Hexion Inc.(Q1 2020 Earningl)

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Corporate Speakers:

- John Kompa; Hexion Inc.; VP of IR & Public Affairs
- George Knight; Hexion Inc.; Executive VP & CFO
- Mark Bidstrup; Hexion Inc.; Senior VP & Treasurer

Participants:

- Nathan Schubert; JP Morgan; Analyst
- Richard Kus; Jefferies; Analyst
- Unidentified Participant; Bank of America; Analyst
- Brian DiRubbio; Baird; Analyst
- Brian Lalli; Barclays; Analyst

PRESENTATION

Operator^ Ladies and gentlemen, thank you for standing by. Welcome to the Hexion First Quarter 2020 Earnings Conference Call. (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. Thank you. Please go ahead, sir.

John Kompa^ Thank you, Brandy. Good morning. Welcome to the Hexion Inc. First 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. As you can appreciate, out of respect for his personal privacy, we won't be commenting further on his status today as he continues to recover.

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.

A replay of this call will be available for one week, and the replay dial-in information is contained in our latest earnings release. Before we start, I'd like to give you 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 risk, 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 George Knight.

George Knight^ Thank you, John. Good morning, everyone. Thank you for joining our call today. By now, you've heard from many other companies in the chemical sector and other industries.

While everyone's business is different, the themes are similar. We are all living in unprecedented times because of the coronavirus pandemic. It's had an obvious impact on Hexion, with Craig Rogerson continuing on medical leave. And I know everyone on the call wishes him a steady recovery.

Before we start with the slides, I'd also like to recognize our associates around the globe who have kept our manufacturing sites running, and those in an office or R&D setting that have continued to work remotely despite Covid-19. Your teamwork is inspiring and your collective efforts are making this new way of working today as normal as possible.

Now, turning to our specific first quarter results. We had a solid quarter considering the volatility in several end markets that developed late in the quarter from the pandemic. Our sales totaled $826 million, while segment EBITDA declined by 14% to $89 million.

First quarter 2020 earnings reflected improved volumes in our Coatings and Composite segment, and the positive impact of our recent structural cost reduction initiatives, while overall results were offset by competitive pressures in our Base Epoxy Resins business and the impact of the coronavirus pandemic that began to impact us in late March.

We estimate that the Covid-19 and the strengthening of the U.S. dollar, compared to other foreign currencies, negatively impacted our first quarter 2020 EBITDA results by approximately $4 million and $2 million respectively.

As we stated in our press release, we are seeing a more significant impact in the second quarter from the pandemic. Because neither the duration nor scope of the coronavirus impact can be predicted, the negative financial impact to our results cannot be reasonably estimated at this time.

Finally, we ended the first quarter with $440 million of liquidity, including $246 million of unrestricted cash and cash equivalents, and are taking a variety of actions to prudently manage our solid balance sheet.

Turning to Slide 5, we've taken a number of actions to mitigate headwinds from the pandemic. These include reducing our 2020 capital expenditures to a range between $100 million to $110 million, and reviewing the timing of manufacturing turnarounds of certain sites around the globe.

Continuing our focus to reduce working capital in 2020, we expect to see a positive impact on our net working capital levels from lower oil prices in the second quarter of 2020, and the pass-through of significantly lower-priced raw materials; reducing SG&A spending wherever possible, such as travel restrictions, instituting a hiring freeze, and reviewing other discretionary spending items, as well as the move to a managed service business model.

We're also delaying approximately $15 million of certain tax payments to later in 2020, and deferring $5 million of certain tax payments to future years in conjunction with the Coronavirus Aid Relief and Economic Security Act, and other tax relief measures in other jurisdictions where we operate.

Finally, we drew down $164 million of revolving credit loans under our credit facilities as a precautionary measure to increase cash balances and preserve financial flexibility.

Turning to Slide 6, we also believe we are better positioned to compete because of the actions we've taken over the last several years. We remain focused on operating safely and following the guidelines of each country in which we operate. Being deemed a business considered critical infrastructure has fortunately enabled us to keep all of our sites running.

In terms of our global footprint, we are serving our customers today with a more efficient manufacturing grid, particularly when compared to the last stage of our economic downturn in 2008.

Our sites are also located in close proximity to our customers, which we expect will become even more important in light of future supply chain planning. We also continue to strategically leverage our existing towing relationships in China, which support our wind energy business.

We've also steadily streamlined our organization through 2 significant cost reductions since late 2017. And our SG&A, as a percentage of sales, is a modest 9%.

We are also staying in close contact with our customers, many of whom we've served for years. We're fortunate that we are not overly dependent on any one end market, customer or geography.

I'd also like to recognize our longstanding suppliers. We work hard to maintain strong relationships with multiple sources for our key raw materials to ensure continuity of supply.

Turning to Slide 7, I've outlined a few key elements of our strategy to improve our profitability and EBITDA margins over time, which we believe supports our efforts to grow our share price. While the pandemic is impacting our business today, we remain focused on these long-term areas to create value.

First, our new product efforts continue and we are building on our successful track record, as we've averaged 20% of sales from new products introduced over the last 5 years.

Second, we see a clear pathway to long-term growth through our productivity initiatives and operating leverage. As we've discussed on the last few earnings calls, we've identified a number of modest self-help capital investments with minimal market risk.

We also have ample capacity in a few key product lines, such as formaldehyde and epoxy resins, and are strategically investing in select growth opportunities that only require modest capital, such as our Australian 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.

Finally, we remain focused on reducing our debt levels going forward through natural earnings growth, while using proceeds from a transaction to delever even more rapidly. 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 quick 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 represent the successor period, and for 2019, represents the predecessor period.

Turning to our Adhesive segment, which includes our Forest Products Resins, Formaldehyde and Phenolic Specialty Resins business, first quarter 2020 revenue totaled $468 million, a 14% decrease from the prior year, reflecting volume declines of 5%, negative price mix of 7% and currency headwinds of 2%.

Segment EBITDA declined by $5 million, reflecting lower volumes due to the Covid-19 impact that began in late March, as well as competitive pricing pressures in our North

American Forest Products Resins business, partially offset by cost actions resulting in improved margins.

Turning to the next slide. In our Coatings and Composites segment, which contains our Base and Specialty Epoxy Resins and Versatics business, first quarter 2020 revenue rose across the board, reaching $358 million, which reflected higher volumes of 12%, offset by negative price mix of 6%, and currency headwinds of 2%.

Segment EBITDA declined by $5 million primarily due to margin reductions in our Base Epoxy Resins, partially offset by improved volumes and margins in our Versatic Acids and Derivatives business.

Turning to the next slide, we continue to realize our cost savings initiatives as planned, and we realized $8 million of cost savings in the first quarter of 2020 after achieving $19 million of savings in 2019. At quarter-end, we had $15 million of in-process structural cost savings, which we expect to realize over the next 12 months.

We also recently announced a partnership with Capgemini to provide certain administrative functions to further improve our organizational efficiency and reduce our costs.

Turning to the next slide. We continue to prudently manage our balance sheet, as liquidity totaled $440 million as of March 31, 2020. A number of items support our attractive free cash flow profile.

Looking at our capital expenditures, we now plan to spend between $100 million and $110 million this year. And we are also reviewing the timing of manufacturing turnarounds at certain sites. Our annual maintenance and EH&S CapEx within the range of $70 million to $80 million per year.

We continue to focus on managing our working capital. Our first quarter net working capital reflected higher receivables due to seasonal volume increases, while inventory and accounts payable declined due to lower raw material prices. As George mentioned earlier, we would expect working capital to decline from lower oil prices and the pass-through of lower-price raw materials in the second quarter.

We expect continued structural improvements in vendor terms to bolster our top-quartile metrics, as we continue to normalize our contractual terms with our suppliers. We expect annual interest costs of approximately $105 million in 2020.

Finally, with no material debt maturities before 2026, we benefit from a long-dated maturity schedule. I'll now turn the call back to George.

George Knight^ Thanks, Mark. As we close, I'd like to again acknowledge the efforts of our global associates, considering how well they are managing the challenges associated with the coronavirus outbreak.

Even with the pandemic, we've seen our teams remain focused on safely doing their jobs, while also going the extra mile to support the communities where we operate.

During this time of great need, our associates have responded by shifting production to make hand sanitizer, donating masks and protective equipment to area hospitals and first responders, and providing food and monetary donations to those in need in several cities.

As a management team, we remain focused on aggressively managing our costs, while maintaining a disciplined approach to capital allocation to reduce our debt. We are also constantly assessing our portfolio or potential acquisitions or divestitures with the goal of driving to maximize long-term shareholder value.

In closing, we believe we are well positioned for the eventual economic recovery. 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 the line of Nate Schubert with JP Morgan.

Nathan Schubert^ So first question, just you mentioned wind energy in the press release as sort of a volume growth business during the quarter. Can you talk about what we're seeing there in terms of volumes relative to sort of where this was at the peak, and if there's been any impact from Covid? I'm assuming that most of that business is in China this year, and if you would expect sort of a rebound post the Covid era?

George Knight^ Sure. Yes, I think as we mentioned, wind energy markets in Q1 were strong for us. We did see a slowdown at mid-quarter when the impact was being seen in China.

That started to pick up toward the end of the quarter, and orders have continued strong on that. In other parts of the world, we have seen fairly strong demand, nowhere near where we were at the peak. But we feel good about the outlook for the year as far as it relates to wind energy.

Nathan Schubert^ Okay, great. And then on the M&A side, can you just talk about sort of what the interest has been like, and how Covid has impacted the timeline there if you still have suitors looking at those assets? And how does the diligence process take place in sort of a world of social distancing?

George Knight^ Yes, as you've seen, it has had impacts on the financing market. So as you talk about M&A, that will impact timing. But as far as the process goes, we're seeing continuing interest. There's a lot of things that could go on even with some of the lockdowns, and we've continued to pursue different opportunities.

Nathan Schubert^ Thank you.

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

Richard Kus^ Clearly, you guys are going to end up with some lower volumes here in Q2. Can you maybe give a little bit more granular detail on what you've seen so far in the quarter? And then maybe a little bit of a discussion of how the benefit from lower oil prices should work in your favor and potentially offset a little bit of that? How should we think about that?

George Knight^ Sure. From a volume standpoint, we're seeing what everybody else is seeing there in the markets there, big impact in April. But as you can appreciate too, the picture is changing every day.

I think when we initially entered the quarter, we thought things would start to pick up in May, June. As things are evolving, it looks like May is going to be another tough month there from a volume perspective. So we're planning accordingly there.

From an oil impact, again, you think 75% of our raw materials -- sorry -- 75% of our sales, our raw material costs, about 60% to 70% are oil-based. So as oil goes down, we do see a benefit that flows through to our margins.

We do have to give some of that back over time since we do have a lot of contracts where we pass raw material price changes onto our customers. But in those other parts of the businesses where we have negotiated pricing, we believe that that'll continue to have a positive impact for us on our margins going forward.

Richard Kus^ Okay. And can you give us a sense maybe by the 2 different businesses that you have, what the magnitude of volume decline that you saw in April was?

George Knight^ Yes, I think again, as you think about the different end markets, in Adhesives, we've got North American housing, a big driver there. That started to really drop off, so that impacted that part of the business.

There's an automotive component for our specialty phenolic resins, but to put it in perspective, automotive only represents about 7% of our sales there. So we did see a big impact on that business.

On the Coatings and Composites, we talked about wind energy continuing to hold steady, but when you get into the Coatings sector, you've got the automotive component, that was way off, as everything was shut down. Any coatings related to marine, also --

Mark Bidstrup^ Some industrial applications.

George Knight^ -- industrial applications, yes. But on the positive side, anything related to packaging or can coating, those types of things, held pretty steady. So I guess it's in line with everybody, we probably saw like a 30% to 40% volume impact in April.

Richard Kus^ All right. Thank you very much. I appreciate it. Good luck, guys.

Operator^ Your next question comes from the line of Roger Spitz with Bank of America.

Unidentified Participant^ It's [inaudible] sitting in for Roger. So I just wanted to get your thoughts on what your Q120 base epoxy level we'd look at would be like, because in 2013 and 2014, you had a negative EBITDA. And in 2015 and 2016, the EBITDA was around $10 million a year. So it would be helpful just to get your thoughts on your level of Q120 basis would be.

George Knight^ Yes, as we said, base epoxy, we had a good quarter from a volume perspective. We were actually up year-on-year. But as Mark mentioned in his comments there, because of the competitive pricing there, our margins in base epoxy were down. We also had a turnaround at our Pernis facility in the first quarter, that from a fixed cost that flowed to the P&L, it was higher in Q1 this year than, for example, the last year so --

Unidentified Participant^ All right. Thank you.

Operator^ (Operator Instructions) Your next question comes from the line of Brian DiRubbio with Baird.

Brian DiRubbio^ George, can you define new products for me, products introduced in, what, the last 3 years, 5 years? And try to give me a sense of what the margin uplift is with new products.

George Knight^ Yes, so yes, as we said, the way we define it would be anything that's introduced in the last 5 years. It can't be a modification to an existing product; it has to be either a substantial change or a totally new product.

One of the things that Craig, he's talked about this before, that while we have a good percentage of our sales from new products, we haven't seen the margin uplift from that, that you'd normally expect. So that's one of the things that we're focused on going forward there, to really capture that incremental margin that we should be seeing from that.

Brian DiRubbio^ Out of curiosity, what do you think that is?

George Knight^ I would say 100 basis points. It's hard to say; it depends on the products and the end market that we're introducing for.

Mark Bidstrup^ But to your question, a couple of the new products over the last few years, one is our next-gen bonding paste. And that's really impactful as the blades get longer and longer, that's one of our higher-margin products.

So from an overall mix percentage, it does help raise our EBITDA percentage. And another one is our BPA-free can coatings, again, another project that's higher than our average coatings margins.

Brian DiRubbio^ Understood, okay. And then could you give me any updates on what you're seeing on competition in your Adhesive business, with MBI taking share away from formaldehyde base resins from OSB.

George Knight^ Yes, really not much has changed there. I think especially now with the pandemic, I think people are very reluctant to change supply chains, move to anything different there.

I think, as we entered this year, we had seen most of the situations where we'd have customers switching, they've really done that. So we don't expect that to have a large impact going forward.

Brian DiRubbio^ Okay. And what impacts do you see right now in Brazil?

George Knight^ Yes, Brazil was a little bit disappointing for us in the first quarter there. We expected more of an economic recovery; we haven't seen that. The other piece that, from a competitive standpoint, we have seen some additional competitor come into the market there, who's been aggressive on pricing, so we've had to deal with that. So in the first quarter, Latin America, while it's not a big piece of our business, was more challenging for us.

Brian DiRubbio^ Great. And just final for me -- as you're thinking about your overall liquidity -- and I know you guys want to drive down your debt and your leverage. So given the current environment, are you potentially concerned about increasing liquidity through additional debt raises at this point in time?

George Knight^ Not at this point in time.

Brian DiRubbio^ Okay. So I guess maybe put another way, liquidity should not be an issue over the next 12 to 18 months?

George Knight^ Yes, as we disclosed in the press release, we believe we have adequate liquidity over the next 12 months. And we haven't -- we don't have a crystal ball as far as what the recovery is going to look like.

But we spend a lot of time looking at different scenarios, different recovery patterns and different levers that we'd have from a liquidity standpoint to deal with that.

Brian DiRubbio^ That's -- and sorry -- finally, cash restructuring, what would that cash outlay be for this year?

Mark Bidstrup^ Yes, cash restructuring will be about $40 million, with the largest chunk of that related to our transition to managed services with Capgemini.

Brian DiRubbio^ Excellent. Thank you so much.

Operator^ Your next question comes from the line of Brian Lalli with Barclays.

Brian Lalli^ A real quick one for you, unless it might've been asked, and I apologize if I missed anything specific on this.

But I guess -- and appreciating that it's hard to forecast as we move through these next few months -- but I guess as you see it now, George, is it safe to say with some of the stuff that you're doing, obviously, taking CapEx down a little bit, the continued focus on working capital, do you envision still the ability to be obviously, on a much lower debt load now, free cash flow-positive for the year?

I guess I'm not asking maybe not a totally fair question, given the EBITDA number might move around, but how are you thinking about that relative to liquidity, debt reduction, the things you've mentioned?

George Knight^ Yes, I think it's difficult to say at this point just because we don't have a good vision of what the recovery is going to look like. As we said, we're focusing on the things that we can have control over, such as CapEx, working capital, expense control.

And we're driving to be cash flow-positive. The big positive for us is just the decrease in interest load that we have to cover there, so but depending on the scenario, we're doing what we can.

Brian Lalli^ Yes, understood. And I guess my second would just be, as you see it now -- and again, appreciate that things can change quickly. But raw materials, it's fair to say that's going to be a decent tailwind.

I guess the question is how much of that can you hold onto as you move through these uncertain times. But is that directionally fair as you think about kind of the next few quarters at least?

George Knight^ Yes, that's directionally fair. We believe that's going to be a positive for us. And as you said, the key will be for how long do we hold onto the increased margins.

Brian Lalli^ Got it. All right. Thanks for the time and best of luck [will all that's happened. Talk to you soon.]

Operator^ I would now like to turn the call back over to George Knight, Acting CEO and CFO of Hexion.

George Knight^ Okay. Thank you, Brandy. So thanks for joining today. I wish everybody a safe and profitable rest of the year there. And we look forward to having you on our next quarterly call. Thanks a lot.

Operator^ This concludes today's conference call. You may now disconnect.