA together and what we're seeing now is we did expect to see a little bit of an uptick on polycarbonate demand in the second half of this year, which would help stabilize the BPA prices. And we just haven't seen that, and that's had an impact on our epoxy margins.

Nathan Schubert^ Great. That was very helpful. And then, just kind of on the segment realignment. Firstly, just as a general statement, it would be helpful if we could get [recast] financials -- historical financials.

And then, secondly, my question is just on your -- on the segment realignment, is that telegraphing sort of internal focus on optimizing these assets versus potentially

monetizing assets? And then on the asset monetization side, is there still anything that you kind of consider noncore? And if so, what?

Craig Rogerson^ Yes. I wouldn't read into anything relative to portfolio optimization relative to the realignment. I mean, what we're looking at doing is looking -- trying to have more of a market focus.

If you look at what is forest products and our phenolics business, those really are adhesives types of businesses. And as we look at potentially growing that portfolio, if we basically minimize the -- well, first of all, our market share is relatively high if we talk about the business of forest products only.

We look at it as more broad adhesives type of portfolio that we could get into. There's opportunities for us to expand beyond the forest products market. And that's kind of the view that we're trying to take internally and externally, similarly with composites and coatings and the epoxy business.

So I wouldn't read too much into that. It's kind of the way we plan to manage the business going forward, with more of an external focus and a product focus. But that really has nothing to do with the optimization.

And to your point, are there businesses within the portfolio that are noncore? I don't like to characterize things as core or noncore. But clearly, there are smaller businesses or pieces of businesses that may make sense to divest.

If we're looking at trying to accelerate deleveraging, for instance, and using the proceeds to delever, we'll always look at that as a use of cash. I know we get below 3x, and I talked about that as a near term goal but we'll also look at some point on some of these things to optimize the portfolio relative to EBITDA margins and improve our margin profile to be able to use some of those proceeds to invest in businesses that offer us growth potential.

And again, that could be in the adhesives side, or the coatings side or the composites side. So that -- I would disassociate anything in the portfolio optimization with the way that we're talking about recharacterizing the business segments, as we talk about.

George Knight^ Yes, Nate, we would expect to restate the prior years and file something when we change the segments in 2020, so people can see things on an apples-to-apples basis.

Operator^ And our next question comes from [Brian De Rubio] with Baird.

Unidentified Analyst^ First question, you mentioned that you expect to produce significant amounts of free cash flow. How are you defining free cash flow?

George Knight^ So free cash flow would be cash flow from operations, less capital expenditures.

Unidentified Analyst^ Okay, perfect. That's what I was hoping for. And as you think about sort of your pro forma adjusted EBITDA numbers and cash generation, obviously, there's still a little bit of disconnect as you have things in process. When should we think about that gap narrowing to where that -- those 2 numbers sort of align with each other?

George Knight^ Well, over the next 12 months, we would expect to have the cost savings actions implemented. So we do have onetime costs related to putting those in place, but I would expect over the next 12 months for that to narrow.

Unidentified Analyst^ Perfect. And as we think about just CapEx for next year, sort of in line still with current levels?

George Knight^ They'll probably be a little bit more. We do have flexibility on some of the growth capital. Craig talked about the additional capacity we're going to be putting in Australia. So this year, while we're at the under \$100 million level, next year, we would expect to be somewhere between \$110 million to \$130 million.

Operator^ (Operator Instructions) And this concludes our Q&A session. I will now turn the call over to Craig Rogerson for any further remarks.

Craig Rogerson^ Thank you, everybody. I appreciate your interest, and we look forward to talking about the Q4 and full year 2019 results on our next call. Again, thanks for your interest. Have a good day.

Operator^ Ladies and gentlemen, this concludes today's conference. Thank you for participating. You may now disconnect.