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- Q3 2016 Hexion Inc Earnings Call

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Craig Morrison *Hexion, Inc. - Chairman, President, CEO*

George Knight *Hexion, Inc. - EVP, CFO*

CONFERENCE CALL PARTICIPANTS

Tarek Hamid *JPMorgan - Analyst*

Roger Spitz *Bank of America Merrill Lynch - Analyst*

Bill Hoffman *RBC Capital Markets - Analyst*

James Finnerty *Citi - Analyst*

Ryan Bloom *Hartford Investment Management - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Hexion, Inc. Third Quarter 2016 Earnings conference call.

(Operator Instructions)

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

John Kompa - Hexion, Inc. - Vice President, IR

Welcome to the Hexion, Inc. Third Quarter 2016 conference call. Leading today's call will be Craig Morrison, 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 on the Investor Relations section of Hexion, Inc. 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 read information about forward-looking statements and the use of non-GAAP information as part of this call. As you know, some of our comments today may include statements about our expectations for the future. Those expectations are subject to known and unknown 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 make 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 our website. Our earnings release and our recent SEC filings are also available on the internet at Hexion.com.

With that, I'll now turn the call over to Craig Morrison to discuss our financial results.



Craig Morrison - Hexion, Inc. - Chairman, President, CEO

On page four, third quarter 2016 adjusted revenues decreased 15% to \$819 million reflecting lower selling prices from the decline in raw material costs, softer volumes in oilfield proppants and specialty epoxy resins, as well as the negative impact of the strengthening US dollar.

Hexion posted a net loss of \$47 million compared to net income of \$7 million in the prior year, while our segment EBITDA totaled \$112 million. On a pro form basis for recent divestitures and non-recurring favorable impacts in the prior year period, total segment EBITDA was flat year-over-year.

In our Forest Products segment, segment EBITDA rose by \$6 million as we posted positive gains in all regions of our global business. The positive trends in our Forest Product segment was supported by our new formaldehyde sites and modestly improving housing starts.

In our Epoxy and Phenolic Coating segment, EBITDA adjusted for the divestitures decreased by \$13 million. This was largely driven by softer volumes in our proppants and specialty epoxy resins businesses.

Our Versatic Acid and Derivatives business partially offset the negative results in the other business units with strong demand. We continue to work to recover Versatic customers lost as a result of the outage while maintaining margins.

Turning to slide five and our combined raw material index, our total raw material cost increased 4% on a sequential basis. When considering our three major raw materials, the average price for phenol, methanol and urea declined 1%, 36% and 31%, respectively, in the first nine months of 2016 versus the first nine months of 2015. We continue to expect raw material pricing will generally remain favorable in 2016.

Turning to slide six, we remain confident in our ability to drive structural cost reductions and are focused on achieving the incremental \$37 million of cost savings. As previously announced, the closure of our Norco site occurred in the second quarter of 2016 as planned. This is projected to add \$20 million in segment EBITDA on a run rate basis.

We are already beginning to realize some of the benefits as we've achieved \$5 million of incremental savings as of September 30.

In addition, in October, we announced that Jody Bevilacqua has been named Chief Operating Officer of the Company. In this new role, Jody will oversee all aspects of the Company's operations for both divisions. The COO appointment is part of broader corporate reorganization, focused on streamlining Hexion's organizational structure, which will increase the overall speed of decision-making and deliver additional savings by reducing corporate overhead costs.

Turning to slide seven, we've highlighted our recent investments in our formaldehyde business that are aligned with our strategy of investing behind our leading specialty technologies. Following our successful startups during the last year, our new plants continue to ramp up production, with specialty-type margins in our formaldehyde business to three new sites strengthen our Americas footprint and we are serving such notable customers as BSF and Monsanto.

While our Latin American business has been softer due to Brazil recession, we still expect the three plants to deliver \$30 million to \$35 million in EBITDA on a run rate basis with the potential of additional upside. This is currently not reflected in our LTM adjusted EBITDA calculation.

Turning to our proppants business, we remain one of the world's largest suppliers of resin coated proppants. The business is currently challenged reflecting the volatility in the oil and natural gas markets. While oilfield proppants business is at a cyclical low, there remains a strong, long-term growth outlook for this sector as drilling activities increase.

For example, resin coated sand demand in North America is forecasted to grow at 24% compound annual growth rate from 2016 to 2019, longer term significant embedded upside opportunity and we remain well positioned through our manufacturing grid, serving all major shale regions.

Now, I'll turn the call over to George Knight to further discuss our financial returns.

George Knight - Hexion, Inc. - EVP, CFO

In our Forest Products resin segment, third quarter 2016 sales totaled \$343 million, 13% decline from the prior year as higher volumes of 1% were offset by negative price mix of 14% primarily due to the pass-through of raw material price changes.

Segment EBITDA increased by 10% due to broad-based gains in our global Forest Products resins, including solid contributions from our North American formaldehyde business and increased raw material productivity. Segment EBITDA margins also improved sharply and totaled 19%, an increase of 410 basis points compared to the prior year.

Turning to the next slide, our Epoxy, Phenolic and Coating Resin segment third quarter 2016 revenue totaled \$476 million or a 29% decrease from the prior year due to a 15% impact from our dispositions, a negative price mix impact of 9%, lower volume of 4% and currency translation headwinds of 1%. Adjusted for the dispositions, revenue declined 17% year-over-year.

Segment EBITDA decreased by \$28 million compared to the prior year as improved results in our Versatics business partially offset softer volumes in base epoxy resins, oilfield proppants and specialty epoxy resins. Adjusted for dispositions, segment EBITDA declined by \$13 million year-on-year. Segment EBITDA margins declined slightly on both a reported and adjusted basis.

Regarding our balance sheet, our cash plus borrowing availability under our credit facilities was \$496 million at quarter end. Our year to date 2016 capital expenditure investments totaled \$91 million. We now expect our CapEx to be approximately \$120 million to \$125 million in 2016.

Net working capital totaled \$506 million as of September 30, up from the year-end of 2015, primarily reflecting higher volumes from seasonality. Net working capital reflected a modest 15% of sales.

Working capital trends are consistent with historical trends. Working capital is expected to decline in the fourth quarter, but we still expect a slight increase in that working capital overall for 2016.

I'll now turn the call back to Craig to wrap up.

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Turning to slide 13, in summary, our third quarter 2016 EBITDA totaled \$112 million or a 5% decline. On a pro forma basis for recent divestitures and non-recurring favorable impacts in the prior year period, total segment EBITDA was flat year-over-year.

We're pleased by strong gains in our Forest Products and Versatic Acids and Derivatives businesses as key components of our specialty portfolio. Our Forest Products business also reflects the incremental volumes from our recently opened formaldehyde plants.

We are focused on streamlining our operations and driving structural costs out of our business. Our in process cost savings stand at an incremental \$37 million.

In closing, we continue to maintain our strong liquidity position with \$496 million of cash and available borrowings. Let me now turn it over to the Operator for any questions that you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)



Tarek Hamid with JPMorgan.

Tarek Hamid - *JPMorgan - Analyst*

In the proppant side, could you talk a little bit about what you're seeing kind of real time in proppant, particularly given that some uncoated sand producers are seeing a little bit more volume come through here on the second half? Maybe just talk a little bit about what you're seeing real time?

Craig Morrison - *Hexion, Inc. - Chairman, President, CEO*

On the oilfield business, on a year-over-year basis, it was down both in volumes and in EBITDA. But on a prior quarter basis, the volumes have started to improve. But I'd say the margins are still under pressure.

So, we are seeing an EBITDA pickup on a quarter-over-quarter basis. And we are seeing double-digit growth in volumes, but it's off of a relatively low base. So, that always has to be kept in perspective.

Tarek Hamid - *JPMorgan - Analyst*

Fair enough. And then as you look some of your cost reduction actions on the epoxy side, do you feel like you now have the sort of right mix of base versus downstream epoxy capacity in the United States or do you feel like you have a little bit more left to do?

Craig Morrison - *Hexion, Inc. - Chairman, President, CEO*

I think in the United States, we're at a good structural point. And in general, we think the repositioning with the Norco facility closure was obviously the right move. We'll continue to assess various options as we go forward as we always look to optimize the business. But we have nothing further to announce at this time, so the current plant structure is what you should probably model.

Tarek Hamid - *JPMorgan - Analyst*

The 8.875 go current on the balance sheet in another quarter and a half; maybe just talk a little bit about sort of your expectations on timing of looking to address those notes and how you're thinking about it?

George Knight - *Hexion, Inc. - EVP, CFO*

We continue to look for opportunities to buy back the debt at a discount. We continue to do that in the third quarter, dropping the balance from \$1.2 billion -- where we started last year at third quarter -- down to \$761 million. So, we'll continue to look for opportunities on that front as they come available.

We are very focused at looking at other options, with keeping in mind when the debt is going to become current. So, we are very much focused on that but we have nothing more to talk about on that today.

Operator

Roger Spitz from Bank of America.

Roger Spitz - Bank of America Merrill Lynch - Analyst

In base epoxy resin, can you comment on the drivers of the softer EBITDA, please?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

The precursors -- the BPA and ECH -- are actually relatively strong and produce good results. The pressure really comes into major resins -- the LER and SER, with the LER obviously being the largest driver.

There's two factors there. The biggest is just Asian capacity and importing and therefore providing significant downward pressure on the margins. And, I would also say western competition has also heated up; it's always hard to tell if that's a result of the import sort of actions or whatever.

But those different factors have really put a lot of pressure on the LER and SER margins in particular.

Roger Spitz - Bank of America Merrill Lynch - Analyst

I know that you've said in the past, that the weak euro slowed imports of Asian product into Europe; is that still holding true or is that not as strong or are your comments more reflective of North America?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

No I would say it's both. North America's obviously also impacted but, I think when people have capacity it's always a matter of what their threshold is and at times that's a moving target. So, it may provide protection for some portion of time, but it's certainly not a total wall or barrier to lock them out of Europe. So, we find it impacting both continents.

Roger Spitz - Bank of America Merrill Lynch - Analyst

Especially epoxy resins, the volumes were down; in the recent past, you've referred to the Chinese and European wind energy. Is that turning around now?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

When you say turning around, do you mean is it strengthening moving into the fourth quarter and beyond? Is that what you meant?

Roger Spitz - Bank of America Merrill Lynch - Analyst

No, I guess in the past quarters, especially epoxy resins, I got the impression, that volumes was up and maybe EBITDA was up and you were noting that there was strength in Chinese and European wind energy. This quarter it sounds like sounds like volumes were down; I'm wondering, is Chinese European wind energy weakening? Is that what's driving the volumes down, especially epoxy resins?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Yes, it's still a very strong performer, but it reached a historical highs in terms of EBITDA and contribution. So, it's not as if all the sudden it's totally collapsed or anything like that; that's not the case.

What happened is China had gotten into such a strong build mode they couldn't install it fast enough, so they had a lot of blades in inventory. And unlike most governments, they really do have the levers to slow things down and speed it up when they choose to. And, so they put policies in place that basically said, until you actually install your access to inventory, you need to slow down your production and so that's what we're seeing.

In the medium to long term and it will continue to be an excellent market. Wind energy is something they are continuing to focus on as an eco friendly source of electricity. As you know, they have a lot of pollution issues. So, we consider it still an excellent place to be; we have a tremendous footprint there in terms of market share and ability to produce.

But we are seeing a period of slow down now that we expect to continue through this year.

Roger Spitz - Bank of America Merrill Lynch - Analyst

Two things on seasonality. Do you expect typical seasonality, particularly in the epoxy, phenolic, coating resins segment as we've seen in the past in terms of sales and EBITDA sequentially from Q3? And also, in terms of the working capital, historically it looks like you've released nearly \$200 million of working capital as a source of cash. It looks like your guidance would imply it's towards the lower end of that range this quarter?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Yes, let me start off with the EBITDA question. We would expect that normal seasonality would apply to this year. We don't see any reason that that would differ significantly. And, I'll turn it over to George Knight for his comment on working capital.

George Knight - Hexion, Inc. - EVP, CFO

On the working capital side, we expect to see the historical normal decrease in working capital in the fourth quarter. To your point, as far as where in the range -- probably somewhere in the middle to the lower end of the range because we do expect to see a slight over all increase in working capital, year on year.

Operator

Bill Hoffman with RBC Capital Markets.

Bill Hoffman - RBC Capital Markets - Analyst

Craig, can you talk a little bit more about the formaldehyde plants, maybe where you're ramping those up just so I get a sense of what the operating rates might be?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Yes, we've had a very successful startup of the two North American plants, which are on the Gulf Coast in Louisiana. And right now, they'd be producing probably somewhere between \$10 million and \$11 million of EBITDA this year out of that \$30 million to \$35 million of potential. They are running very well, so they are fully capable of ramping up.

Brazil has more or less not required at this time due to the economic slow down when we first started the plans. Eventually, we will need that capacity because it's still a growth region. But, as all of you are very familiar with, they are coming out of a fairly deep recession for a couple of years, but their outlook medium to long term continues to be very strong and we'll be the big supplier of formaldehyde down there.



We still think the \$30 million to \$35 million is appropriate outlook; it's just a little slower ramp up due to Brazil and then some other factors such as excess capacity in China on some downstream customer chemicals that aren't pulling quite as much in North America as we might have originally thought.

Bill Hoffman - RBC Capital Markets - Analyst

And, then just regarding the epoxies business -- the specialty side -- is there many share shifting or do you think this is all driven by the wind side at this point?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

No, actually, in the biggest segment of wind we've taken share this year very successfully while also expanding our margins. So, I think we've done it very successfully. When you go into some of the subsegments, there is always a little bit of share shifting, depending on what you are focused on -- what you have capacity on.

But, generally the big driver of the slow down right now is not driven by share shift; it's driven by the wind energy change in policy in China.

Bill Hoffman - RBC Capital Markets - Analyst

Final question for George -- thoughts on CapEx for next year or any sort of major projects at this point?

George Knight - Hexion, Inc. - EVP, CFO

Yes, I think next year probably we'll be in the \$120 million to \$110 million range. No big plants on the horizon. Normally our maintenance CapEx is between the \$80 million to \$90 million and then we have smaller growth type productivity projects that make up the difference.

Operator

(Operator Instructions)

James Finnerty with Citi.

James Finnerty - Citi - Analyst

Just following up on resin coated proppants. You mentioned that on a sequential basis, EBITDA did improve. So, does that imply that it's actually a pretty positive EBITDA in the third quarter?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Yes, we don't comment on the exact numbers, relative, but let's just say it's not a significant contributor by any means yet.

James Finnerty - Citi - Analyst

And, then following up on the working capital -- just on the other side of it -- you said a slight increase year over year; slight increase, we should think of as less than \$50 million on a year over year basis?



George Knight - Hexion, Inc. - EVP, CFO

Yes.

James Finnerty - Citi - Analyst

On the formaldehyde plant in Brazil, given that it's not needed right now, is there a specific a cost in maintaining it on an annual basis that we should think about?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

No, it would be minimal; it's not really a factor in the financials.

Operator

Ryan Bloom with Hartford.

Ryan Bloom - Hartford Investment Management - Analyst

I just wanted to get a sense in terms of global demand -- where you might be seeing the greatest strength and weakness? I know Latin America has been cited. So, if you could just probably put that into context. And then within that also role in the Versatics demand -- which has been strong -- is that mostly a function of China demand?

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

No, let me start with the first part of your question and I'll make sure I come back to the Versatics piece.

When you look at total demand, I don't think people are seeing a strong growth engine anywhere in the world right now. Historically, China has played that role and I think while they're still growing at a very respectable 6% or so, it certainly doesn't compare to the 12%, 13%, 14% growth they historically had. And, I think all of you are very familiar with some of the challenges they have in their economy and some of the bubbles that have grown relative to housing, et cetera.

That doesn't mean there's not areas -- for instance, wind energy in China has been very favorable for us, with very strong demand -- but those are very select segments that the government chooses to invest in. You look at other parts of the world, Germany remains healthy, but again it's like the U.S.; it's low, single 1%, 2% growth.

It's not a rapid growth. I'd say that's largely true for Northern Europe; Southern Europe continues to have its challenges. And then you look at Latin America and it tends to be challenged, although it's improving slightly as it comes out of the recession and we're seeing some pick up there.

Finally, in the U.S. I think you see the 1.5%, 2% growth -- we just came out of our Industry Council meeting and an economist was projecting that will grow for the next couple of years significantly stronger at 3% to 3.5% percent. He thinks it will be a very positive North American environment for the next couple of years.

So, there is no big growth engine in the world; it's certainly not a 2008 type weakness, but it's just kind of muddling along. And depending on very specific segments you are in, you may feel it some more or less.



When you look at Versatics, it's really not Asia driven; it's much more North American and European-based driven by auto and construction. And as the technology has held up well, we're continuing to develop new R&D projects for it -- new product development projects for it. So, we continue to have a positive outlook for that product line.

Operator

I am showing no further questions. I would like to turn the call back over to Craig Morrison for any further remarks.

Craig Morrison - Hexion, Inc. - Chairman, President, CEO

Thank you very much, everybody, for participating. We'll look forward to entertaining your questions next quarter and appreciate your participation. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. You may all disconnect. Everyone, have a great day.

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