Hexion Inc.(Q2 2020 Earnings)
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Corporate Speakers:

- John Kompa; Hexion Inc.; IR
- George Knight; Hexion Inc.; Acting CEO & CFO
- Mark Bidstrup; Hexion Inc.; SVP & Treasurer

Participants:

- Nathan Schubert; JPMorgan Chase & Co.; Analyst
- Antonia Yuan; BofA Merrill Lynch; Analyst
- Eleni Kessler; Jefferies Group LLC; Analyst
- Brian DiRubbio; Robert W. Baird & Co.; Analyst
- Tony Delserone; Federated Hermes; Analyst

PRESENTATION

Operator^ Ladies and gentlemen, thank you for standing by, and welcome to the Hexion Second Quarter 2020 Earnings Conference Call.

(Operator Instructions)

Please be advised that today's conference may be recorded.

(Operator Instructions)

I'd now like to hand the conference over to your host today, Mr. John Kompa, Investor Relations for Hexion. Please go ahead, sir.

John Kompa^ Thank you, Liz. Good morning, and welcome to the Hexion Inc. Second Quarter 2020 Conference Call.

Leading today's call will be George Knight, acting Chief Executive Officer and Chief Financial Officer; and Mark Bidstrup, Senior Vice President and Treasurer. As previously announced, Craig Rogerson, our Chairman, President and CEO, remains on medical leave. Out of respect for his personal privacy, we won't be commenting in detail regarding his status today, but he is recovering well.

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 IR section of Hexion. 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 review information of 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 forecasts 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 SEC filings are available on the Internet at hexion.com.

With that, I'll now turn the call over to George Knight.

George Knight^ Thank you, John, and good morning, everyone. I'd like to reiterate our opening comments regarding the status of Craig as he continues to recover well. I know everyone joining the call today wishes him continued progress.

Now turning to the quarter. Because of the efforts of our manufacturing leadership and our associates, we continue to operate our manufacturing sites in the face of the coronavirus pandemic during the second quarter and beyond. In addition, our associates in R&D roles are socially distancing and practicing good hygiene in our labs, while those in corporate functions are either working from home or using flexible arrangements to occasionally be in the office. In all cases, we remain focused on serving our customers without interruption. While the pandemic has clearly had a impact on demand around the world, it hasn't stopped our plans to drive long-term growth.

We continue to operate our plants safely, prudently manage our balance sheet and deliver the innovative solutions that we are known for with our loyal customers. I continue to be impressed daily by the teamwork that our associates are demonstrating during these challenging times.

In terms of our financial results, sales in Q2 totaled $628 million, down 30% from prior year, reflecting softer volumes and the pass-through of raw material price declines, while segment EBITDA declined by 42% to $65 million. Second quarter results reflected softer volumes across the portfolio, and an $8 million negative impact from a temporary manufacturing outage that's centered around electrical issues from our supplier at our Pernis site following the planned turnaround.

Despite the year-over-year decline due primarily to COVID-19, our volumes and segment EBITDA steadily improved sequentially each month within the quarter. We were also encouraged by our July 2020 results as volumes continue to improve on a monthly basis compared to June.

While our earnings were down, we drove strong free cash flow and generated $54 million of cash in the second quarter of 2020, which was supported by our ongoing focus on managing working balances. We also further strengthened our liquidity, which increased by nearly $40 million compared to Q1 2020 and totaled $479 million at the end of Q2.

Turning to Slide 5. We've again highlighted how we are focused on cost and cash items that we can control, and we believe we are well positioned today to weather a broad range of recovery scenarios and take advantage of a rebound in demand.

First, we remain focused on operating safely by following the guidelines of each country in which we operate. Creativity of our manufacturing, EH&S and HR leadership, taking all possible safeguards to minimize COVID risk at our sites has enabled us to keep our sites running. We're also serving our customers today through an efficient manufacturing grid as we steadily implemented rationalizations throughout the network over the years.

We've also streamlined our organization through 2 significant cost reduction initiatives since late 2017 and continue to closely monitor all variable costs this year. We're also making good progress on the creation of our business service group through our partnership with Capgemini for certain administrative functions, which will further improve our efficiency and reduce costs.

We continue to benefit from our customer, end market and geographic diversification, and we are not overly dependent on any 1 customer, end market or geography. Finally, we continue to leverage our strong supplier relationships with multiple sources for our key raw materials to ensure continuity of supply.

Turning to Slide 6. We've highlighted our wind energy business, which has demonstrated resiliency this year despite the pandemic. This is a global business for us with significant operations in North America, Europe and China. In line with industry forecasts, we saw an improving market for new wind energy installations last year, and 2020 has been another year of solid growth.

As a complete solutions provider for composite systems and wind turbines, we experienced continued solid demand in the first half of the year. Longer term, we continue to expect secular growth in renewable energy to support our wind energy business.

In addition, just last month, Hexion's latest generation of bonding paste was used by a large Chinese wind energy customer for its grid-connected offshore wind turbine installation off the Chinese coast. With turbine blades that were 90 meters long, our proprietary binding paste offers durability and excellent fatigue performance for onshore and offshore applications.

Globally, offshore installations represented about 10% of the new installations in 2019, which was the highest level to date, and this growth is expected to continue.

Turning to the next slide. We continue to leverage 3 main strategies to drive long-term shareholder value.

First, we remain committed to steadily introducing new products, which have accounted for about 20% of our annual sales over the last 5 years. We are gearing our innovative programs on developing products that are aligned with key mega trends and sustainable in nature, such as the latest generation of bonding paste for wind energy, waterborne coatings, fire retardant resins and composite materials for automotive lightweight.

Second. We believe we are well positioned for growth through our productivity initiatives and operating leverage. We continue to effectively manage our cost base after reducing fixed costs by $78 million from 2017 to 2019. This has resulted in stable fixed cost base that will drive future operating leverage as volumes eventually recover from the COVID-19 impact.

In addition, we are not capacity constrained in terms of needing to add capacity in key product lines to meet customer demand when demand recovers. We have increased our investment in productivity CapEx in 2020 and are planning for a further ramp-up in 2021.

We are also selectively investing in high-return projects where we have limited excess capacity, such as the Brimbank phenolic reactor expansion.

Third, we continue to closely monitor the landscape for opportunities to strengthen our portfolio, whether that is through potential divestitures or targeted mergers and acquisitions.

Proceeds from any such transaction would be used to invest in our business and to reduce our debt. I'll now turn the call over to Mark Bidstrup to discuss our financial results in more detail.

Mark Bidstrup^ Thank you, George. As a brief reminder, following emergence from our balance sheet restructuring on July 1, 2019, our financial results reflect the impact of fresh start accounting as our revenue and segment EBITDA for 2020 represents the successor period and for 2019 represents the predecessor period.

In our Adhesives segment, which includes our wood adhesives, formaldehyde and phenolic specialty resin businesses second quarter 2020 revenue totaled $346 million, a 33% decrease from the prior year, reflecting volume declines of 26%, negative price/mix of 4% and currency headwinds of 3%.

In an encouraging trend, adhesives volumes improved sequentially within the quarter, rebounding from the trough in April. Segment EBITDA declined by $22 million, reflecting lower volumes in our North American and Latin American wood adhesives business, which is driven by lower residential construction and furniture demand as well as declines in phenolic specialty resins impacted by weaker industrial and automotive markets, which were partially offset by cost actions resulting in the improved margins.

Turning to the next slide. In our Coatings and Composites segment, which contains our base and specialty epoxy resins and Versatics businesses. Second quarter 2020 revenue declined by 25% to $282 million, which reflected volume declines of 18%, negative price/mix of 5% and currency headwinds of 2%. Segment EBITDA declined by $26 million, reflecting volume declines in our base epoxy and Versatics business driven by overall weakness in the market, primarily in the automotive, industrial and nonresidential construction industries, partially offset by strong demand in U.S. and China wind energy markets, supporting our specialty epoxy business. Weaker margins reflect the combination of softer volumes, a competitive base epoxy market and costs associated with our planned turnaround.

Turning to the next slide. We continue to prudently manage our balance sheet as liquidity rose sequentially and totaled $479 million as of June 30, 2020. Supporting our strong free cash flow profile, we now expect to spend approximately $110 million to $120 million this year, and we continue to review the timing of the manufacturing turnarounds at certain sites. Our annual maintenance and EH&S CapEx remains in the range of $70 million to $80 million per year. We also expect that our future CapEx plans will include numerous productivity CapEx initiatives to fuel long-term growth.

Second quarter 2020 net working capital reflected primarily lower accounts receivables due to volume declines and lower raw material prices. Looking ahead, third quarter cash flow will be impacted by the timing of long-term compensation payments and international pension contributions as well as an expected increase in net working capital driven by improving volumes.

We would then expect to benefit from normal Q4 seasonality. Annual interest costs are expected to be approximately $105 million in 2020. Finally, with no material debt maturities before 2026, we continue to benefit from a long-dated maturity schedule.

I will now turn the call back to George.

George Knight^ Thanks, Mark. In summary, our priorities remain unchanged, beginning with our associate safety. We are committed to continuing to take all the appropriate precautions during the pandemic that has enabled us to operate our manufacturing sites during these challenging times and to be good neighbors in the communities where we work and live. We remain focused on driving long-term growth by leveraging our diversified end markets and global presence as well as aggressively managing our costs. We are maintaining the disciplined approach to capital allocation to reduce our net debt over time, which we will believe will be supported by any proceeds from future divestitures.

While the second half of the year will continue to be hampered by softer demand from COVID-19, we are well positioned for the eventual economic rebound as we work to maximize long-term shareholder value. Operator, that concludes our prepared remarks. We'd now like to open the line for questions.

Thank you.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

Our first question comes from Nathan Schubert with JPMorgan.

Nathan Schubert^ So my first question is just on volume evolution. Can you maybe talk about sort of where the trough was, I suspect it was in April in terms of sort of year-over-year volumes and how far down you were? And then kind of where we're at now just across your whole business line, any 1 specific business line.

George Knight^ Okay. Well, I mean you could see for the quarter, we were down 27% overall from a volume standpoint year-on-year. As you said, the trough was in April.

Sequentially, we did see about a 9% improvement in May, 7% improvement in June. And then as we talked about an additional sequential improvement in July from a volume perspective. So for us, that's a good sign. Sequentially the things keep improving. Overall, still from last year, sequentially, on a month-by-month basis, we're still down about 15% year-on-year.

Nathan Schubert^ That's very helpful. And my next question is just sort of on M&A and potential asset divestitures. Can you maybe just discuss where you're at with that? And then also, how much do sort of travel and local and state lockdown and social distancing affects your ability to do -- or for potential suitors to do due diligence on your assets?

George Knight^ Yes. I mean it makes things more difficult, as you said, but I've been surprised how creative people have been. You read stories about how -- what different workarounds people are doing from a due diligence side as far as even using drones to do plant site visits and things like that. So for us, as you said, it's been difficult with the pandemic. But as we talked about, we're continuing to look at our portfolio and see how we could optimize that going forward. We really don't have anything else to announce as of at this point in time.

Operator^ Our next question comes from Roger Spitz with Bank of America.

Antonia Yuan^ This is Antonia Yuan speaking for Roger. So my first question, I'm just wondering if you could provide more details on your base epoxy EBITDA level for the quarter.

George Knight^ Yes. I mean I think it was a challenging quarter for our base epoxy business there. Combination of the impact of the pandemic on volumes, continued pressure on margins on that business and then we talked about the temporary outage that we had when we were coming out of our turnaround at the end of Q1.

Antonia Yuan^ Okay. Just wondering, so OSB prices have reached really high level recently. I was just wondering if you were able to get any pricing flexibility for your Phenolic Resins?

George Knight^ Yes. I mean when you think about our wood adhesive business, about 60% of that business we've got contracts where we have to pass on any raw material price changes to our customers. So we don't have a lot of additional flexibility from a pricing standpoint there, where the [board] pricing improvements help us is more from a demand standpoint. What we've seen is some of our customers starting to open up and looking to open up some of the mills that they had shuttered previously. So it's really helping us from a demand side.

Operator^ Our next question comes from Eleni Kessler with Jefferies.

Eleni Kessler^ First question for me is, I know that you obviously saw decline in revenue just from contractual pricing coming down. Could you talk to, though the benefit or any benefit from EBITDA you might have gone from lower raw materials net of that lower contractual pricing?

George Knight^ Yes. Net net, the impact to the lower raw material prices was a positive on the EBITDA side. Normally, when prices go down, even in those contracts where we pass it on, there is usually a 30- to 45-day lag there. So we benefit from the lead lag as well as in some of our specialty lines where we don't have those contracts in place, the lower raw material prices definitely helped us in the first half of the year.

Eleni Kessler^ Great. And do you have a -- could you quantify, though, the net positive impact to EBITDA.

George Knight^ No, we normally don't disclose that.

Eleni Kessler^ Okay. And then my second question is, you're just kind of talking about the pretty decent sequential improvement you're seeing. Could you just talk more specifically about any specific end markets or industries that are showing the most accelerated improvement? And then any specific verticals that have been lagging?

George Knight^ Sure. Yes, it's very end market specific. Some references were made on the home construction in North America. That's driving good sequential growth there. Wind energy continues to be strong there. Agriculture has been strong all along for us there. Some of the other construction markets, we're starting to see those pick up.

And again, it's very region specific. So more improvements in North America and in China versus Europe. We tend to see Europe lagging a little bit. Some of those markets are continuing to be challenged. Oil and gas continues to be challenging there. Automotive, while we've seen a pickup there, we haven't seen anything sustained and that's something we're looking out [as far as] to see how that develops over the next quarter.

Operator^ Our next question comes from Brian DiRubbio with Baird.

Brian DiRubbio^ I have a couple for you. As I look at SG&A costs, which obviously were down pretty material. Can you give us a sense of how much of that is sustainable at the current level?

George Knight^ Yes. I mean we have continued to look at cost reduction efforts. Over the last 2 years, you've had 2 fairly large programs where we've taken out SG&A costs. We're seeing the benefit of that. Some of the offsets, though, that we've had to overcome is just normal inflation as well as with the ending of the shared service agreement between Momentive and Hexion at the end of last year. We do have some incremental costs that we had to cover this year.

But despite all that, as you note there, we have seen some continued decreases on the SG&A side. I have to say a lot of the actions that we've taken during the pandemic have been more of on the temporary side of things where we want to make sure that as things pick up, we're well positioned to take advantage of that.

Brian DiRubbio^ No. That's absolutely fair. And just to clarify, the $8 million hit to EBITDA because of that outage. A, was that in your adjusted EBITDA number? And B, how much -- was that $8 million totally because of the electrical issue? Or is that sort of the combination of the turnaround plus the electrical issue?

George Knight^ No, that was specifically related to electrical issue, and those amounts are included in our results. If you think about it, it's extra costs of probably between $1 million to $2 million and then about $6 million of lost EBITDA on revenue that we were not able to ship.

Brian DiRubbio^ Great. 2 final ones for me. Did you receive any benefits from the CARES Act?

George Knight^ Yes, the benefits that we received are mostly on timing on tax payments. So -- and also on the pension side, we were able to defer 1 of our contributions that was previously going to be due in September that we pushed off until next year. But no monetary awards or anything like that from the stimulus act.

Brian DiRubbio^ Okay. And then in the queue last -- in your first quarter queue, you mentioned -- it was mentioned about a $10 million loan for share repurchases. Have you guys actually repurchased any shares with that transaction?

George Knight^ Yes.

Mark Bidstrup^ Yes. We repurchased the shares in the first quarter, but we have not made any share repurchases in the second quarter.

Brian DiRubbio^ Great. And just a final comment for me. I mean I've been following you guys for a long time. It's really great to see cash flow now actually aligning with EBITDA. It's a long time coming, but you guys finally did. So congrats on that.

Operator^ Our next question comes from Tony Delserone with Federated Hermes.

Tony Delserone^ Gentlemen, could you speak to statutory -- or excuse me, effective and cash tax rates?

George Knight^ Yes. Tony, it is difficult on the tax rates for us because we continue to be in a valuation position in the U.S. So when you look at our effective tax rate, you do get some strange numbers there. I think what we try to look at is cash taxes and ways to minimize those right now given that in certain geographies, we continue to have valuation allowances. So you don't get the benefit of any losses in those jurisdictions.

Tony Delserone^ Would it be possible to put a number to that?

George Knight^ Yes. We'll look at that. Off the top of my head, I don't have that right here in front of me.

Operator^ I'm showing no further questions in queue at this time. I'd like to turn the call back to George Knight, acting CEO and CFO for Hexion.

George Knight^ Thank you, operator. Thanks, everyone, for joining the call today. As we talked about, we remain committed to growing our business and delivering sustainable EBITDA growth over time to our shareholders. We continue to carefully manage our costs, selectively deploy growth capital and strengthen our balance sheet. We look forward to updating you again on our next earnings call in November. Thank you.

Mark Bidstrup^ Thank you.

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