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KEMIRA.HE - Q3 2018 Kemira Oyj Earnings Call

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PRESENTATION

Olli Turunen *- Kemira Oyj - VP of IR*

A very warm welcome to Kemira's Third Quarter 2018 Result Presentation. My name is Olli Turunen, and I'm responsible for Kemira's Investor Relations. Today's presentation will be held by our President and CEO, Jari Rosendal; and Q3 finances will be covered more in detail by our CFO, Petri Castrén. After both presentations, you have a chance to ask questions over the webcast and also here in the room. Let's begin. Jari, please go ahead.

Jari Rosendal *- Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Thank you, Olli. Good morning. Some of the highlights of the quarter. Our organic growth continued pretty strong, led by Industry & Water, and -- but also Pulp & Paper grew nicely. Sales price increasing -- increases are continuing, but we need to catch up and, as said in the statements, I would like to see that progress being even faster, but we're going to the right direction.

We improved our operative EBITDA, and it's encouraging especially when we think of that this is the first quarter where we don't have the benefit of the Venator fire insurance coverage. So that's now over and that's a EUR 2 million roughly comparison point.

FX has been tough on us for this year, year-to-date, minus EUR 70 million compared to last year, which is a big number. Hopefully, that's now easing off. We are progressing in our strategy execution, and we now have gotten the government permits in order to close the JV deal during the rest of the year in China.

So let's look at the Q3 numbers shortly and Petri will elaborate these a bit more later. Organic growth came to 9%, and our reported revenue was 670% -- sorry, EUR 670 million. Most of the organic growth came from sales prices and less from volumes. Strong momentum continued in oil and gas, but all areas also saw growth. One new thing is good to note in our numbers that in Q3 we had Oil Sands delivery campaign on delay, treating tailing spawned material. Most of it was during Q3, and it's now over for the season. That's a new business for us that has good opportunities and good volumes going long-term forward, but that is clearly diluting and affecting Q3 relative profitability.

Operative EBITDA increased by 5% from EUR 84.5 million to EUR 89 million. EBIT and -- operative EBIT and EPS increased also.

Looking at Pulp & Paper, and I'll be talking about year-to-date, organic growth has been above our targets, but profitability has been hampered by FX. Year-to-date organic growth has been 6%. Bleaching and sizing markets are strong. And our plants are running well, some raw material issues in the sizing side, but that's been there for a longer time. Sales prices are starting to catch up, but our focus is in the process and functional chemicals, and we still need work to do. Year-to-date operative EBITDA EUR 2 million up compared to last year, but please note that there's a EUR 10 million impact by FX in 9 months.

And as said, we have the permits now for the JV to go forward and close the deal, start the completion of the plant and plan for ramp-up sometime next summer.

Industry & Water, organic growth year-to-date 12%, led by oil and gas. Oil and gas growth year-to-date 26%, but it's worth to note that it's -- there's been 18 months of recovery, now real growth. So this growth pace will be now easing off. That's a natural development, so nothing to worry about. We see the market that's growing strong, but we won't be growing so big double digit numbers next quarters.

Positive development also in the water treatment area, but naturally more modest than in the oil and gas. One development in the quarter was the surprise Venator titanium oxide closure announcement here in Finland. They earlier announced that after the fire in early 2017, they will be reconstructing the plant, but now they abandoned that, and they plan to close the plant sometime by 2021. We have not received any raw material from them during the last 18 months, so how we operate is going well. We now have to then plan during the coming quarters on what is our longer-term reaction to their decision. And as said, insurance coverage is consumed up.

We continue to construct the special polymer plant for CEOR in Rotterdam and that's planned to start ramp-up in Q3 next year. For I&W, clear improvement in operative EBITDA from EUR 89 million EUR 98 million year-to-date, despite the EUR 7 million FX impact year-on-year comparison.

Looking and reminding of the sort of foundation for strategy on business selection, the fundamentals on what we are working on. Global growth, urbanization, sustainability needs drive use of water, energy, pulp, packaging and tissue, and we're at the heart of those. E-commerce driving really big way packaging and different than going to a normal shop and not needing so much packaging. Resource efficiency for energy is driving unconventional oil and gas demand. And the plastics dilemma, for example, drives for need for recyclable packaging out of fiber.

Regulation is getting tighter and tighter, and water intake quality, meaning that more treatment is needed, is getting more challenging. So thinking of medium and long term, we're in a right place from a strategic point of view.

Demand for pulp in the world remains strong. And bleaching is obviously needed when pulp was to be made white for paper and tissue and other applications. Newsprint is going down. That means that there's less recycling of paper in the market, so that drives the pulp demand. Also, the Green Fence initiative in China is limiting recycled paper entry to Chinese players, so they are more reliant on virgin pulp.

This time last year, we started ramp-up of Joutseno, investment of new line of EUR 50 million to bleaching capacity. So I can state that the timing of that investment was really good. We have already added some new reactor sales into that site and increased somewhat the capacity, so -- and we continue to look at additional debottlenecking possibilities at all of our bleaching sites. Another example, and you can see the onetime cost in this quarter, we have, for the past 20 years, been making washing detergent in Sweden, consuming some of our bleaching capacity. That business now is ramping down and the outlook is not so good. And we have a strong demand for bleaching chemistries, so we are closing down that plant and directing that capacity to our Pulp & Paper customers and -- which is in core of our strategy. The closing down cost would be around 1/3 of the investment cost for releasing that capacity, so it makes perfect sense from a strategic point of view. So bleaching continues to be strategic to us. We do have our proprietary technology to manufacture it. So we are committed to serve our customers in the bleaching space.

Looking at the water trend and that area. So classical water treatment and knowledge continues to be another backbone of our business. We deliver chemistries and technologies to treat drinking water, meaning, raw water taking in and turned into drinking water. We are a part of the waste water sludge removal in municipalities. We are in industrial processes in recycling the water and feeding it back to the process. And we are treating industrial waters that are released back to the nature. And often they have to be even more clean than the raw water intake was originally to the industrial plants.

Regulation, as said, is tightening all the time. And if you're not aware, EU is in the process of relooking at their 20-year back regulations in Europe regarding water quality, wastewater treatment. Those are not applied in European countries equally even at today, but after 20 years, EU is looking at what is the next level of regulation here in Europe.

To close off my update, good organic growth, driven by sales prices. We had a good campaign of -- and technical success to the Oil Sands, but the numbers are not there. We have to next work on our numbers for the next season. Price increase is still in progress, but we need to push more, as we are, in [inflatory] raw material and transportation market, so it's not by far over. We are somewhat overshadowed by the FX in the progress that we are making in the business. The JV now is going to closing by the end of the year, and we increased our operative EBITDA to the comparison period. So we reiterate our outlook for the year. We expect our operative EBITDA to increase from prior year level.

I'll stop here and ask Petri to continue with some of the details. Petri, please.

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

Thanks, Jari. Okay. Can work it out. So I think a couple of things that I will focus on, and I think the key takeaways from the quarter is the good underlying growth, really led by I&W and especially oil and gas and also about the pricing and raw material trends that we see and also the fact that this organic growth is now coming primarily from pricing rather than volume growth as we really start to be more also capacity-constrained regarding that.

So a very solid growth in Q3, 9%. Actually, 9% organic growth second quarter in a row. It is coming from mostly sales prices, where if you remember about a year ago, it was all volume growth. So there's been a clear trend mix regarding that. Some of the growth that we are seeing, and I am particularly referring to the Oil Sands campaign now, which is significant or good part of the volume growth, is coming at a low -- very low margin. It is coming at a positive margin, but still a margin that is clearly diluting our business. But nevertheless, we can say that the -- we happily note that the volume growth and also the improved pricing actually led to EUR 89 million of EBITDA, which is the highest EBITDA, absolute euros, since 2009. So there's a little bit of a cause for celebration as we are going into the right direction, even as we are not yet fulfilling our targets regarding relative profitability.

Currencies, like Jari said, year-to-date and particularly first half was a big story. Now Q3 not so -- not so much, small negative, less than EUR 2 million. The quarter included EUR 14 million of items affecting comparability. This is -- primarily, it is the Swedish restructuring that Jari was talking about where we are actually allocating capacity to our core pulp customers.

EPS, earnings per share, up 12% because of the higher operative EBITDA. And actually the items affecting comparability are pretty much the same as in the comparison period.

Finally, I note that some of you who are modeling very closely will see that the depreciation expense was about EUR 3 million higher than our normal sort of quarterly run rate. It is sort of -- at this time of the year, we will do a more thorough check on all of our assets and there are certain impairments that we need to do for assets that are not worth it and that they are in the books, and it is, sort of, onetime catch up of approximately EUR 3 million in the depreciation expense.

Looking at the raw materials, which I'm sure everybody is quite keen and interested in it. First of all, we continued in the positive trends, so that our sales prices are exceeding the variable cost. However, the variable cost impact is quite significant. So EUR 42 million versus EUR 39 million actually rounds up to net positive EUR 4 million, so a small positive. And as Jari said, it is one of those -- it is the highest priority short term that we now have in the company that we will focus on the sales prices as we continue to see the trend of increasing raw material prices.

Regarding the analysis though, I'll make a little bit of a caution here that we don't make 2 straight-line comments, because this is approximation and product mix can always have some impact to the numbers, particularly when the numbers are relatively -- if they are small. So in Q2, the caustic price increases actually were exaggerating the positive aspect of it. And now in Q3, the high volume of Oil Sands deliveries actually were muting the positive impact of it. So I'm referring to the net EUR 11 million versus net EUR 4 million. So if you, sort of, were to eliminate the product mix impact, the line would be much straighter. So I'm not worried about the EUR 11 million turning to EUR 4 million, rather worried about the overall trend that we make enough of progress.

In Pulp & Paper, 7% organic growth. This can be split for 3% volume and 4% pricing, and some of that pricing was the caustic. And we'd raised the caustic because good part of the -- a big part of the caustic is traded products that we sell at a fixed margin. I think, one of the key positives for the segment during the quarter was encouraging development in our APAC business, where 2 things we can note. Clearly, we have been able to pass on some of the price increases, so we have been able to improve profitability, and also, during the quarter, we have had, clearly, improved availability of the key raw materials. In some quarters, we have had issues of getting this. So it is visible that when we have access to the raw materials that we are going into the right direction. Nevertheless, APAC is still diluting our margins. So there's work to be done, but it's going into the right direction.

Moving on to I&W. Again, the story is the oil and gas business driving the top line growth. Oil and gas growth organically at 28%, and now it represents this quarter more than 10% of Kemira volume. So you remember, some time ago, we were looking at oil and gas less than 5% or approximately 5% of Kemira revenue. So now this important growth area is actually more than 10% of Kemira revenue. Jari mentioned that this growth will decelerate, and particularly, as now some of the Q3 growth came from this campaign in Oil Sands, and we will not recognize those revenues in Q4 and Q1, maybe some again in Q4, but not in the winter period. So this growth will decelerate in terms of volume. Obviously, raw materials tend to drive a lot what happens to the pricing, and this is the area where the pricing is the most dynamic. So we are typically the fastest in terms of passing on to the -- price increases to our customers in this part of the business.

Capacity continues to be quite well utilized, so that's another reason why we will see only limited volume growth.

Some comments on the water treatment. EMEA, perhaps somewhat limited growth. Clearly, seeing the pressure on recurring raw materials. North America has been historically a tougher market for us. And against that backdrop, performance during Q3 is somewhat encouraging. So we have seen some improvement in the top line and profitability. APAC is a very small market for us. And clearly, the volumes decreased there. We also -- we had issues of passing on price increases. We also had, in some cases, even issues of having product available for our customers in APAC as this is the least strategic market for us.

Moving on to the key figures slide. I'll point out a couple of things. CapEx year-to-date has been about EUR 30 million lower than last year. We do have a seasonal tendency in our CapEx to be second half-heavy. But I think we're still quite comfortable that we will land somewhere close to the low end of the EUR 120 million to EUR 200 million range that we have indicated for the year. So that's on CapEx. Operative return on capital employed is a key asset efficiency KPI that we follow and it's on an improving trend even as higher raw materials cost and volume growth has led to higher inventory levels. And this inventory value buildup is the biggest reason why the year-to-date cash from operations is somewhat lacking behind 2017 and the resulting increase for the net debt. However, as I said, we have said in the past, we do have a seasonal tendency to the working capital. So last year, cash flow from operations was approximately EUR 70 million during the Q4, and I would expect that this year the Q4 will follow that general pattern, not estimate on the number, but on the pattern itself.

So with that, I'll conclude. And we'll be ready to turn to the Q&A session.

Olli Turunen - *Kemira Oyj - VP of IR*

Very good. And I'll also remind you that you can type the questions over the webcast tool and I'll then pick them up over the laptop, but let's first start here in the room. Are there questions in the room?

QUESTIONS AND ANSWERS

Anssi Kiviniemi - *SEB, Research Division - Analyst*

Anssi Kiviniemi from SEB. Question on Industry & Water. The operative result was slightly better compared to last year and that's, kind of, fair, but when we think about the good momentum in the oil business, shale especially, probably that improves. So that makes me, at least, to think that the municipal business is under pressure. So is this, kind of, a correct assumption? And how do you see the contract cycles in municipal business? Are most of the contracts negotiated during Q4? Or are those evenly spread out throughout the year?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

So I'll start from the municipal contracts. There are thousands of them. So they are, through the year, renewed and contracted. So there's no really onetime or seasonality in that. Obviously, holiday seasons are something different, but no sort of big lump in Q4. In the I&W, I think the Oil Sands deliveries are something that are now diluting that business. It's roughly close to EUR 20 million of deliveries in Q3, which we haven't had in comparison period. This was the first time we did it. And as said, it's positive margins, but clearly diluting. So this was our first trial session and big volumes, so we still have work to do to optimize supply chains and how we deliver that and are gearing better to do that then springtime, summer next year. I think we are gaining up on the water side of business and catching up on the raw materials. So your interruption of -- reading of the situation is not entirely true. Petri mentioned that we are better in North America. We also are gaining up in Europe. Shale business is strong and CEOR is going along. We just need to get that plant ready next summer to really get our numbers straight.

Olli Turunen - *Kemira Oyj - VP of IR*

Are there further questions in the room? If not, operator, please go ahead.

Operator

(Operator Instructions) Our first audio question comes from Panu Laitinmäki, Danske Bank.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

I have 3 questions. First one is on the pricing versus raw materials development. On Slide 11, you said you are not worried about EUR 11 million turning to EUR 4 million, but still going back to this -- like the impact on -- from sales prices was EUR 42 million in Q3 and EUR 47 million in Q2. So is all of this explained by the change in sales mix? Or is this, kind of, let's say, weakening trend in pricing? Or how should we look into the next quarters going forward? So that's the first question.

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Okay, I'll take that. Sales mix is 1 area. Then the other area is also in the sales mix that there are a lot of maintenance stoppages, especially in the Nordics, in the Pulp & Paper mills. And that's obviously a stronger area of our business, so that's part of the sales mix. But really, this -- these deliveries to the Oil Sands is 1 thing. Is there anything else?

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

So maybe I clarify that, because it was my statement. So I'm not worried about EUR 11 million turning to EUR 4 million, because the mix explains part -- big part of it. I rather see that EUR 11 million turning to EUR 20 million and EUR 30 million. That's the big picture. So that's what we need to drive over it. So that don't make too much, sort of, estimates on whether small numbers turn this way or that, because that can be explained by mix issues that you don't necessarily see. But nevertheless, the issue remains. We need to pass on raw material costs to our customers.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

Okay. So we should expect EUR 20 million to EUR 30 million going forward at some point?

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

I wish.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

Yes, okay. Well, the second question was about Industry & Water margins. Still going back to the previous question, so if I look at the numbers, the sales was up EUR 25 million and EBITDA less than EUR 1 million. And did I understand that the deliveries in oil and gas were EUR 20 million to the Oil Sands?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Oil Sands were close to EUR 20 million. So that tells you so -- tells you also that what we're doing is walking away from some business and some contracts that are not worth it. And then the EBITDA, you have to take the FX also into account when you look at the numbers.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

Okay, but my question is really that what happened in the business excluding this Oil Sands development? Like was the part of the business that's not oil and gas increasing or decreasing? And what should we think about that in the coming quarters?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Well, we're shaping our portfolio. Our APAC business is small, but not that strong. So we need to fix that in the Industry & Water. Our oil and gas continued to grow strongly in the shale business, not to look at the Oil Sands. So that part is fine. We're not looking for driving growth in the water treatment business. If we get some, it needs to be profitable growth. We are working more on the relative profitability.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

Okay. And my third question was related to the comment that you are ramping up the new capacity for CEOR in Q3 next year. So is it until that when the new business is burdening or -- your margins? Or how should we think about this?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

We are making margin on that business, but yes, it's diluting. And until we in-source all of that capacity, which we are now tolling outside and obviously having tolling costs, once we in-source that, then our margins will recover to the business plan level.

Olli Turunen - *Kemira Oyj - VP of IR*

Okay, operator, are there further questions over the phone?

Operator

(Operator Instructions) We have a follow-up question from Panu Laitinmäki, Danske Bank.

Panu Laitinmäki - *Danske Bank Markets Equity Research - Senior Analyst*

Topics I already asked. But can you give any kind of indication how do you see things developing in terms of EBITDA growth of Q4 and going forward compared to what we saw? I mean, there is some changes, as you mentioned, in this pricing versus raw materials and FX and everything, but just any more color would be welcome.

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Well, if you look at sequentially, you need to look at the Oil Sands volumes going out, and then looking at also that seasonally Q4 starts to see some winter conditions. So some of our businesses are slowing down. Our organic growth has been robust year-on-year, so we intend to do that. But as said, our focus is not on growth, but the relative profitability and really driving the prices up on the back of the raw materials and getting back what we lost the previous years.

Operator

Our following question comes from Robin Santavirta, Carnegie.

Robin Santavirta - *Carnegie Investment Bank AB, Research Division - Financial Analyst*

First of all, in terms of still on raw material dynamics going into Q4 and 2019, I assume, based on your introduction and your comments, that we should expect the input cost deal to increase now in Q4 at least a bit, but do you have any visibility about 2019, especially the early parts of 2019 at this stage already? And what would, sort of, those be, if you have?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Well, some of the fundamentals are a bit different in some of our key raw materials, because it's not so much of their input cost, meaning, oil and gas price what you've seen being really volatile the last weeks even, but it's more about the supply/demand balance, and there is a short market in many of the areas. So we continue to see some creeps, no real shocks. Even the hurricanes last month or 2 didn't bring any shocks to the system, luckily, like it did last year. So small creeping up and that makes it easier for us to also roll an argument that in front of our customers.

Robin Santavirta - *Carnegie Investment Bank AB, Research Division - Financial Analyst*

And then on this, for the first time in a long time, there has been a greenfield order of a quite big pulp mill in Chile. Now you're very strong in pulp bleaching. Could that project be interesting for you, first of all? And how should we look at that? Any chance that you would, if you are interesting, actually receive, sort of, a project along with that pulp investment?

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Well, it's a project where they are fixing up existing capacity and increasing capacity. We're not serving that customer at the moment. But as said, we're committed, and I prefer not to talk individual customer cases.

Robin Santavirta - *Carnegie Investment Bank AB, Research Division - Financial Analyst*

All right. And then finally, just on CapEx. I understand you said lower end of that EUR 180 million to EUR 200 million this year. Would you mind to shed some light about 2019 CapEx levels? Is a good estimate at this stage, roughly, the same level? Or will it be lower or higher in 2019?

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

So first of all, let's correct, the range is EUR 160 million to EUR 200 million, and it's at the low end of that. So rather closer to EUR 160 million than EUR 180 million is the message.

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

For this year.

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

For this year. Next year CapEx is still up in the air and it depends on the timing of some of the bigger investments whether they will take place or not. So really I will hold on comments on next year CapEx levels.

Olli Turunen - *Kemira Oyj - VP of IR*

Operator?

Operator

There are no further questions at this time. Please go ahead, speakers.

Olli Turunen - *Kemira Oyj - VP of IR*

Very good, thank you. Are there further questions here in the room? No. So this concludes the Q3 result event. Thank you for your participation, and have a good day.

Jari Rosendal - *Kemira Oyj - Chairman of Mgmt. Board, President & CEO*

Thank you.

Petri Castrén - *Kemira Oyj - CFO, Member of Management Board & President of Americas*

Thank you.
