Q2 2016 Results Conference Call (Script)

Mark Davis

Good morning, ladies and gentlemen. Thank you for joining us for our conference call and webcast today.

As usual, joining me today is Rohit Bhardwaj, our Chief Financial Officer.

Before I commence the review, I would remind you that our presentation contains certain forward-looking statements that are based on current expectations, and are subject to a number of uncertainties and risks, and actual results may differ materially. Further information identifying risks, uncertainties and assumptions, and additional information on certain non-IFRS measures referred to in this call can be found in the disclosure documents filed by Chemtrade with the securities regulatory authorities, available at sedar.com.

One of the non-IFRS measures that we will refer to in this call is Adjusted EBITDA, which is EBITDA modified to exclude only non-cash items such as unrealized foreign exchange gains and losses. For simplicity, we will just refer to it as EBITDA as opposed to Adjusted EBITDA. Both these terms are fully defined in our MD&A.

Once again, most of our businesses were stable in the second quarter. We generated Distributable cash after maintenance capital expenditures of $39.7 million, or 57-cents per unit, compared to $38.8 million or 56-cents per unit for the same period last year. EBITDA for the quarter was $59.4 million, which was slightly higher than the second quarter of last year.

As Rohit will outline, our two major segments SPPC and WSSC both generated EBITDA slightly higher this quarter than they did in the second quarter last year. Regarding our Water Solutions business, we've previously discussed our strategy of adding new plants, expanding our product range, and stabilizing our alum business. The second quarter results show the positive benefits of these initiatives and we continue to be pleased with this business and our progress in improving it. Turning to our SPPC segment and its largest product, sulphuric acid, there was a further development on one of the issues we had mentioned during our last call.

This related to the customer that makes another chemical, caprolactum, by using acid from our over-the-fence acid plant.

This customer publicly announced on June 30, 2016 that their plant operations will gradually wind down over the next 16 months. Our Augusta, Georgia plant is essentially a dedicated plant for this customer. Although we are exploring other merchant marketing opportunities and equipment modifications to keep our acid plant viable, we do not expect to recover the same rate of earnings historically generated by this pipeline customer.

To put this in perspective, we anticipated generating EBITDA of about US$7.0 million or free cash of about US$6.0 million this year from this plant, which we acquired as part of our acquisition of General Chemical. The customer has an existing contract with us through 2021 and the contract includes a capacity reservation fee equal to about half of the EBITDA indicated above through 2021. We expect the customer to perform the contract through 2021, and if not we intend to pursue recovery of these fees which, if successful, will mitigate some of this loss until 2021. Clearly, it's not a desirable turn of events, but neither is it material when Chemtrade's earnings as a whole are considered.

So, to summarize, the second quarter of 2016 was one of generally steady performance from most of our businesses. We are facing some future disruption because of the imminent shutdown of a customer's operation, but are also seeing positive developments from our Water Solutions initiatives and a substantial organic growth opportunity in one of our specialty chemical businesses, which I will talk about in my concluding remarks.

Rohit will now provide you with some additional details on the second quarter financial results.

Rohit Bhardwaj

Thank you, Mark and good morning everyone.

In general, our businesses operated well in the second quarter. Our water business was stable, and our acid businesses performed well. The acid issue Mark mentioned will affect us in the future and in this quarter, the write-down affected net income, but as it's a non-cash item it did not affect EBITDA. Financial results benefitted from the stronger US dollar; however, this was offset by the lower prices for sulphur in both our SPPC and International segments and lower volumes of sulphuric acid in our International segment.

Revenue for the second quarter of 2016 was $304.2 million, a decrease of $34.6 million from 2015. The primary reason for the decrease was lower prices for sulphur in both our SPPC and International segments and lower volumes of sulphuric acid in our International segment.

For the three months ended June 30, 2016, Distributable cash after maintenance capital expenditures was $39.7 million, or 57-cents per unit compared with $38.7 million or 56-cents per unit in 2015.

Aggregate EBITDA for the second quarter of 2016 was $59.4 million compared with $58.7 million in the second quarter of 2015.

Turning to segmented results for the quarter, SPPC generated revenue of $144.6 million and EBITDA of $38.9 million compared with $158.4 million and $38.0 million, respectively, in 2015. The main reason for the decreased revenue, year over year, was lower selling prices for sulphur, partially offseting the positive impact of the stronger U.S. dollar. The increase in EBITDA was due to continued strength in our regen products. There was also a small benefit from the stronger US dollar.

As Mark mentioned, our plant in Augusta, Georgia supplies sulphuric acid products to a customer that has publicly announced that their operations will be gradually winding down over the next 16 months. Because the cash flows associated with our assets will no longer be able to support their carrying value, we recorded a write-down of $55.7 million in the quarter. This was partially offset by a large income tax recovery of $27.0 million, primarily as a result of the reversal of certain deferred tax liabilities associated with the assets that were written down. Finally, we also recorded an impairment loss of $3.1 million related to the intangible assets associated with this customer.

Our WSSC segment reported second quarter revenue of $117.5 million compared with $117.8 million in 2015. EBITDA was $31.5 million, up slightly from the $30.8 million generated in 2015.

Our International segment reported revenue of $42.0 million for the second quarter, compared with $62.5 million in the second quarter of last year. The lower revenue was due to lower volumes of sulphuric acid and lower selling prices of sulphur. In general, international markets for sulphuric acid have been weak in 2016 relative to 2015. EBITDA for the quarter was $2.7 million, compared with $3.5 million last year.

Maintenance capital expenditures in the second quarter were $8.7 million, bringing our spending on maintenance capex for the year-to-date to $13.6 million, which is below our anticipated annual run rate. However, as in recent years, this is mostly a timing issue, and we believe we will reach our expected spending level as the year progresses. We now expect maintenance capex for 2016 will be somewhat less than the $50.0 million level that we had previously indicated.

Excluding unrealized foreign exchange gains and losses, Corporate costs during the second quarter of 2016 were $13.7 million, which was essentially the same as the second quarter of 2015.

Our balance sheet at June 30, 2016 continued to be in sound shape. We had drawn down about US$470.2 million on our senior credit facility. Our term loan is fully drawn but we maintain about US$444.8 million of undrawn capacity, which provides us with ample liquidity. The credit facility matures in October 2020.

I’ll now hand the call back to Mark.

Mark Davis

Thank you, Rohit.

While our sulphuric acid business faced some residual challenges from the sourcing issues in the first quarter, most of our businesses, including the acid business, performed well and we were still able to generate Distributable cash that was comfortably ahead of our distributions to unitholders. , The diversity of our operations means that adverse issues like the one affecting our plant in Georgia, will not be material to Chemtrade in the aggregate.

On a more positive note, we want to provide some details of an organic growth opportunity that is now coming to fruition. Previously, we have described some of our other recent organic growth initiatives, such as the new adjuvants facility we are building; the expansion of our portfolio in the water solutions business; and the expansion, now completed, of our caustic pellet operations. We had indicated that all of these activities would fall within the $10.0 – $15.0 million annual growth capex forecast.

We are pleased to now advise you about a growth project in our Potassium Chloride, or KCl, business in Midlothian, Texas. At this facility we make high purity KCl for the food and pharmaceutical markets. We see high purity potassium chloride as a key inorganic salt for both the pharmaceutical and food markets. Recently issued voluntary FDA guidelines recommend the US Food industry work towards a 50% reduction in sodium chloride (salt) content in their products over the next 10 years and potassium chloride is one of the ways in which the food industry can help meet those guidelines. Further, the market for "active pharmaceutical ingredient" or "API" KCl is increasing as the drugs used to treat diabetes and hypertension find wider use. We have decided to expand our existing facility by more than 50% at a cost of approximately $30.0 million. Recently we concluded a long term sales contract with our key API customer that links their growth with ours. We expect that this project will generate a return of capital in excess of 30% and come on line sometime in 2018.

Thank you for your attention. Rohit and I would now be pleased to answer questions.

Operator (Joanna): Thank you. Ladies and gentlemen, we will now begin the question and answer session. Should you have a question, please press * followed by 1 on your touchtone phone. If you are using a speakerphone, please lift the handset before pressing any keys. Your first question comes from Nelson Ng from RBC Capital Markets. Nelson, please go ahead

Nelson: Great, thanks. Just a few clarification questions on the Augusta facility. Has it been determined how the facility will phase down over the next 16 months and does that mean that you're in a run rate EBITDA of about $7 million U.S. when that facility will gradually step down through that 16 month period as well?

Mark: It's not determined. A little bit more colour: as the customer winds down, which time is still in flux, our plant will end up winding down with it. What supports the continued earnings flow, as I mentioned, is regardless of how much they produce, until 2021, at least, there's a capacity reservations fee that they will owe us which is essentially equal to about half of that EBITDA run rate that I mentioned. It's hard to tell you what the linear answer to that question is.

Nelson: I see. Have you written down the facility down to zero or is there still some value you're holding on the balance sheet for that facility?

Rohit: No, we actually did write it down to zero even though we are evaluating our options there. From an accounting perspective we do want to try to create a model that shows value there and we're unsure what the value is going to be so we wrote it down to zero.

Nelson: Ok, and then if that facility would no longer be in use and you have to kind of decommission it, do you know roughly how much it would cost to decommission a facility like that?

Mark: It's not a big ticket item. As a general statement, it's the salvage value. For any of them, steel would offset the cost of decommissioning. And again, this is still late breaking news. We're not even sure if it does shut down, whether or not we can use some of the capital equipment elsewhere in our system, as you know we have a number of acid plants.

Nelson: I was just wondering from an environmental mediation perspective

Mark Davis: It's not a big pregnant cost, we'll see in the future.

Nelson: Ok, got it. Just on the CAPEX side, you mentioned that KCl and some investments on the water side; all in, $10-15 million for water-related investments and $30 million for the KCl, so that's about $40-45 million. Does that sound about right for the next year or so?

Rohit: The $30 is a one off so that's just for that one project. But $10-15 on the water we have said this year; we have spent about less than half of that for this year. We're willing to spend a bit more for the rest of the year but that $10-15 is probably good for a couple of years and $30 for the one-time thing.

Mark: And the $30, again, the actual spending profile is still being worked out, but it's probably $20 next year and 10 in '18, something like that. It's probably something in the fourth quarter this year, 2/3 in '17 and 1/3 in '18.

Rohit: And we can give more clarity on the next conference call on that project.

Nelson: Ok, just one last question. We're kind of already half way through Q3, does it look like it's going to be a pretty flat quarter year over year? Are there any things or surprises we can expect in Q3 that we would hear about in a few months? Obviously, I think FX would be a potential slight benefit and then you're still seeing lower sulphuric acid prices.

Mark: I don't think FX is a big benefit year over year, right? We haven't yet been surprised by the preliminary stuff we've seen so far this quarter.

Nelson: Ok, great. Thanks Mark

Mark: Thanks

Operator (Joanna): Thank you. Your next question is from Jacob Bout from CIBC. Jacob, please go ahead.

Jacob: Good Morning

Rohit: Good Morning Jacob

Jacob: Just on the expansion on the potassium chloride plant, why did you decide to do it now? Two, what type of return are you expecting on this investment?

Mark: I'll answer the last one first. We indicated we expect a return on capital of about 30% on $30 million. That's in the range of the return. Why now actually, is that there is more demand today than we can actually reliably supply on our API product. The drugs that we're spec'ed into actually, that are and will continue to be in production, have a growing demand base so, there's a demand pull for the product. And then on the food side because you end up getting both of these things when you expand, as we indicated, there's a drive towards reducing actual salt in a bunch of foods, and potassium chloride has and will continue to be one of the key ways of actually replacing that sodium content.

Jacob: I got on the call a little bit late but did you mention how long you think it's going to take to build this facility?

Mark: Oh yes, we'll be online in 2018.

Jacob: And do you think you'll be able to sell all the product immediately?

Rohit: Yeah, we're pretty close

Jacob: And then in that $10-15 million in CAPEX, I'm assuming that covers off that PACl platform expansion you were talking about previously?

Mark: Yes, it does.

Jacob: Where are you at with that?

Mark: One is up and running. The second one is, do you remember if it was going to be commissioned soon?

Rohit: Before the end of the year.

Mark: Before the end of year and then there's probably a third one next year

Jacob: What type of returns do you think you're getting or will be able to get on that? Might be similar to the potassium chloride plant?

Rohit: Probably not as high as the potassium chloride. I think we've said probably in the 20% range.

Jacob: And then on the WSSC division, can you talk about the EBITDA margins? It looked to me like it was a slight improvement. How much of this was U.S. dollars? I know that you had some issues in the past with, I wouldn't call it predatory pricing but more competition on the pricing side. Are you seeing any of that or is that basically all resolved?

Rohit: So, the FX shouldn't really be an issue if we talk about margin percentage because the revenue and EBITDA both are U.S denominated so FX shouldn't be a factor and the pricing is a little bit more stable

Mark: There's a number of different products and it's hard to generalize. We can generalize by saying that the margins in our Alum business are actually stronger this quarter than they were this same period last year.

Jacob: And did you cover off the impact of the forest fires in the quarter?

Mark: We didn't mention, but it was not material to us. There are some extra costs that were running around and stuff but it's just not material to us.

Jacob: But you're basically getting a flat fee from that Syncrude?

Mark: We get a flat fee and we get some upside depending on production throughput and pricing of the by-product that gets sold. Again, the differential for us is not material.

Jacob: Alright. That's helpful, thanks guys

Mark: Thanks

Operator (Joanna): Thank you. Your next question is from Joel Jackson, BMO Capital Markets. Joel, please go ahead.

Joel: Hi, Good morning. Just following up on Nelson's question, were you saying you see Q3 trending about flat with year over year we saw in Q2 for overall earnings for Chemtrade?

Rohit: I don't think I want to get too precise with that kind of guidance but I think that questions was have we seen any surprises so far in the quarter and we haven't.

Joel: Ok so, I'm just going to ask then. I'll just ask it. Not Nelson's question, my question. Are earnings trending similar in Q3 year over year performance versus Q2?

Mark: Not an issue what the comparison is. What we said actually 6 months ago is that we thought that 2016 should look a lot like 2015 and I don't see any reason to change that.

Joel: So, similar earnings in '16 and '15 is still the guidance?

Mark: Yes

Joel: Ok, in SPPC margins were really high. Sulphur and sulphuric acid prices obviously had come down because you had your best margins in that division for many years. Can you talk a little bit? Is it all in regen and what's going on in the business?

Rohit: As we've said in the past when selling prices are high our margins are low, percentage margins are low; and conversely when selling prices come down the percentage margin goes up and that's just the function of the way we have our risk-shared contracts, particularly in the SPPC segment. So, it's not just a regen thing. Generally, that's what tends to happen in a low pricing environment.

Mark: But we can also say actually, the regen continues to be a good performer for us and as you know regen margins are generally higher than merchant asset margins.

Joel: With Vale and Copper Cliff you had the issue in Q1 of being a good customer and taking more tons than you had to. How did that play out in Q2 and also, if that situation was to rise again in the future, have you had discussions about making sure that maybe Chemtrade is taken care of a little bit better in the future?

Mark: I'll give two answers. One is actually, they ran above what I think we expected in Q2 as well just not to the same magnitude which is I think what we indicated in our last call. They've now recently returned to a more usual run rate for us. We always have discussions with our long term partners like Vale about what an appropriate sharing of extra costs or extra benefits and we'll continue to have those discussions with Vale but quite frankly, we don't feel hard put upon by actually continuing to serve them. It's been a good long term relationship for us and one of the values we add is an ability to handle peaks and valleys of by-product production.

Joel: Ok and finally, what's sort of the appetite now for acquisitions? You're still running 2.5 or 2.6x leverage, you're adding a bit more gross capital here in Texas with the KCI plant. Are you being pitched a lot versus the last couple of years, what's your appetite right now?

Mark: Our appetite is actually always veracious but cautious. Joking aside, we're always looking to add size scale and diversity of earnings as long as it's in businesses we understand and that fit our business model. I think I've said before is there's always assets available in the chemical industry. People are always taking things apart and putting them back together again. We have and continue to see a number of opportunities that if we chose to execute on them we can do but, we continue to be disciplined and only actively pursuing things that we think fit us. But there's plenty to do out there right now if it fit our business model and valuations worked.

Joel: One more question actually. If I understand, for you to hit about flatish earnings in '16 the second half earnings have to be higher than the second half of '15, is that right?

Rohit: So, the first quarter you know we were down. I wouldn't take those comments that literally because in the first quarter we mentioned those three specific issues we had with acid, and we were down about $4-5 million. It's unlikely that we will make that back up.

Joel: Ok, so flat is earning, ignoring $5-6 million hit that you had in Q1?

Rohit: That's the ball park. It's still high and we still have a few months to go…

Mark: And we're not going to, and we don't get, frankly, that precise. We have actually told you all about this issue in Augusta which again, is not material in aggregate but if you're asking about $2-3 million offs period to period we're not sure we're going to be able to offset that.

Operator (Joanna): Thank you. Ladies and gentlemen as a reminder should you have any questions, please press *1 on your phone. Your next question is from Steve Hansen from Raymond James. Please go ahead

Steve: Hey guys. The organic build opportunity actually sounds quite attractive. I'm just curious whether there's other opportunities within your system that might also be on the table at some point in the near future. Could you elaborate on those? And maybe just a broader question or statement; is this a reflection of the multiples being paid in the sector right now and it's just that much more attractive to preserve organic growth versus acquire?

Mark: I'll answer it a bunch of different ways. We've always been desirous of organic growth but a number of the products in our portfolio didn't really have an organic growth profile. Again, I think if we go back a year and half ago or so, we actually said one of the attractive things about the assets we got when we acquired General was not only did we actually know a bunch about the business, but there were few assets that actually had organic growth potential – adjuvants, the water business that we talked about, and now KCl. If you take those and our ultra-pure sulphuric acid business, that's probably where we look for organic growth and the most likely places to find it. We will continue to actually look for where we can grow our business organically. There's not a plethora of opportunities but there are these ones that we're doing and hopefully we'll find some others. Based on our current product portfolio we're not going to magically overnight turn into an exponential organic growth machine just by the fact that we'd like to be.

Steve: Understood. Is that something you contemplate then when you're looking at these new businesses? I know you've always historically looked at some of these more mature type businesses, perhaps with less organic growth but are contemplating that as you look to broaden the portfolio or diversify?

Mark: Certainly. We'll look the same as we always do with this difference. I think we've said this before, we spent a lot more time diligencing the downside than actually the up. But once we're actually content that we actually have boxed the downside is certainly it entered our minds to how can we grow what we have either by just making it better. As we've said before, investing capital into the process and improving our processes but then what other things can we do to actually organically grow the business. We'll definitely be looking for opportunities to do that but again, I don't want to oversell it. Our primary focus, too, will be actually protecting against the down.

Steve: Understood. And just one last one if I may on the Augusta facility; do you have a sense on when you'll get clarity on the timing of the wind down or I guess, the cadence of the wind down and how that residual payment streams might work on a recovery basis?

Mark: I think we'll have better visibility on the over-the-fence wind down frankly in the next two months probably. It might actually take another 3 or 4 months after that for us to figure out the best and highest value use for our asset.

Steve: Understood. Thanks guys, I appreciate it

Mark: Thanks

Operator (Joanna): Your next question is from Anoop Prihar from GMP Securities, please go ahead

Anoop: Good Morning. Mark, just a point on clarification on the Georgia facility. The capacity reservation fee just to be clear, that's a fee that you would collect annually over the remaining term of the contract?

Mark: Yes

Anoop: Ok, thank you

Mark: You're welcome

Operator (Joanna): Thank you. Your next question is from Ben Thorek from Waratah, please go ahead.

Ben: Hey Mark

Mark: Hey Ben

Ben: How are you doing?

Mark: I'm alright, thank you

Ben: I just had a quick question on the plant closure, I know that this is for caprolactum. Is this indicative of something in the industry or just a one-off for this individual client?

Mark: I think it's actually good for their industry because their industry is suffering from overcapacity which is depressing prices and all that good stuff. Quite frankly, we don't follow the overall industry that closely because there's a bunch of plants in Asia and things like that that we don't deal with. I think this is the big event in the North American caprolactum industry and it should have a good knock on effect for the worldwide industry but I'm not really sure how it affects the industry outside North America.

Rohit: And we don't have any other plants that are hooked into the industry directly like this.

Ben: Ok, and do you know where the utilization rates go for the industry with this plant closing?

Mark: No. As we've said in our last call the industry tried to force through a price increase that they all needed to make money and it wasn't successful and obviously part of the reason it wasn't successful is over capacity. So, if you start watching now it wouldn't surprise me if they come back and try and force through that price increase. But again as Rohit says, we're really not too connected to that industry other than this one plant.

Ben: Ok, thanks so much for your time

Mark & Rohit: Thanks Ben

Operator (Joanna): Thank you. There are no further questions at this time, you may proceed.

Mark: Thank you all for your attention, we look forward to talking to you next quarter.

Operator (Joanna): Ladies and gentlemen, this concludes today's conference call. We thank you for participating and ask that you please disconnect your lines.