Q3 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.

One other preliminary comment — we took steps to strengthen our capital structure during the quarter by issuing $144.0 million of convertible debentures. This provided us with longer term money than our bank debt and increased our ability to incur additional bank debt for other purposes such as potential acquisitions. The proceeds from this Canadian dollar debenture were used to repay US dollar bank debt, resulting in a foreign exchange loss of $20.3 million. For the purposes of discussing our third quarter operating results, we will exclude the effect of this foreign exchange loss on EBITDA and Distributable cash.

Chemtrade's core businesses delivered essentially the same results this quarter as they did in the third quarter last year. Excluding the foreign exchange loss I just mentioned, we generated EBITDA of $62.0 million and Distributable cash after maintenance capital expenditures of $36.2 million, or 52-cents per unit. This was comfortably ahead of our distributions of 30-cents per unit for the quarter.

Our two major segments, Sulphur Products and Performance Chemicals (or SPPC) and Water Solutions and Specialty Chemicals (or WSSC), both generated stable EBITDA year-over-year. Both segments generated EBITDA relatively similar to last year due to the diversity and strength of the underlying businesses, despite facing some operational issues.

The SPPC segment's EBITDA was slightly higher this quarter than the third quarter last year. SPPC achieved this result despite the reduction in contribution from our acid plant in Augusta, Georgia that we referred to last quarter. We also encountered some weakness in merchant acid selling prices, but because of our risk-shared contracts, the effect on margin was not significant. Further, strength in other products in SPPC helped offset the negatives.

Due to our origins as a merchant acid marketer and the volume of merchant acid we market, we tend to spend a lot of time and attention on this business. However, our acquisitions have helped us diversify away from being solely a merchant acid market supplier. While all our acid businesses – merchant, regen and ultra pure – are interdependent, merchant acid margins now represent only about a third of the aggregate margin we realize in the acid business.

Our Water Solutions business, part of our WSSC segment, continues to show signs of stability. We are pleased with the traction we're seeing on our strategy of expanding the product range in that business. Our second polyaluminum chlorate (or PACl) plant and our new aluminum chlorohydrate (or ACH) plant are scheduled to come on stream towards the end of the first quarter of 2017. Expansion of our Specialty Chemicals businesses is also on track. The new adjuvants facility in Berkeley Heights, New Jersey is on schedule for completion late next year, and I'll have an update on the expansion of our potassium chloride plant in Midlothian, Texas, in my closing remarks.

So, to summarize, our two significant segments had steady performances in the third quarter of 2016. Demand for most of our products was steady. Merchant acid pricing did move lower in the quarter, but our risk-sharing business model, diversity of sources of earnings, and broad customer base helped mitigate any adverse effect.

Our International segment generated lower EBITDA than it has in recent quarters. This is partly due to weaker conditions for sulphuric acid in certain international markets. More importantly, one key acid customer built its own acid plant and therefore bought less acid. On a go forward basis, we will generate some income by supplying sulphur to this customer, but it will not replace the lost acid margin.

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

Rohit Bhardwaj

Thank you, Mark and good morning everyone.

In general, both our SPPC and WSSC segments operated well in the third quarter. Our International segment did not perform as well, which I'll address in a minute.

Revenue for the third quarter of 2016 was $308.3 million, a decrease of $56.2 million from 2015. About $24.5 million of this decrease came in the International segment due to lower volumes and prices of sulphuric acid and lower prices for sulphur. The balance came primarily from SPPC due to lower prices for sulphuric acid and sulphur.

For the three months ended September 30, 2016, Distributable cash after maintenance capital expenditures and before the foreign exchange loss on the debt repayment, was $36.2 million, or 52-cents per unit compared with $45.1 million or 65-cents per unit in 2015. Aggregate EBITDA for the third quarter of 2016 before the foreign exchange loss was $62.0 million compared with $68.5 million in the third quarter of 2015. As a general statement, SPPC and WSSC were both similar to last year and the decrease is attributable to the International and Corporate segments.

Turning to segmented results for the quarter, SPPC generated revenue of $146.4 million compared to $172.4 million last year. The main reason for the decreased revenue, year-over-year, was lower selling prices for sulphuric acid and sulphur. Despite the revenue decrease, EBITDA this year was $39.7 million compared with $38.9 million in 2015. As Mark mentioned, lower selling prices did not have a significant impact on EBITDA due to our risk-shared contracts. These results were achieved despite the lower profitability of our Augusta, Georgia plant. As we discussed last quarter, the customer supplied by our sulphuric acid plant is winding down its operations and in early November they ceased operations and therefore we stopped production as well. We will incur some costs in the fourth quarter to safely shut down and moth ball the plant in hope of repurposing this asset in the future. As mentioned previously, we have an agreement with this customer through 2021 which provides us with some mitigation for the loss of this earnings stream.

Our WSSC segment reported third quarter revenue of $126.6 million compared with $132.3 million in 2015. EBITDA was $33.5 million, essentially the same as the $33.7 million generated in 2015. The head line numbers mask underlying strength in results for alum. Our alum business has stabilized and we actually realized higher profits in alum this year than we did in the third quarter of last year. Some of this recovery is masked by operating issues at one of our PACl sites. We ensured that our customers remained supplied, but our cost to do so eroded some profitability. We also had some lower production at our Midlothian site as we start to implement the expansion plan. We expect that there will be further downtime in the fourth quarter for the same reason. Finally, the lower acid pricing we mentioned in the context of SPPC earnings did benefit WSSC, as sulphuric acid is an input into alum production.

Our International segment reported revenue of $35.2 million for the third quarter, compared with $59.7 million in the third quarter of last year. EBITDA for the quarter was $1.0 million, compared with $3.2 million last year. While in aggregate this $2.0 million dollar difference may not be material, it is material to this standalone segment. The lower revenue and EBITDA were primarily due to lower volumes of sulphuric acid and lower selling prices of sulphuric acid and sulphur. In general, international markets for sulphuric acid have been weak in 2016 relative to 2015. Additionally, as Mark mentioned, the key customer who has built its own sulphuric acid plant bought less acid. This customer was a key baseload of our offshore business which represented about half of the segment's historical business. We will bear some fourth quarter costs as we exit this business and are reducing our guidance for International's annual EBITDA to less than $10.0 million from the $10.0 – $15.0 million we have indicated in the past.

Maintenance capital expenditures in the third quarter were $11.5 million, bringing our spending on maintenance capex for the year-to-date to $25.1 million, which is below our anticipated annual run rate. As we noted last quarter, we expect maintenance capex for 2016 will be somewhat less than $50.0 million. Non-maintenance, or growth, capex in the third quarter was $2.7 million, bringing our growth capex for the year-to-date to $7.1 million.

The biggest difference between this quarter's EBITDA and last year's is found in the Corporate segment. Even excluding realized and unrealized foreign exchange gains and losses, Corporate costs during the third quarter of 2016 were $12.5 million, compared with $7.0 million in the third quarter of 2015. There are two primary reasons for the difference. First, due to an increase in our unit price, LTIP costs this year were $2.0 million higher than the third quarter of 2015. Secondly, last year's corporate costs benefitted by a gain of $4.1 million related to settlement of a lawsuit associated with the Marsulex acquisition in 2011.

Finally, a couple of comments on our balance sheet. We strengthened our balance sheet during the third quarter by issuing $144.0 million of seven year 5% coupon unsecured convertible debentures and using the net proceeds to pay down long-term debt. While this does not change our overall leverage it reduces our senior leverage, which in turn reduces our senior borrowing cost. It also provides additional term on our debt. At September 30, 2016 we had drawn down about US$345.0 million on our senior credit facility. From a senior debt-to-EBITDA ratio perspective that puts us at about 2.1 times. Our term loan is fully drawn but we maintain about US$570.2 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.

Our third quarter operating results again demonstrate Chemtrade's ability to generate Distributable cash well in excess of distributions to unitholders. The diversity of our operations and nature of our business model dampen the effect of adverse issues such as a customer closing its plant or building their own acid plant, decreases in pricing, or the myriad of production issues that occur when you operate over 50 facilities. Pursuing diversity of products and sources of earnings has been one of our core strategies since inception, and the benefits are quite clear.

We operate our business for the long-term, always pursuing long-term sustainable earnings. Since we don't run our business on a quarter-by-quarter basis, we usually don't talk about specific quarters. However, this year our fourth quarter does deserve some comments.

Ignoring the foreign exchange loss, we have generated about $175.4 million EBITDA year-to-date, or Distributable cash of $1.64 per unit, while distributing $0.90 per unit. In general, the fourth quarter tends to be our lowest Distributable cash quarter due, in large part, to our tendency to have the highest capital spending in that quarter.

As you know, we don't generally provide future financial guidance, but when we see something unusual on the horizon, we proactively disclose its potential financial effect. For example, last year when we announced our third quarter results we advised of a weak fourth quarter. Last year, for our North American business segments, the fourth quarter represented roughly 22% of annual Adjusted EBITDA. Similarly, this year, we expect that the fourth quarter will be the weakest quarter of the year and will represent roughly 20% of annual Adjusted EBITDA for our North American business segments. There are a number of reasons for this.

This year the situation is exaggerated as we have five plants undergoing maintenance turnarounds in the quarter. We will perform turnarounds at four of our regen plants as well as at our potassium chloride (or KCl) facility. Three of the regen plant shutdowns were pushed back to the fourth quarter from earlier in the year to benefit from strong regen demand.

The fourth regen plant turnaround was not planned to be in the fourth quarter. Last year at our Richmond, California facility we replaced a major piece of equipment that has been defective since start-up. We have purchased a replacement and this will be installed in the fourth quarter this year. This will result in a significant loss of profitability due to the downtime related to the installation. We are in discussions with our insurer regarding coverage and are in the process of making a claim against the equipment provider. As I said, we benefitted earlier in the year by delaying the three shutdowns and one of the plants will further benefit by being able to forego a turnaround next year as it's being turned around late this year. However, when coupled with the unplanned turnaround at Richmond, we expect to generate lower regen acid earnings during the fourth quarter as well as lower merchant acid earnings, as those customers will have to be supplied from places that are less than optimal for freight. Moreover, we will incur a significant capital spend related to these maintenance turnarounds.

We will also be taking some downtime at our Midlothian KCl facility. This will allow us to implement the first phase of the expansion plans we previously discussed. While the major expansion costs won't occur until later in 2017, we are implementing some modifications in the fourth quarter this year, which will detract from fourth quarter earnings but should deliver enhanced earnings starting in the first quarter of next year.

Recall that we make high purity KCl at our Midlothian plant, which we see as a key inorganic salt for the food and pharmaceutical markets. We have concluded a long-term sales contract with our key API customer that links their growth with ours, and we're confident that we'll add additional customers for this product. As we noted, the cost of this expansion will be approximately $30.0 million, and we expect that this project will generate a return on capital in excess of 30% and come on line sometime in 2018.

So, to summarize, our fourth quarter will be more challenging than most as we juggle all these activities but we will be past the turnarounds by year end.

As we have mentioned on recent calls, we are pursuing a number of organic growth initiatives that will strengthen our product portfolio and also our customer relationships. Earlier I mentioned the second PACl plant and the ACH plant which are expected to come on stream towards the end of the first quarter of 2017, and our new adjuvants facility will be completed next year. We expect growth capex, other than the KCl expansion to be less than $10.0 million in 2017, so while they aren't big ticket items, they are significant in that they strengthen our operational base and our service capabilities.

Finally, I'm sure many of you are following our pursuit of Canexus. The Canexus assets would fit well into our company and continue diversifying our sources of earnings with products that we believe are steady cash flow generators. Our offer of $1.50 represents a premium of over 20% of their unaffected share price before we announced our interest.

Much more of the background, rationale and other matters can be found on line at www.canexusoffer.com.

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

Operator (Chris): 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. You will hear a 3 tone prompt acknowledging your request and your questions will be polled in the order received. If you are using a speakerphone, please lift the handset before pressing any keys. Your first question comes from Orhan Eldarav from RBC. Orhan, please go ahead

Orhan: Hey guys. So, I just wanted to follow up on the customer that is producing their own suphuric acid. It's sort of going to be an ongoing thing. First, I wanted to hear your thoughts on international market for the sulphuric acid. Would you be able to replace the short fall in the near future; is there robust demand?

And then the second one: what would be the financial impact on a run rate basis for EBITDA if it is an ongoing thing? Thanks

Mark: I guess two things: the international market is currently suffering from weak sulphuric acid prices and the customer that built was a key lynchpin for us in the offshore market. We're still figuring out frankly, what it all means. We've indicated that the run rate on that business has gone from 10-15 to less than 10. As a general statement, the off shore acid business represented about half of that segment's profitability. That is going to decrease and we're still actually surveying the scenery to see exactly what to, but less than 10 is the indication we're giving.

Orhan: Ok, so just to confirm: you said that that this client represented almost half of the International business or the offshore?

Mark: The offshore acid business and not to actually minimize this one customer. This one customer was a key part of the offshore business.

Orhan: Ok, cool. And then with respect to Canexus process: we know that you're waiting until January for that expiration date. In terms of your near term plan, would you ideally try to get Canexus to the negotiation table, wait until the offer expires or have you been talking to shareholders? Can you provide some colour on how you're approaching the process? Thanks

Mark: As you've seen, we've a number of times asked the Canexus board to accelerate the timeline for our offer and to constructively engage with us in a transaction that we think can be mutually beneficial for both their shareholders and ours. We continue to encourage that and hope that we'll find a resolution that's good for both of us.

Orhan: Ok, and have you been speaking to Canexus shareholders and having conversations with them, getting a sense of what sort of price would be reasonable potentially for them?

Mark: Not surprisingly, we receive a number of inbound calls. What I think is true and what we continue to believe is the offer we have on the table is 8.4x multiple of Canexus's indicated midpoint of their earnings which we think is a fair offer for a business such as this.

Orhan: Ok, and just one last thing; more of a housekeeping item. With respect to the turnarounds: you said that you're still expecting to hit the maintenance CAPEX of $50 million for the year if I'm not mistaken. Is the CAPEX going to be more elevated in the next year as it resolves the turnarounds or is it going to be completely done and dealt with in Q4?

Rohit: These will be done in Q4 and we're seeing somewhat less than 50. There are a few moving parts as always, but we expect to be less than 50 for this year. Next year we don't see any reason for it to be up, it should actually be a little bit lower than this year, than the $50 million. Most of these are planned and as Mark said, one was unplanned but we hope to recover something on that front. On a general basis, next year should be a bit lower.

Orhan: Ok, that would be it for me. Thanks guys

Mark & Rohit: Thank you

Operator (Chris): Thank you. Ladies and gentlemen as a reminder, should you have a questions please press * followed by 1 on your touchtone phone. Your next question is from Steve Hanson of Raymond James. Steve, please go ahead

Steve: Good morning guys, just a couple for me. I think you mentioned in your prepared remarks, you're in the process of shutting down the Augusta plant, but I just wanted to know if there's any update on whether the merchant opportunities might exist there on a longer term basis.

Mark: We're still kicking at that. Again, in the prepared remarks what it says is we're going to shut down the plant and moth ball it and hope that we can actually re-purpose it. We have a couple of irons in the fire but again, we just stopped production a week ago so there's still some moving parts but we're still hopeful we'll find something but as we've been saying, no guarantees.

Steve: Ok, understood. And as you evaluate this international business with the loss of the key customer, is there a size or a scale in that business where it just becomes too small; I don't want to say not worth your time, but where it becomes non-important enough that you decide to divest.

Mark: Every business that generates cash is worth our time. Having said that, it's run pretty autonomously out of Europe and we've always said that. The linkage is that it gives us better market knowledge, eyes and ears on the international market which is just good for our businesses. Because of its size as you say, it's not critical to the rest of the organization but it's also fair to say that we have a competent management team over in Europe and the amount of time we need to spend on that business quite frankly, is not a lot. So, that's where we are.

Steve: Understood. And just the last one and I'll jump back into the queue. You mentioned I believe, a couple of different issues for the quarter; but the PACl site that had some problems — Is that something that has been addressed or is it continuing or are we past that trend? It wasn't clear on the remarks

Mark: It's continuing. Now remember again in perspective, is that we've always said is our water business is primarily an alum business. We are actually doing a good job of expanding into PACl and ACH but in our view, the predominant driver in that business for as long as we can see will still be alum, the other stuff are enhancements. Again, in the remarks what we say is some of the strength we've actually seen in our alum business is not as obvious as it might otherwise be because some of the operating issues we had in the PAC plant. It will probably continue in the fourth quarter and hopefully by the end of the year we have it lined out. But from a 100,000 ft. materiality perspective, it's actually not material. As we said, there was a number of little operating burps in the quarter so, you add them all up they have an effect; any one of them isn't material.

Steve. Understood. And just to clarify that recovery or that strength that you're seeing in the alum business; that's just a continuation of some of the reduced competitive pressures we've been talking about in past quarters, is that correct?

Mark: I guess three things. A few quarters ago we said that we think the pricing has stabilized. Secondly, our volume is good. And thirdly, if you think back to what we said when we bought the General assets in 2014 is the key raw material of sulphuric acid and price of acid has gone down which helps margins.

Steve: Understood, that makes sense. Thanks guys, appreciate it

Operator (Chris): Ladies and gentlemen as a final reminder, should you have a question please press * followed by 1 on your touchtone phone. There are no further questions as this time, please proceed.

Mark: Thank you everybody for your continued support and interest, and we look forward to talking to you next quarter. Thanks.

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