Q3 2017 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.

For the third quarter we generated about $82 million of EBITDA and 51 cents per unit of distributable cash after maintenance capex. For the first nine months of this year, excluding Canexus acquisition costs of $3.5 million, EBTIDA was $225.2 million. Also, recall we didn’t acquire Canexus until March. Distributable cash, for the nine months excluding the acquisition costs and the related $18.3 million foreign exchange loss of $18.3 million was $1.61 per unit vs. distributions of 90 cents per unit.

Although we are clearly generating significant earnings and cash, the third quarter was a disappointment for us. For that reason we are going to spend more time than usual this quarter explaining what happened, and more importantly, why we do not foresee the events of the third quarter happening again.

First, let me start with the good news. The markets for our products are generally quite good. Demand for regen services and ultra-pure acid, caustic soda and hydrochloric acid are all robust. Demand for merchant sulphuric acid, sodium chlorate and our water solutions products are all firm and, in certain cases, improving. This was also the case in the third quarter. So, based on demand and pricing for all our major products we could have, and should have earned

substantially more in the third quarter than we did. The problem for our SPPC and WSSC segments was our inability to provide our customers with the products they wanted and were willing to pay for.

Rohit will provide the year over year segment comparisons, but first I want to lay out the big general themes that led to the quarter’s results. These comments apply only to our SPPC and WSSC segments, as our new Electrochemicals, or EC segment continues to perform well.

As noted, most of the adverse effect on earnings can be attributed to a shortage of product. This resulted in loss of profits either from sales we could have made, or from extra costs incurred to keep our customers supplied. Since we are in for the long term, our efforts to supply our customers caused short term pain, but, we believe has longer term benefits.

Starting with our sulphuric acid business, as many of you know, even though the means of production are often shared, the business really consists of three product groups.

· Regen acid services for refineries;

· Ultra-pure acid for the semi-conductor industry; and

· Merchant acid for broad industrial customers.

Consistent with recent quarters, demand for both regen and ultra-pure acid has been robust. Therefore we started the third quarter very tight on product and excess production capacity. Demand for merchant acid was also firm. The supply for our merchant acid is a combination of by-product producers and our own plants. During the second quarter, our two major by-product producers supplied substantially less product than expected, so we started the third quarter low on merchant acid inventory. This shortage of product and reduced incremental production capacity became acute when Hurricane Harvey hit, affecting some of our production at the same time as our primary by-product supplier supplied substantially less merchant acid than planned. We went to great pains to keep our customers supplied, but between downtime (our Beaumont, Texas plant was essentially off line for a month), purchase and transport of third party product, or illogically located product, our financial results were significantly less than they could have been. Beaumont is a significant plant for us as it provides both regen services and a large quantity of merchant acid.

One more comment about the sulphuric acid business.

We also had an issue producing ultra-pure (or UP) acid at our Tulsa facility. UP is produced to very strict specifications, measured in parts per trillions, for sale into the semi-conductor industry. Our key facility, located in Tulsa, Oklahama, took a turnaround, and when it was started back up it had some issues with its discharge meeting environmental permits. By the time we were able to identify and then fix the issue, we lost almost a month of production.

So putting this all together, but for these issues we should have generated at least $10 million more in this segment — about $3 million from Hurricane Harvey, $2.5 million from ultra-pure production, and another $5 million if our by-product producers and plants had produced as planned.

WSSC has a similar but slightly different story. Two of our key water chemicals plants (one of which makes the higher value ACH product we are now selling) have seen significant personnel turnover. Although both plants are now appropriately staffed, production at both of these facilities was significantly less in the third quarter than capacity as the training of new staff to ensure safe operations takes time to do properly. This shortfall was felt in the third quarter, which is traditionally the high season for this business. Again, demand and pricing for our products was not the issue; our inability to meet demand resulted in a shortfall to our expectations.

As I said at the outset, most of these issues are behind us.

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

Rohit Bhardwaj

Thank you, Mark and good morning everyone.

As Mark indicated, it was a strong quarter for our EC segment, but disappointing results from SPPC and WSSC for the reasons he outlined.

Revenue from continuing operations for the third quarter of 2017 was $400.5 million, an increase of $127.5 million from 2016. This increase was primarily due to revenues of $161.3 million generated by the newly acquired businesses, partially offset by lower revenues in the SPPC and WSSC segments.

Aggregate EBITDA from continuing operations for the third quarter of 2017 was $81.9 million compared with $60.8 million in the third quarter of 2016. The increase is mainly attributable to the contribution of approximately $52.2 million from the new businesses in the EC segment, partially offset by lower EBITDA in SPPC and WSSC.

For the three months ended September 30, 2017, Distributable cash after maintenance capital expenditures from continuing operations was $46.8 million, or 51-cents per unit compared with $15.4 million or 22-cents per unit in 2016. The per unit amounts are based on a weighted average number of units outstanding of 92.6 million units in the third quarter this year, versus 69.1 million units outstanding last year. It should also be noted that a foreign exchange loss of $20.3 million was incurred in the third quarter of 2016.

Turning to segmented results for the quarter, SPPC generated revenue of $123.3 million compared to $146.4 million in 2016. EBITDA for the quarter was $24.5 million, which was $15.3 million lower than 2016. From a revenue perspective, as Mark mentioned, there was a combination of reasons. The main reason for the year-over-year decrease was $13.6 million of lower revenues for sulphuric acid due to the effect of the shutdown of our Beaumont plant as a result of Hurricane Harvey and decreased by-product supply. We also had $8.7 million of lower revenue due to reduced volumes of liquid sulphur dioxide (or SO2)as a result of exiting the liquid SO2 business in eastern Canada towards the end of 2016. EBITDA was lower due to the impact of lower opening inventories, and the production disruptions which necessitated alternative sourcing of product at higher cost, including additional freight.

Our WSSC segment reported third quarter revenue of $105.4 million compared with $113.6 million in 2016. EBITDA was $21.8 million compared with $30.5 million generated in 2016. The decreases were a result of lower volumes due to production issues and higher costs to source alternative product to meet customer demand.

Our EC segment reported revenue of $171.8 million, most of which is attributable to the newly acquired businesses. EBITDA was $55.4 million, compared with $3.0 million last year.

It should be noted that results include severance costs of roughly $0.8 million incurred during the quarter.

Excluding unrealized foreign exchange gains, Corporate costs during the third quarter of 2017 were $19.9 million, compared with $12.4 million in the third quarter of 2016. The increase was due primarily to higher incentive compensation accruals of $5.0 million, and higher costs of $0.9 million related to the acquired businesses.

Maintenance capital expenditures in the third quarter were $14.6 million. We expect maintenance capex in 2017 to be between $60.0 million and $75.0 million, which includes the newly acquired businesses at an annual run rate of $30.0 million.

Looking ahead to 2018, we expect maintenance capital expenditures to be roughly $100 million and this includes the additional amounts we had previously said that we would incur at the newly acquired sites.

Finally, some comments on our balance sheet. We continue to repay debt and maintain ample liquidity. We have roughly US$380 million room on our US$ 525 million revolving facility. During the quarter in order to save standby fees, we decided to reduce the size of our revolving

facility by US$200 million and to increase the size of the accordion feature of our credit facility by US$200 million.

I'll now hand the call back to Mark.

Mark Davis

Thank you, Rohit.

Our performance in the third quarter was disappointing. However as I mentioned on the positive side, the fundamentals for our key products are sound.

On merchant sulphuric acid, we see modest price increases going into 2018. For sodium chlorate, industry publications anticipate larger price increases in 2019. Of course, this remains to be seen but North American operating rates remain quite high for the sodium chlorate industry and we expect that to continue.

As noted when we acquired Canexus, the chlor-alkali earnings have historically been the most cyclical. Obviously, our 2nd Quarter and 3rd Quarter results were greatly affected by the strength of our chlor-alkali markets. One chlor-alkali product, hydrochloric acid, is used in the fracking industry. Even though fracking activity in the 3rd Quarter was low relative to the previous five year average rate, it was significantly higher than 2016. This resulted in both volume and price improvements, boosting our results. However, the most significant factor is the strength in caustic soda, another chlor-alkali product. This is primarily a price-driven benefit due to steady demand and tighter, more expensive imported product due to reduced supply in Europe and particularly China. Industry publications indicate a further increase of caustic pricing in Q4. At some point this product will cycle downwards but industry publications don't see this happening for several years. When it does happen, the rest of our products will continue to provide balance to our portfolio and generate the returns we expect.

As we close out 2017, I wanted to remind you of some seasonality in our legacy business. In the past we had mentioned that Q2 and Q3 are our stronger quarters and generally account for roughly 55% of our business EBITDA. In 2016, Q1 and Q4 did account for 45% of business EBITDA, although Q4 was weaker than normal, but since Q1 was stronger than normal, in aggregate the results were as anticipated. In 2017, given the weakness in Q3, the seasonal impact between third and fourth quarters from an EBITDA basis is unlikely to be as pronounced as last year. As usual, we do expect to see significant capex spending in Q4.

In conclusion, with the issues of Q3 largely behind us, and stable markets for our key products, we see a more positive outlook ahead.

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

Operator (Leonie): Thank you. Ladies and gentlemen, we will now begin the question and answer session. Should you have a question, please press star, followed by one on your touch-tone phone. If you are using a speaker phone, please lift the handset before pressing any keys. One moment please for your first question. Your first question comes from Joel Jackson from BMO Capital Markets, Joel, please go ahead

Joel: Hello, thank you. Good Morning Gentlemen. I just have a few questions. Just on the last point Mark on some of the guidance for Q4 that you were suggesting or giving some {inaudible} Q4 could be…

Mark: Sorry, Joel. Can you speak up just a little bit?

Joel: I'll speak up. Could you talk about specifically in SPPC and WSSC? Should the businesses in Q4 '17 be better than Q4 '16? Q4 '16 was a tough quarter for both businesses. Maybe you can talk specifically in both segments, SPPC and WSSC, all these different puts and takes you've spoken about, what gets better from Q3. What looks better versus year over year? Thanks

Rohit: So, the comments Mark made were about around our legacy business so, in aggregate between WSSC and SPPC, you're right, both those were weaker than normal in Q4. So, in aggregate we do expect that those 2 business segments will perform a bit better than last year. I don't think I want to get into very specifics about each business, and each product, but in aggregate, our legacy business…if you look at Mark's comments last year the seasonality impact when you put all that together you should expect better results than last year.

Joel: Ok, so that's helpful. If I drill down on WSSC a little bit more, you're expecting Q4 results to be flat or flat-to-up in Q4. So, you had some issues, maybe some of the legacy GC plants that aren't maybe following some of the procedures you'd like them to. You made some decisions to replace people. So, when you look at the rest of the many plants you have in that segment, are some of these issues still persistent at those other plants? Have you addressed them? Will you address them? How can you show that we can get some better performance out of this business going forward? Thanks.

Mark: If you go back into the history of General; General itself is a roundup of a bunch of different companies so, there's a bunch of different cultures within the plants. We, I think as most of you know are pretty strong adherents to the Responsible Care ethic and what we found…we've owned the General facilities for 3 years now as well we found over time there was some cultural things, as you've mentioned that we felt needed changing for long term good of actually both the facilities and Chemtrade. We took what we thought were some pretty draconian actions on some things earlier in the year. I will tell you actually that we're quite pleased with our recent performance. We actually think that people understand when we say we want people to operate safely, we actually mean we want people to operate safely. We think that the significant steps that we've had to take actually are largely over now but it does still take time to actually train up new people to operate our facilities safely. Quite frankly, we're willing to sacrifice production until we make sure we can actually produce safely. I think those issues are largely behind us now.

Joel: Ok, thank you Mark

Mark: Thanks Joel

Operator (Leonie): Thank you. Your next question comes from Nelson Ng from RBC. Nelson, please go ahead

Nelson: Thanks. Just a quick follow up on the Water segment. So, the reduced production was purely due to I guess, HR reasons rather than actual technical issues with any of the facilities?

Mark: Definitely the predominance was, yes.

Rohit: We had some effect of the hurricanes there, too, but not significant.

Nelson: Ok, got it. And then Mark, you mentioned the focus on safety. So, it might be too early but has safety been an issue in the previous few years and has there been a big improvement in, I guess in the number of incidences?

Mark: Yeah and let's put it all in perspective. Our safety record is actually consistent with the CIAC's safety record, maybe slightly worse but not materially. We just think that no one should ever get hurt in our facilities. So, there's not a rash of actually bad injuries. What we actually did see is some practices that could have led to bad injuries. So, the responses we took were quite frankly, proactive to actually what we saw were unsafe working conditions as opposed to actually a rash of injuries. Again, we try and get ahead of the ball but there's just some things that we thought we shouldn't allow to keep going because the potential for someone getting seriously injured was there. Again, it's not a rash of injuries, it's a proactive action for some practices that we thought could have led to a rash of injuries.

Nelson: I see. And then a quick question on the North Vancouver facility. So, it looks like you sold a little bit more product in Q3 vs Q2; are you pretty much running the plant at or even above capacity now? I guess the question is how sustainable is that before you need to take some down time?

Mark: Well, it's not above capacity. The plant has been running well this year. As we all know, if you back and look at actually Canexus's history with the plant since the technology conversion there was a bunch of fits and starts and issues and to their credit, they picked away and actually fixed a bunch of them. From our perspective, there's still some more work to be done on the plant. We're not ready to say actually that the run rate has achieved in 2017, it's locked and loaded for the future but the fixes, we think the fixes on a go forward basis are that we need to make and we'll make them, are identified and we don't see big blips going forward.

Rohit: Some of the benefits we are getting are also because as Mark mentioned, the upswing in HCl because what that allows us to do is displace chlorine which we typically don't make money on. We run chlorine so that we can make as much caustic as we can but then as the HCL market picks up we are able to transfer more into production of HCL which also has the benefit of displacing low margin chlorine. So, that's some of the benefits we're getting.

And then last year because of the operational issues that Canexus had, they were also having to buy caustic on the open market and not make much money on that to make sure customers are supplied. So again, now we are able to run the plants much better this year.

Nelson: Ok, do you know what the rough operating rate is at that facility?

Rohit: Yes, I think that we did say from an MECU basis, I think we were at…it's in our MD&A but let me just pull it up right now. In terms of operating rates, we're running close to practical capacity. So, from MECU perspective we are roughly at about 100,000 tons in the quarter.

Nelson: Ok, got it. Thanks

Operator (Leonie): Thank you…

Rohit: Sorry. Excuse me, sorry. It was 66,000 MECU, 100,000 tons was chlorate

Mark: There you go.

Nelson: Ok, thanks Rohit

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

Rahul: Hi, good morning Mark and Rohit. This is Rahul Long for Jacob

Mark: Hi, good morning

Rahul: Good morning. So, I just had a question for the SPPC segment. So, you mentioned operations are back to normal but is there any remaining high cost product left in inventory resulting from that by-product supply issue? Basically just trying to get at whether you're expecting a squeeze in margins going into Q4?

Mark: You know, there probably is but actually it shouldn't be a material squeeze. We don't have that much inventory. We don't have that much inventory of anything but we don't have that much inventory actually of acid which is why when you have a combination of hurricanes and shortages by our by-product guy, you're short for products and have to scramble. So, it's not like we're sitting on a bunch of high cost inventories so, it won't be material in the quarter.

Rahul: Ok, and maybe just moving to the Electrochemicals business. So, I'm just looking at Canexus's financials last year and we assume that Prince George sort of offset Nanaimo, port volumes look to be a little lower year over year. I mean, is that a fair assessment? Maybe if you could just talk about your outlook for Chlorate from a volume perspective going forward.

Rohit: I think the volumes are pretty flat in Chlorate so, I'm not sure the math you're doing but Chloral 8 is actually pretty flat compared to last year.

Mark: Again, I think as we indicated is the industry itself in North America is running at pretty high utilization rate and our utilization rate is similar to industries.

Rahul: Great, and…..sorry Mark?

Rohit: Ok yeah

Rahul: Maybe just last question here on corporate costs. So, $19.9 million for the quarter, $5 million higher in compensation accruals; how should we be thinking about the high levels of compensation accruals is this sort of recurring level or more of a one-off for the quarter?

Rohit: This is more of a one-off. So, when we say it was $5 million higher, it's $5 million higher than what would be the typical run rate. If you took that out of corporate you get closer to a run rate for corporate costs.

Rahul: Ok, perfect. That's it for me guys.

Mark: Thanks

Operator (Leonie): Thank you. Your next question comes from Damir Gunja from TD Securities. Damir, please go ahead

Damir: Thank you, good morning

Rohit: Good morning

Damir: Rohit, is there any FX impact we should be thinking about running through the P&L this quarter?

Rohit: I guess it depends compared to what but compared to last year, yeah. We were slightly unfavorable on FX. But keep in mind that last year we didn't have Electrochemicals numbers and that's where there's more FX sensitivity. So, if you look at our MD&A we actually do give you some good sensitivity analysis on foreign exchange so that's where the best place to get it is.

Mark: In a general statement, we like a lower Canadian dollar more so now than we used to because of the production in Canada from the former Canexus assets and a bunch of it sold into the U.S

Rohit: And if you see, we're actually now…previously we didn't really used to do any financial hedging because that long term debt was in U.S Dollars which gave us a good natural hedge. Also after the EC acquisition we do have a hedge program and that's also outlined in the MD&A.

Damir: Ok and just a second follow up for me. Just to confirm, in the merchant business the lower production out of the two suppliers, was that something unforeseen or I imagine it was, or a scheduled shut down or…?

Mark: Look, it was unforeseen. Again, for background as you all know is these guys make metals. What falls out of the metals is by-product acid. Our biggest by-product supplier which you all know is actually changing its process to move from 2 furnaces down to 1 so we knew their production forecast, we knew their plans and quite frankly, as much as surprising to them as to us is they didn't produce as much by-product at the end of the second quarter running into the third quarter as well. So yes, it was unexpected.

Rohit: Just as we said in the past, lower volume is not really going to hurt us as long as we know about it and can plan accordingly because we don't really make a lot of money on the last tons of acid we sell. Typically our system has enough buffer in it to absorb some variation but given where we started our third quarter with low inventories and then the hurricane and then unexpected shortage of the product, that was too much for our system to handle and it wasn't that we were foregoing margin, it was more of incurring extra costs to get replacement product and illogical freight and in our business freight is a big factor. So, those are the things; the unexpected nature is what led to the issues.

Damir: Ok, thanks guys

Mark: Thanks

Operator (Leonie): Thank you. Your next question comes from Benoit Laprade from Scotia Bank. Benoit, please go ahead.

Benoit: Thank you, good morning gentlemen. At first I just wanted to follow up on Joel's original question. Just to be clear, you would expect better Q4 this year than last year in both SPPC and WSSC is that how we should understand that?

Rohit: I think what we said in aggregate, our legacy business should be better than last year in Q4.

Benoit: Ok, perfect. Turning to Electrochemicals – in terms of seasonality, would you expect to run the plant at the same type of rate in Q4 than Q3?

Rohit: So, there's not much seasonality in that business. If anything, the fracking activity is a little better, I believe. So really, there's not any seasonality I should worry about there.

Benoit: Ok and in chlorate, Mark you mention about price increases for 2019; if we look closer at 2018, would you expect to raise prices to at least match the electricity cost increases for 2018?

Mark: Yes. We're still hopeful actually that 2018 actually price is higher than in 2017 right? Based on the industry publication, looks relatively flat year on year but it shows it going up in '19. We're always trying to increase prices.

Benoit: Absolutely. And turning to Brazil – not sure exactly how that flows through that fixed U.S margin contract but Fibria will be taking down time in Q4 and potentially more next year. Can you walk us through the implication from that margin contract?

Mark: In our world actually, the amount of down time Fibria is taking into 4th quarter in aggregate isn't material to our financial results. We've read their announcements with probably the same amount of interest some of you have and it looks like they're trying to be a market steward. So, they'll take some down time in the 4th quarter which as I said, shouldn't be material as it flows to our results. I think it remains to be seen what they'll actually do in 2018 as a whole

Rohit: But the way fixed margin contract works is we do get affected if there's lower volumes so, we aren't insulated from lower volumes but as much as it's not material.

Benoit: Fair enough, thank you

Mark: Thanks Benoit

Operator (Leonie): Thank you. Ladies and gentleman, as a reminder should you have a question please press * followed by 1. Your next question comes from Anoop Prihar from GMP. Anoop, please go ahead.

Anoop: Ok, my questions have been answered. Thank you

Mark: Thank you

Operator (Leonie): Thank you. Your next question comes from Trevor Johnson from National Bank. Trevor, please go ahead

Trevor: Hey, good morning; just had a quick one. Just curious if there's any business interruption insurance or anything like that you might be able to access given some of the issues Q3 rode over your hands?

Rohit: Yes, so we do carry business interruption insurance. Given the size of what we outlined and given the deductibles that we run, we will be pursuing a claim but it's unlikely to be too large.

Trevor: Got ya, thank you very much.

Operator (Leonie): Thank you. Your next question comes from Steve Hanson from Raymond James. Steve, please go ahead

Steve: Good morning guys, just two quick ones for me. One is, I apologize if I missed it earlier but just a status update on your Midlothian upgrade in Texas; just where that's at at the current stage

Mark: It's doing fine. The first uptick we got actually, I think we talked about 2 quarters ago when we did the first stage and we're continuing on that project. It probably slips into 2019 but we're still picking away at actually improving Midlothian.

Steve: Ok, that's helpful. And then, just on the M&A front, we've started to see more smaller hive off divestures on some of the larger entities. Of late, there's been some activity in the space in Canada recently. Just curious about what you're seeing in the pipeline for opportunities that might fit within your existing portfolio?

Mark: I think I'll give you a consistent answer. I like being consistent, right? There continues to be a number of assets that are attractive to us. With financing markets the way they are and interest rates the way they are. I guess we see acquisition potential as requiring some degree of synergies before we think it's actually good for our shareholders. Doesn't necessarily have to be operating synergies, it could be back office cost synergies, which is primarily what Canexus was. Valuations seem pretty robust right now so it either needs to be right down the fairway for us or we need to believe we can synergize the business I think to make it financially worthwhile.

Steve: Ok, that's helpful. That's it for me, thanks

Mark: Thanks Steve

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

Mark: Thank you all for your attention and we're looking forward to having a much less eventful 4th quarter.

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