Hexion Inc.(Q3 2020 Earnings)
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Corporate Speakers:

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

Participants:

- Richard Kus; Jefferies Group LLC; Analyst
- Brian DiRubbio; Robert W. Baird & Co.; Analyst

PRESENTATION

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

(Operator Instructions)

Thank you.

I will now turn the call over to John Kompa, Investor Relations for Hexion. Please go ahead, sir.

John Kompa^ Thank you, Christy. Good morning, and welcome to Hexion's Third Quarter 2020 Conference Call. Leading today's call will be Craig Rogerson, Chairman, President and CEO; George Knight, Executive Vice President and Chief Financial Officer; 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 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 read the 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 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 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, and good morning, everyone. It's great to be back on the earnings call and to be able to reconnect with our shareholders regarding our performance. First, I'd like to acknowledge George Knight and the senior management team for assuming additional duties during my medical leave. I'd also like to acknowledge all of our associates who continue to safely operate our manufacturing sites and serve our customers in the face of the pandemic.

While COVID-19 continues to create uncertainty and hamper our visibility, we were pleased to see the recovery begin to take shape during the third quarter as we narrowed the gap compared to prior year performance and saw a solid sequential rebound in our volumes and EBITDA. We continue to strategically invest in our business to drive long-term growth and carefully manage our balance sheet until the recovery becomes more entrenched throughout our portfolio. Most importantly, we continue to operate our plants safely by taking all necessary precautions as our highest priority remains the health and safety of our associates.

Turning to our results. Our financial statements reflect our pending transaction and the impact of discontinued operations as the assets and liabilities have been segregated on the balance sheet. Our results from operations and cash flows have been differentiated between continuing and discontinued operations. All of our results presented today and in the future will be prepared on a continuing operations basis. George will talk more about what this means and provide additional details.

Third quarter sales totaled $634 million, reflecting softer volumes and the pass-through of raw material price declines, while segment EBITDA from continuing operations declined by 13% to $91 million compared to the prior year. The prior year also included $18 million of segment EBITDA related to deferred revenues that was accelerated last year as part of fresh start accounting. Excluding fresh start accounting, third quarter 2020 segment EBITDA increased by 6% over prior year. Our results reflected improvement in several key end markets, offsetting the impact of the coronavirus pandemic that began in mid-March.

Third quarter 2020 segment EBITDA margin from continuing operations totaled 14.4%. Compared to the second quarter of 2020, third quarter segment EBITDA improved 60%, driven by steadily improving volumes while increasing sequentially each month within the quarter and since April of 2020. Our volumes continue to improve sequentially in

October as well, although our visibility remains limited regarding the fourth quarter of 2020 because of the pandemic as well as normal year-end volatility. December is always a question.

Turning to Slide 5. As previously announced, the highlight of our quarter was entering into a definitive agreement to sell our Phenolic Specialty Resin, Hexamine and our European-based Forest Product Resins businesses for approximately $425 million to Black Diamond and Investindustrial. Consideration consists of 30 -- $335 million in cash and certain assumed liabilities with the remainder in future proceeds based on the performance of the business. The transaction is intended to close in the first quarter of 2021, subject to regulatory approvals and other customary closing conditions, including works council consultation.

We plan to use the net sales proceeds in part to reduce indebtedness as well as for general corporate purposes, including investments in our businesses. We've talked about this as a priority for the last few quarters, and we are pleased to move diligently towards the finish line despite the logistical challenges due to COVID-19. I'm confident associates that are part of the transaction will have exciting opportunities ahead, and I'm also excited about our portfolio as we will be comprised of a streamlined portfolio of specialty businesses going forward. We believe these businesses form a strong growth platform due to the industrial logic, global manufacturing network, proprietary technology and strong customer relationships.

Now turning to Slide 6. A key part of our growth strategy has been developing products that demonstrate sustainable attributes: from composites that support lightweight automobiles to wind energy and adhesive resins that support the efficient use of lumber resources and homebuilding. We also recently introduced our strategic sustainability goals intended to support our associates, our communities and the environment while also accelerating our growth.

We believe all of these goals work in tandem with each other to create shareholder value. Specifically, these goals center around minimizing climate change, supporting our associates' wellness and reducing spills and releases and responsible product stewardship. Collectively, these goals underscore our commitment to responsible chemistry.

By aligning our sustainability metrics with our R&D and commercial teams, we also believe we can continue our momentum for new product development, which has accounted for about 20% of our annual sales. We've committed that by 2030, all of our new products will incorporate sustainable attributes. A sustainable product is one that has one or more of the following attributes within the full value chain: improving energy efficiency, reducing material consumption, increasing use of sustainable raw materials, contributing to the circular economy and/or mitigating climate change. I look forward to periodically highlighting additional new products that are sustainable in nature, such as the one featured on the next slide.

I'm excited to highlight our ArmorBuilt fire-resistant wrap, which is a new product design to address the alarming growth in wildfires. These wildfires not only leave a devastating impact on land and lives but destroy much needed utility infrastructure which takes time and money to rebuild. ArmorBuilt greatly improves fire protection when applied to a substrate. ArmorBuilt wrap is a proprietary intumescent fiberglass-backed wrap that is affixed to wooden utility poles and can be applied to either new or existing poles. When the poles encounter heat from a wildfire, the wrap literally expands, discharge the fire and protects the underlying pole from burning and collapsing. Designed to protect a critical utility infrastructure, the product also supports emergency access during evacuation scenarios, which typically include down utility poles.

ArmorBuilt wrap has passed the wildfire simulation burn certification for fire resistance, an industry standard in fire protection. The product is currently being produced at our Portland, Oregon site and is already being installed in California. It's a great example of a new product design to close -- in close collaboration with a key customer. We are excited to initially partner with one of the largest providers of treated wood poles in North America to introduce the product to market.

Now turning to Slide 8. I'll highlight another trend that we anticipate will support long-term growth in our Adhesives segment. We've all seen the recent positive headlines regarding housing demand. Housing starts increased to a seasonally adjusted annual rate of 1.41 million units in September, finally surpassing the long-term average of approximately 1.35 million starts and a strong bounce back from the April trough.

With low U.S. mortgage interest rates and millennials reaching peak homebuyer age, medium-term U.S. housing demand is expected to be strong. Forest Economic Advisors also forecast housing starts to increase by around 200,000 annually over the next 5 years. We remain encouraged by the outlook for homebuilding as a key driver of business and are working hard to strengthen our leadership position.

Now turning to the next slide. Our Coatings & Composites segment benefits from diverse end markets and exposure to sustainable mega trends. The recovery that we began to see in automotive market supports long-term growth in our composite solutions. These materials enable the production of lighter weight, higher strength parts that reduce overall vehicle weight and improve gas mileage and performance.

Improving demand also drove higher volumes in our Versatic Acids and Derivatives business in the third quarter. Specifically, our Cardura technology enables coatings with superior appearance and durability as well as low VOCs. Improving architectural coatings demand supported our improved third quarter performance in our VeoVa product line, which makes decorative paints look better and last longer, reducing overall cost for our customers. From a sustainability perspective, this also reduces the total energy used over the lifetime of an application, considering the improved durability.

Our materials also help wind energy -- also help make wind energy a practical alternative to fossil fuel by lowering the total cost of wind energy and reducing environmental impact. Our epoxy materials reduce cycle time in many cases, enabling energy savings during manufacturing of the blades. Finally, by improving the fatigue performance of highly stressed blades like longer blades, Hexion products improve the durability and useful life of turbines.

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

George Knight^ Thank you, Craig. Before turning to our segments, I wanted to highlight the impact of our pending transaction on our financial statements. As Craig mentioned, all of our results presented today and in the future will be prepared on a continuing operations basis.

So as of September 30, 2020, we reclassified the assets and liabilities of our pending divestiture as held for sale on the unaudited condensed consolidated balance sheet and reported the results of its operations as income/loss from discontinued operations, net of taxes, on the unaudited condensed consolidated statement of operations. Amounts for prior periods have been retrospectively reclassified for all periods presented. Please see the addendum for additional financial schedules related to discontinued operations. We'll also be filing an 8-K in the future with additional quarterly schedules for our historical periods.

Turning to Slide 12. In our Adhesives segment, which includes our wood adhesives and formaldehyde businesses, first quarter 2020 revenues totaled $293 million, a 19% decrease from the prior year, reflecting volume declines of 8%, negative price/mix of 8% and currency headwinds of 3%. Segment EBITDA declined by $19 million compared to the prior year. However, if excluding the 2019 impact from fresh start accounting, segment EBITDA was nearly flat with the prior year and our EBITDA margins improved by 350 basis points. We were also encouraged that through quarter end, our Adhesives segment volumes have steadily increased each month from the trough of April 2020.

Turning to the next slide. In our Coatings & Composites segment, which contains our epoxy resins and Versatics businesses, third quarter 2020 revenues increased by 3% to $341 million, which reflected volume gains of 13%, positive foreign currency translation of 2% and negative price/mix of 12%. Segment EBITDA increased by 14%, reflecting volume increases broadly across our business units, reflecting strong demand from China wind energy supporting our specialty epoxy business. Our Versatics Acid and Derivatives volume also improved year-over-year due to strength in architectural coatings and recovering automotive demand. We were pleased that our EBITDA margins increased by 140 basis points year-over-year.

Turning to the next slide. We continue to prudently manage our balance sheet as liquidity totaled $452 million as of September 30, 2020. We still expect to invest approximately $110 million to $120 million of CapEx this year. We've demonstrated that we can consistently drive free cash flow and plan to expand our investments in productivity and growth capital expenditures to drive future growth in 2021 and future years. Our annual maintenance and EH&S CapEx remains in the range of $70 million to $80 million per year.

As expected, third quarter cash flow was impacted by the timing of long-term compensation payments and international pension contribution. Our third quarter net working capital primarily reflected higher accounts receivable due to volume increases and decreased inventory due to lower raw material prices.

Looking ahead, we expect that our fourth quarter cash flow will be positively impacted by the normal seasonality, resulting in favorable net working capital. We also expect to be free cash flow positive in 2020. Finally, with no material debt maturities before 2026, we continue to benefit from a long-dated maturity schedule.

I'll now turn the call back to Craig.

Craig Rogerson^ Thanks, George. We continually align our priorities with our long-term strategy, starting with our associate safety and taking all the appropriate precautions during the pandemic that has enabled us to run our manufacturing sites without interruption and to be good neighbors in the communities where we operate. 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 a disciplined approach to capital allocation to reduce our net debt, which would include proceeds from the pending sale. We also remain focused on our other portfolio optimization opportunities.

The fourth quarter continues to be impacted by softer demand from COVID-19. This hampers our visibility, but we are encouraged by the recent volume trends and recovery in several key markets, as we said earlier. We believe we are well positioned for an economic rebound and remain focused on maximizing long-term shareholder value, including potential open-market share repurchases.

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

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

And your first question comes from Richard Kus of Jefferies.

Richard Kus^ So first one I have, on the Coatings & Composites business, very robust volume performance there. I know auto is recovering, and architectural, certainly everybody knows, has been doing pretty well. But can you be a little bit more specific about maybe how volume trended in those 2 end markets?

And then how was volume in China wind specifically? And do you expect that to continue for the foreseeable future?

Craig Rogerson^ George, do you want to comment first?

George Knight^ Sure. Yes, yes. So maybe in reverse order. I mean China wind continues to be strong. So after we came out of Chinese New Year this year as well as the impact of COVID in China in the first quarter there, the wind volumes really picked up. They've been strong all year really driven by the incentives that they've put in place there in China to stimulate the production on the wind energy side.

So we expect those to continue through the end of 2020. 2021, we expect to see some decreases in volume in China just because of the absence of the incentives, but China continues to be pushing the investment in wind energy. And while not as strong as 2020, we expect going forward that volumes continue to be strong in China as well as in the rest of the world there on the wind energy side.

In the automotive and architectural paints, as Craig mentioned, April this year was the trough. We saw continued improvement on a monthly basis through -- since then. And as we said, our Versatics volumes were actually up year-on-year, really a combination of the architectural improvement as well as automotive.

So again, as Craig said, we're cautiously optimistic for the rebound continuing. But as you're seeing with the increase in positive cases around the world and some countries starting to put additional restrictions in place there, it's hard to say how that's going to play out as we get into 2021.

Richard Kus^ Got you. Understood. And then congratulations on the divestiture. It's great that you guys were able to get that done.

My question is maybe about capital allocation there. How are you thinking about prioritizing repayment of debt, growth CapEx, bolt-on M&A and then share repurchase? I think you mentioned there at the end opportunistically. So big picture, how are you thinking about that? And to the extent that you elect to do some bolt-on M&A, what are areas of focus for the business?

Craig Rogerson^ Let me try to start, and then George and Mark, please feel free to chime in. Paying down our debt and getting our debt-to-EBITDA ratio down closer to 3x is a major priority. Clearly, we want to invest in growth projects, in these self-help projects that I mentioned before that are low risk and improve our bottom line pretty steadily, but we don't have to spend significant CapEx out of the proceeds to do that.

We generate cash flow, and we can spend that kind of money out of our general cash flow we get from the businesses. So we continue -- we will continue to invest and hopefully accelerate our investments in growth of new -- in growth projects as they become more available to us and we get those approved internally. But paying down debt is clearly the top priority.

We are continuing to look at bolt-on acquisitions. I would say that with the criteria we put on them, the pipeline narrows down relatively quickly, but we do continue to look. We're looking at technology more than assets, so it will be relatively low cost, I would say, $50 million or less typically. And they are across the portfolio but probably more heavily loaded towards the adhesives side. There are just more there for us to look at.

And if you define -- one of the advantages of defining the portfolio beyond forest products into adhesives is that there are a lot more adjacencies that we can look at that make a lot of sense for market access and from the technology that we have. So we can look at those adjacencies as potential sources of bolt-on M&A. But clearly, the top priority is debt paydown.

Operator^ (Operator Instructions)

And your next question is from Brian DiRubbio of Baird.

Brian DiRubbio^ Just back on the asset sale. George, can you help us get a sense of how much will the initial proceeds are going to be in cash versus other liabilities that are extinguished?

George Knight^ Yes. The cash proceeds before leakage will be about $305 million. So of the $335 million, there's $30 million of assumed pension liabilities.

Brian DiRubbio^ Perfect. And then what's the timing again for the full, I think it was, $425 million that you're going to get possibly?

George Knight^ So there's an earn-out provision based on performance of the business over a 3-year period. There's annual targets so we can earn amounts each year over the 3 years.

Brian DiRubbio^ Okay. That's -- and then they get paid out each year potentially?

George Knight^ That's correct.

Brian DiRubbio^ Okay. Excellent. And then -- so again, I know you're trying to figure out how you want to deploy this. But as we think about the $305 million of cash, and I know that's before leakage, should we think about maybe like 2/3 going towards debt paydown? And how does wind in -- do we think about the earn-outs going forward?

George Knight^ Yes. I mean as far as the amount of actual cash, we do have some requirements under the indentures that we'll make sure that we're hitting that. And then as Craig said, we'll look at the alternatives for the piece that we have some flexibility to see in the short term and medium term where can we get the best return.

Brian DiRubbio^ Okay. Understood. Maybe switching gears. Craig, the Adhesives business -- I guess, the OSB business.

Obviously, housing is on fire right now. Can you help us understand -- I know you had a couple of customers shut plants. I think it was over the last year or 2, meaning OSB plants. Do you see those plants coming back online at this point given the demand for housing? And how do you see that impacting your Adhesives business?

Craig Rogerson^ We haven't seen yet any announcements of returning of operations of the plants that were shut down. What has happened is the plants that are running are running very hard. And the reason I think that some of these plants aren't restarting yet is because, if you look at the board prices, the profitability of our customers is very high at this point. So they're managing that to some extent, managing supply versus demand.

But what it does do is it puts a lot of strain to operate those plants as efficiently and effectively as possible. And so they are looking for the technology that allows them to do that, and that tends to favor us, the service we provide, the technology we provide. And so our business has been strong. The volumes have been strong and hopefully will continue.

At some point, the decisions are going to be made if this remains at these levels, meaning the demand decisions around restarting some of those mills. Some are down -- some plywood plants, some other plants may be down permanently, but others were just mothballed and could start back up. But again, we haven't seen those announcements yet.

There are some new facilities that are going to come on late '21 into '22. We feel good about that business as well. We've got some new technologies that go specifically into OSB that allow us to, again, be more efficient and effective and allow the operators to optimize those lines and get the most production that get out of it. And in times when demand is high and board prices are high, clearly, that's a focus and to our advantage. So we feel pretty good about where we are going forward.

The question is -- like everything else in this kind of new normal, is it's hard to have visibility out very far and what could happen that could change that, right? So a renewed lockdown, whatever. But we're seeing the strength not just in North America but in Latin America and Brazil as well. So it's across the Americas, and we're poised to be able to take advantage of that.

Brian DiRubbio^ Got it. I guess just a comment you made on some new plants coming up. Do you know if they're going to be using formaldehyde-based adhesives? Or are they going to go at the MDI route for those new plants that you mentioned?

Craig Rogerson^ We have some new products that compete very well with pMDI, so we're optimistic that we'll prove the advantage as we go forward. Trials are -- have been run or continue being run, extended trials with some of our new technology. And we feel good about our position -- competitive position going forward.

Brian DiRubbio^ Great. And then final one for me. Just as we think about the portfolio, are you happy where it stands now? Or should we expect some more pruning over the next year or so?

Craig Rogerson^ Am I happy where we are now? No. I'd like it to be less cyclical. I'd like the margins to be higher. Some of that is work we can do through new product innovation. Some of it is further reshaping the portfolio.

It doesn't just mean selling things or pruning things. We can also find ways to be able to add to the portfolio, not just do bolt-on acquisitions, but I think mergers or other kinds of alignment. And we are actively pursuing those. So I'd like it to be less cyclical, higher margins and have the growth potential that we're all looking forward to as we go forward. So we continue to work on the portfolio.

Operator^ We have no further questions at this time. I will now turn the call back over to Craig Rogerson, Chairman, President and CEO, for closing remarks.

Craig Rogerson^ Thanks. Thanks for joining us on our call today. We remain committed to growing our business and delivering sustainable EBITDA growth over time for our shareholders. We continue to carefully manage our costs, selectively deploy growth capital and to strengthen our balance sheet.

We look forward to updating you again on our next earnings call in March when we'll be talking about the full year performance. So again, thanks for your interest, and thanks for your participation in the call. Good bye.

Operator^ Thank you. This does conclude today's conference call. You may now disconnect.