

Hexion Inc.(Q3 2021 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:

- Roger Spitz; BofA Securities; Research Division, Director and High Yield Research Analyst
- Richard Kus; Jefferies LLC; Fixed Income Research, Analyst
- Oren Shaked; BTIG, LLC; MD of Fixed Income Credit Unit

PRESENTATION

Operator^ Good day, and thank you for standing by. Welcome to the Hexion Third Quarter 2021 Earnings Conference Call. At this time, all participants are in a listen-only mode.

After the speakers' presentation, there will be a session as a question during the session. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, John Kompa, Investor Relations for Hexion. Please go ahead.

John Kompa^ Thank you, Franzie. Good morning, and welcome to Hexion's Third Quarter 2021 Conference 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 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 press release.

Before we start, I'd like to review 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 at hexion.com.

Please note that we'll be limiting any comments today regarding the status of the potential spin of Hexion's epoxy business and an IPO of our Adhesives and Versatic acids product line to the language in the press release issued earlier this morning. With that, I'll now turn the call over to Craig Rogerson.

Craig Rogerson^ Thanks, John. Good morning, everybody. I appreciate you all joining our call to discuss our latest quarterly results. Before we move into the quarter, I wanted to highlight our announcement in late September.

As previously announced, the management team and our Board continues to evaluate strategic value creation options, including the potential spin of Hexion's epoxy business and an IPO of Hexion's Adhesive and Versatic product lines.

The potential spin transaction in IPO remains subject to SEC review, European Works Council review and market conditions. Like everything we do at Hexion, the strategic direction is a testament to our people, our focus on operational excellence and our drive towards increasing shareholder value.

Now turning to our third quarter results, we are pleased to report another very strong quarter. Third quarter sales totaled \$945 million, primarily reflecting sharply higher volumes in both segments, improved market conditions in our epoxy and Versatic businesses and significant material price increases contractually passed through to customers across many of our businesses.

Segment EBITDA from continuing operations rose sharply to \$188 million, which more than doubled the prior year period and increased by \$28 million or 18% sequentially compared to the second quarter.

Our results continue to be driven by a product portfolio that is strategically aligned with key sustainability market trends, positive market conditions and our pricing actions. Demand from several key end markets such as housing, remodeling and architectural coatings continue to be strong, and our third quarter EBITDA margins approached 20% and increased 550 basis points compared to the prior year.

Despite various logistic and supply chain challenges throughout the sector, we continue to serve our customers by leveraging our integrated value chain and our extensive

manufacturing footprint. Finally, the combination of our improved earnings and the use of a portion of the proceeds from our recent divestiture has driven our net debt-to-pro forma EBITDA leverage ratios were modest 2.3x.

I'll turn to Slide 5. Codes that allow for use of wood -- or changing build to codes that allow for use of wood in multi-store commercial building. We're seeing increased demand and long-term pull-through for the use of adhesives in cross-laminated timber applications.

The benefits of wood-based construction enabled by our adhesive technology are amazing. While historical focus has been on operational covering the (inaudible) savings, focus has shifted to CO2 release on materials used to build the structures or embodied carbon.

The processing of wood requires less energy, resulting in fewer greenhouse gas emissions than other major building materials. For example, it takes 5x as much energy to produce glass as lumber or wood for construction, 7x more for steel, 40x more for aluminum and 100x more for cement. Building with wood can also materially reduce costs compared to other building materials with estimates ranging between 25% to 50% lower.

I'll turn to Slide 7. Our adhesive resins are literally the glue that makes the efficient and sustainable use of wood possible. Without our resins, only about half of the tree could be utilized as lumber. By using our resins, 97% of the tree is used.

For responsible forestry products, the building industry leverages trees purposely grown in tree farms. The wood then sequesters carbon oxide, helping to reduce greenhouse gas emissions. As a company, we continue to align ourselves with key organizations that can help guide our strategic vision.

We are pleased to announce that we recently joined the UN Global Compact. Our sustainability metrics announced earlier this year were also developed with the UN Sustainable Development Goals in mind. We look to continue the significant progress we've made already again in the coming years.

While sustainability is growing in prominence, we've been focused on these core principles for some time, and we're being recognized for it by various third parties.

For example, we earned the ENERGY STAR Partner of the Year Award from the United States Environmental Protection Agency's ENERGY STAR program, which recognized more than 250 sustainability projects ranging from waste production to energy efficiency throughout the company since 2014. In addition, V.E ranks Hexion among the Top 4 companies in the North American sector in its most recent ESG assessment.

Now turning to Slide 8. We have real momentum in our business as the third quarter marked the fifth consecutive quarter of year-over-year gains in segment EBITDA, reflecting strong demand from new home construction, remodeling, architectural coatings

and general commercial construction as well as the general economic recovery from the pandemic.

This demand is driving segment EBITDA margins of nearly 20%. We've exceeded our stated leverage ratio goal of 3x or less as our LTM pro forma EBITDA-to-net debt ratio stood at 2.3x at quarter end due to earnings growth and debt pay down from our divestiture.

Finally, we continue to focus on value creation opportunities, including the separation of Hexion epoxy business and an IPO of the Adhesives and Versatic product lines. I'll now turn the call over to George Knight to discuss our financial results in more detail.

George?

George Knight^ Thank you, Craig. In our Adhesives segment, third quarter 2021 revenue totaled \$428 million, a 46% increase from the prior year, reflecting positive volume gains of 5%, price mix increases of 38%, largely through the pass-through of higher raw material prices, and positive foreign currency translation of 3%.

Segment EBITDA increased to \$72 million and a 24% increase due to positive demand in North America from residential construction and repair and remodeling markets as well as strong year-over-year results in our Latin America and Australia and New Zealand resins businesses.

We also saw solid gains in our Merchant Formaldehyde business despite the negative impact of Hurricane IDA. While our overall profitability increased by \$14 million year-over-year, our EBITDA margins decreased due to the mathematical impact of passing through raw material price increases when calculating the percentage.

Turning to the next slide, in our Coatings & Composites segment, third quarter 2021 revenue increased by 52% to \$517 million. Pricing positively impacted net sales by 55% due primarily to improved market conditions in our base epoxy and specialty epoxy resins business and raw material price increases contractually passed through to customers.

Foreign currency translation positively impacted net sales by 2%. Volumes negatively impacted net sales by 5%, which was primarily related to volume decreases in our specialty epoxy product lines, partially offset by increases in our epoxy and Versatic acid and derivatives businesses, driven by strong global demand and continued global recovery from COVID-19.

Segment EBITDA increased dramatically, driven mainly by volume increases in our base epoxy and Versatics businesses and price increases in our base and specialty epoxy businesses. Within Versatics, we continue to drive strong growth in our architectural coatings business. EBITDA margins also increased sharply and exceeded 26% for the quarter.

Turning to the next slide, our balance sheet remains strong as liquidity totaled \$721 million at quarter end. Through the first 9 months, we've invested \$80 million in capital expenditures. We continue to expect to invest approximately \$115 million to \$125 million in CapEx this year.

We expect our cash taxes to now range between \$30 million to \$40 million. Based on our strong customer brand and higher volumes, we built working capital in the first 9 months of the year and expect to see a decrease in the fourth quarter, consistent with historical trends.

However, we expect to have an overall increase in working capital for the year due to the large year-over-year increase in sales. Through the first 9 months of 2021, net cash from continuing operations totaled \$106 million. As Craig mentioned, our net debt-to-pro forma EBITDA leverage stood at only 2.3x at quarter end. I'll now turn the call back to Craig.

Craig Rogerson^ Thanks, George. In closing our prepared remarks, I'd like to acknowledge our skilled manufacturing operators and R&D associates around the world to continue to operate safely and develop the next-generation products against the backdrop of COVID-19.

It's our dedicated associates in these roles that continue to drive strong progress against our key 2021 priorities. Against each metric, revenue, EBITDA, EBITDA margins, operating cash flow, we're seeing the benefits of our multi-year initiatives of focusing relentlessly on the customer and developing tailored solutions for their unique challenges.

Our strong balance sheet also positions us well to make future growth investments to continue to serve them. Finally, we continue to evaluate strategic value creation options, including the potential spin of Hexion's epoxy business and an IPO of Hexion's Adhesives and Versatic product lines.

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

QUESTIONS AND ANSWERS

Operator^ Thank you. (Operator Instructions) Your first question comes from the line of Roger Spitz of Bank of America.

Roger Spitz^ So I don't know if you're willing to chat about this or not, but can you supply Olin with epi in Europe so that perhaps they shut down their Stade epi plant, sort of the reverse of what I understand you did with your Norco epi plant and perhaps you do a North American/European epi swap? And if so, when did this all occur? When did it start?

Craig Rogerson^ We don't have any supply relationship with Olin epi in Europe.

Roger Spitz^ Okay. Good. Okay. And do you -- can you give a view of the planned Versatic acid Q4 '21 planned maintenance turnaround? What do you think the EBITDA impact might be? Or if you can provide that sort of less the scheduled number of days down do you expect?

Craig Rogerson^ George, I don't have that specifics.

George Knight^ Yes, I'm not sure in the number of days, Roger, but the EBITDA impact will probably be in the \$5 million to \$7 million range.

Roger Spitz^ Even better than the number of days. Can you chat about the -- I'm assuming it's the Chinese wind energy that when you spoke about Chinese demand being down. Can you elaborate a little bit on that? This is related to especially epoxies, of course.

Craig Rogerson^ Right. Well, it's been down significantly really for the second half of the year, maybe even a little longer than that, primarily due to the high price epoxy resins and their inability to pass it through with their government contracts. So they've taken the tack to -- they had run it up last year and had it in subsidies moving away.

Their production of blades has been way down this year, but that inventory is going down. So that's what the basis for the resumption, probably not early in 2022, but sometime in the second half of '22, we'll see a resumption of that volume relative to wind in China as they still have their goals to meet relative to the next 5-year plan on renewal energy sources.

So, we're very optimistic going forward. This year, it's been off, but the demand has been strong in the non-wind sectors. So, that's somewhat of a blessing in disguise relative to our ability to supply all of that need. But the expectation for that overall market, specifically, you're right, in China is what we're referring to was soft this year. The rest of the world was relatively strong in wind in 2021. It's expected to continue in 2022.

Roger Spitz^ And last is, did you give the EBITDA impact of Hurricane Ida your Q3 numbers?

Craig Rogerson^ George, what was the impact of Ida? It's primarily in the formaldehyde business, right?

George Knight^ Yes, it was primarily in the formaldehyde. It was about \$3 million to \$4 million in Q3.

Operator^ Your next question comes from the line of Richard Kus from Jefferies.

Richard Kus^ So firstly for me, can you talk about maybe some of the regulatory pressures that are occurring in China and the impact on epoxy capacity over there and

whether or not you think that has caused maybe structural changes to the market overall to your benefit?

Craig Rogerson^ I would say there's -- if there are issues around the regulatory, it's more around production in epichlorohydrins and that's a significant wastewater generator and there's significant capital cost, including in the facilities to treat that wastewater. Historically, that hasn't been done to the same extent in China as elsewhere in the world (inaudible) expenditures made, those capital investments made.

But now with the regulatory tightening, there is some of that and some of the epi production has been shut down temporarily and it's been quite a while now. So I don't know (inaudible) temporarily last -- but that certainly has been an impact on one of the inputs into the overall costing and price of liquid epoxy resins and so it flows through the chain into specialty resins. So that's been -- that's certainly been an impact on the supply-demand dynamics with one of those key precursors.

BPA is the other one and BPA availability really trends more with how polycarbonate demand is. And we're seeing a little bit of softening of that in China right now with the overall softening of the economy.

But right now, it seems like epichlorohydrin is the kind of the long pole in the tent -- or the short pole in the tent relative to the overall supply-demand dynamics. And again, some of that is because of environmental issues in producing epichlorohydrin in China.

Richard Kus^ Got it. And do you think these factors will allow you maybe to keep price a little better should input costs end up declining here and maintain maybe a little bit of the margin?

Craig Rogerson^ Well, that's certainly the hope and our visibility isn't real long, but now we're getting towards the end of 2021 and the fourth quarter still looks relatively strong from a pricing perspective. First half, at least the first quarter and maybe into the first half, we feel pretty good about it.

There's other things, too. I mean, this whole logistics supply chain issue, right, the cost of getting product in and the uncertainty of security supply bringing in from Asia, whether it's to Europe or the U.S., I think it's also moving those or holding those prices up. It's hard to see the second half of the year at this point next year, but no reason to be pessimistic, but it's just hard to see that far out.

But I think that some of those dynamics, like we talked about with epi, like the issue with freight and logistics and concerns around security supply, I think, could hold prices up longer than we initially anticipated. We were seeing it first jump up late last year and early this year.

Richard Kus^ Got you. Okay. And then maybe lastly for me. You touched a little bit on what '22 looks like. Maybe -- and I fully appreciate the adhesive side and the tailwinds that you see on the building and construction piece.

Maybe if you could give us a little bit of a sense of what you expect to see just from a demand standpoint in epoxies, maybe going through Q4 into Q1 and then broadly how you're thinking about that in the different end markets throughout 2022?

Craig Rogerson^ We feel good about Q4, and we'll have some -- we think we'll have some seasonality effect in Q4, like we always do, but not nearly to the same extent. And that's what George referred to relative to the working capital release. Normally, we see a big release of working capital. And the fourth quarter, that's a softer quarter compared to the other 3.

We think the fourth quarter is going to be a strong quarter this year. Again, maybe not as strong as the third quarter, but it will be a strong quarter. And if you look at other fourth quarters, it should be very strong. So we expect that to -- so to your specific question, we expect the market trends from a volume demand perspective to stay strong in Q4 and into Q1. And right now, we're still optimistic about Q2, just uncertain about the second half of the year, and that's how we're kind of building our projections for next year.

As I mentioned, the non-wind, we expect it remains strong. The wind outside of China is solid and kind of expect just because the blade inventory will, at some point, be consumed sometime in the second half of next year, we expect China wind to start to come back as well.

So from a volume perspective, we're pretty optimistic about next year. The real question is how long will pricing hold at the levels that we're at or near the levels that we're at right now. And again, fourth quarter into the first part of the year, we feel pretty good about it based on the things that we just went over.

Richard Kus^ That's great. Well, I appreciate the time. Congratulations on a strong quarter, and I'm glad to hear things are going well. Thanks, guys.

Craig Rogerson^ Thanks you.

George Knight^ Thanks.

Operator^ (Operator Instructions) Your next question comes from the line of Oren Shaked from BTIG.

Oren Shaked^ Craig, you mentioned you're continuing to evaluate strategic alternatives and you do talk about the potential spin. Maybe give us a framework for -- you've now been engaged in these discussions for quite a bit of time.

So you must have some sense at this point as to how things are likely to progress. Can you give us a sense for what these conversations are yielding? Is the spin a very likely scenario? Is it just one of several scenarios? Can you maybe provide a little bit more color on that?

Craig Rogerson^ Yes, I really don't want to say much more than we said in the press release, I would say that -- I'll only add the spin we view and the IPO as very viable alternatives, and we continue to evaluate all the alternatives. Things are progressing. We're getting inputs from the SEC and that's progressing as expected.

Again, we're getting in these inputs and the Board will make the decision that they do create the most value for our shareholders. So again, I don't want give any specifics, but nothing certainly changed relative to the announcement we made in late September that spin and the IPO are very viable alternatives and ones that we can control.

Oren Shaked^ Okay. And as it relates to the IPO, that was intended to be a Q4 event. Is that still the timing?

Craig Rogerson^ It's still -- we are moving along the track when that's still possible. Again, market conditions and all those other and things that I mentioned relative to the approvals that are required need to happen in the pace that they were expected. But as we see here right now, that's still a potential date. And if it slips into January, we feel good about the first quarter.

So that window -- we're talking about open windows, that window relative to the trends of the businesses, the markets we're in, our performance still looks strong. The variability is market conditions and that's an uncertainty. And that's one of the reasons why we're pushing for sooner rather than later just because we don't know. But as we get towards the end of the year, we're still on track, and we could hit that date.

Oren Shaked^ And as it relates to the cycle that you talked about earlier, I think you used the words may be higher for longer or something along those lines. Is it fair to say that during the course of the conversations that you've had and just assessing where your epoxy business fits relative to some others that, that thought process is something that pervades the marketplace?

Or is that something that you think in terms of a perspective that is unique to how you see the world versus maybe how others see the world?

Craig Rogerson^ No, I think it's a consistent opinion on how we see it. There's no question that this business has cyclical characteristics historically and no reason to believe that, that general tendency will be the case going forward.

So I'm not trying to convince anybody that there isn't a cyclicity in this business. But to your earlier point, that it looks like it's higher and longer because of those issues that we talked about earlier is the case doesn't seem to be under much debate.

Oren Shaked^ Okay. And lastly for me on Adhesives, the volume growth there in the quarter was certainly a little softer than 2Q.

Craig Rogerson^ Yes. I mean the growth rate was soft. It was a good quarter and continue to reflect the higher housing starts that we had seen. But yes, I mean, second quarter was being compared to the second quarter last year, which was abysmal during the beginning of the pandemic.

We feel real good about the demand. I mean there's going to be a little seasonal moves as we get to the fall, but remodelings remain strong, furnitures remain a strong segment and housing starts over the near and midterm are projected to be very strong. Our customers are running flat out. So, we see no issue relative to demand. It's going to continue to be strong.

George Knight^ Yes. And the other factor that impacted volume was Hurricane Ida on our Merchant Formaldehyde business at the end of Q3.

Operator^ And speakers, we don't have any questions over the phone. Mr. Craig Rogerson, please continue.

Craig Rogerson^ Thanks. And thanks, everybody, for your questions and thanks more so for joining our call today. We're pleased that we're able to report that we continue to drive strong year-over-year and sequential earnings growth and we remain committed to delivering the sustainable and profitable growth in the quarters and years ahead.

We look forward to updating you on our next investor call and hope you guys have a nice weekend. So thank you very much.

Operator^ And ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.