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KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

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OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

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PRESENTATION

Olli Turunen - *Kemira Oyj - VP of IR*

Ladies and gentlemen, very warm welcome to Kemira's Third Quarter Result Presentation. My name is Olli Turunen. I'm happy to say that we have published excellent results again. Let's hear the drivers behind the strong numbers presented by our President and CEO, Jari Rosendal; and our CFO, Petri Castrén.

After both presentations, you will 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 afternoon from my side also, and welcome. As the title said, we had a strong Q2 -- sorry, Q3. Last 2-year focus on value over volume and active price management has shown the expected results. Also, other operational improvements and added capacities are contributing to the profitability, which reached 17.1% on operative EBIT level in Q3. This has been a long process. But as you can see, step by step, we have been able to improve performance. In July, after Q2, I talked about softening markets, but that -- we didn't see that in our demand and in our numbers yet. But during Q3, we started to see some effects. But as you can see from the numbers, the effects are not very big yet. But in North American shale and in some other areas, we started to see some softness in the market. Some softness also in the Pulp & Paper, mostly in paper and board, but hopefully, nothing dramatic. Water treatment still looking good and demand going steady.

So let's look at the Q3 main figures. Revenues, EUR 690 million. Organic growth flat by our own design, driving the change from our product portfolio and focusing on value over volume.

Industry & Water, organic growth 6% year-on-year. Operative EBITDA, EUR 118 million, and as said, 17.1% from revenue. A nice increase from last year, even if we take out the positive IFRS 16 impact, which was roughly EUR 9 million. Also, operative EBIT grow -- grew nicely to EUR 71 million and EPS, EUR 0.27. I'd like to point out that Q3 typically is the strongest quarter of our fiscal year.

Then going to the segments and Pulp & Paper revenue, EUR 383 million and organic growth came slightly down due to mainly our own planned actions in product mix optimization. Excluding the ECOX closure, we did end of last year and the market price dropped mostly on traded caustic soda in the Nordics. Excluding those, the organic growth was flat. Operative EBITDA margin improved to 16%, being EUR 61 million. Pulp prices started to level off some and some small recovery in some pockets. Although, I'd like to remind that pulp prices are indirect to us. So we are linked to tonnages and -- from our customers, and demand has remained solid. Some short-term softness in North America and EMEA. Paper and board chemical demand, but really not to be seen in our Q3 numbers. We are managing our cost base well in Pulp & Paper.



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

Then looking at Industrial & Water segment, a really strong quarter. Again, as said, solid water treatment market, and we are performing really well in our water treatment. North America, especially, has improved a lot during the last 2 years. We started to see slowdown in the shale, as I said, and that really happened end of the quarter and not really much visible in our numbers. But let's see what happens in Q4 and Q1. Typically, winter has an impact on that.

So when waters freeze, operations get more expensive for the shale players. Organic growth, 6% and oil sands tailing treatment season starts to be over. So the next quarters, that revenue is mostly out of our numbers until the springtime, and they start the summer campaign again.

We divested a small service business here in Finland, and we also divested a coagulant plant in Italy. This is basically cost management and cost base management, but not material impact in our numbers in this year. An exceptionally good quarter with operating profit margin of -- EBIT margin of 18.5%.

Our strategic investment projects are continuing well. We have started up our Chinese new AKD sizing plant this week and are ramping it up during the next months. And gradually, it starts to show in our numbers then during next year. Our specialty polymer plant in Netherlands is close to final stages, and we will start to ramp it up in the coming weeks and ramp it up in -- during Q4 and then beginning of next year.

The South Korean polymer and U.S. polymer plants are under construction and progressing well, and we'll be ramping those up beginning of 2021.

We also made a press release this morning on a smaller investment to U.K., where the market demand is expected to grow for coagulants due to regulation change on capturing more phosphorus from wastewaters. So in practice, on that one side, we are doubling our capacity to match the market demand growth in coming years.

As you can see from the pie chart, I'd like to remember -- remind that we do have 4 a sort of backbone product groups in our portfolio: bleaching, coagulants, polymers and sizing and strength, and all of these investments are hitting those areas that we see further growth opportunities in demand in the world. So sticking to our strategic focus.

During the last years, we've been making solid progress in improving our profitability and profit margin. This is a result of multiple actions and systematic execution of our plans. It's not only about FX. It's not only about raw material prices. It's not only about sales prices. Although, we have had to correct those. In recent times, it is a factor of many improvement actions that you can see listed here that we have announced and executed during the years, and now they are gradually contributing in. I won't go through the chart, but it's something for you to look at that it's not only the price game that is driving this. We are not done yet. There are lots of opportunities in this complex value chain that we can still capture more value and take more out of this machine, but this demonstrates on what we have been doing so far and continue to do next quarters and years.

So summarizing our main focus areas. Going forward we continue active price management. I also already said in July, value over volume, we have reached our targets there. Now we need to look at our price management going forward. It doesn't mean that we still cannot increase prices in some pockets. You might have noticed that in September, we did announce water treatment polymer price increases in Europe. So there are still areas where we need to do things, but we need to be also sensitive that we don't overprice ourselves and lose volumes in wrong places.

We continue to work on our product portfolio and optimize that and our service offering also to -- not to overserve but not underserve either. And when we measure our Net Promoter Score from our customers and we measured it now for a while, it has continued to go up. And that's sort of a proof that we are doing something right. And obviously, we intend to continue to do that. We continue this work on our supply chains, our sourcing, our internal processes, meaning our operational excellence. There's more to gain from there. The ramp-up, as I said, for our Chinese new AKD plant happened this week, and now we need to get it up and running and contributing to the numbers, also completing the Rotterdam polymer plant and then continue the big plants in U.S. and South Korea. Obviously, in these times, we also continue to have prudent cost control in all areas.

I'll conclude my Q3 update here and ask Petri to come and give some insight on the numbers.



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

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

Thank you, Jari. So excellent, excellent quarter. So let's take a little bit of deeper look on what were the key drivers driving the result. So to start with the pricing management. So growth was relatively moderate at 3% year-on-year, especially as about 2% was -- came through stronger FX. And again, the key currency is the stronger U.S. dollar versus a year ago. Sales price is up 3%. And Jari already mentioned, the Oil & Gas business area as well as the particularly North American Water businesses were where we have done -- which are the key areas of improvement.

Volumes delivered were down 2%. And actually, this is an improvement over Q2 when the year-on-year comparison was 4% negative. And again, the key items here, perhaps, to point out is the seasonal Canadian oil sands business, which is water treatment business in the oil sands.

Looking at the EBITDA bridge at the bottom of the page. Improved sales price impact is, by far, the largest contributing factor. Raw material environment looks quite benign now with some raw materials like caustic soda, it has actually declined quite a bit. The third part of that EUR 13 million is the impact of caustic soda. And here I must say, and I've said this in the past as well that this actually does not -- for the most part, does not impact our profitability. As for most of the caustic that we sell is a traded product that we sell at fixed margin or fixed fee rather.

Currency situation is largely what it has been throughout 2019, so a positive contributor in the year-on-year comparison. With current FX rates, we should continue to see positive contribution in Q4, but the impact of that positive should actually come down as the dollar comparison, it's a bit stronger Q4 -- from Q4 '18.

I'm also quite pleased about our fixed costs management for the year. We have largely killed inflation. It's the internal term that we use. If we take out the Chinese AKD plant, so we have had to add fixed cost. Because of that, we bring operators on board, so we have something like 200 -- actually, closer to 300 employees by now. And like Jari said, we're just now starting up that process, so we have incurred that costs in advance. And the other cost item which we have is somewhat higher incentive accruals because the year is actually going quite nicely.

Finally, on a comparison on the bottom right. When you look at apples-to-apples, cleaning up for the IFRS 16 impact, our profit improvement on EBITDA is EUR 20 million, which is well over 20% improvement year-on-year, so continuing on a nice trend.

Looking at the raw materials, I think the key point's already covered. Perhaps, you can see on the right that the net positive impact has continued to grow in Q3. And again, perhaps, one point to mention here is that while comparing individual quarter, Q3 versus Q4 -- Q3 of last year, raw materials declined EUR 13 million, that's on the right-hand chart. But if you look at the left-hand chart, when we look at sort of a smooth and 12-month trailing period, we are still in the comparison above the trend line. The 0 line shows that we are in at increasing raw material environment. However, obviously, that is coming down now.

Anyways, I think it's fair to note that considering the 10-year picture you see on the left, we are at a historically very good situation right now. Now as we are in the middle of planning for 2020, we are forecasting roughly flat raw material prices across the basket. Obviously, again, there are individual raw materials which are going down. There are some, where we actually see -- expect some movement downwards as well. And again, we know the macroeconomic uncertainty. So the macroeconomic disturbances could have an impact on that or individual supply chain issues.

Cash flow. Strong results are also driving our cash flow improvement. Even if we adjust for the IFRS 16 classification change in the -- and also the pension fund return, which we had earlier in the year, year-on-year, we are EUR 80 million ahead in cash generation, which is quite significant improvement. And also I'd like to remind that this time of the year that we are -- we do have a seasonal rhythm to our cash flow. It is second-half weighted. And typically, it's even fourth-quarter weighted. And so that's just our rhythm that we have incurred in the past years, and I don't see why it wouldn't happen this year as well.

Finally, note on 2019 CapEx. We still expect that the CapEx without M&A will fall within this EUR 180 million to EUR 220 million range, even as the annualized rate over the 9 months is significantly below that EUR 120 million annualized. It would be EUR 160 million, but we expect that we will have a catch-up in Q4 CapEx. And it is some of these projects that Jari mentioned, driving that the Chinese plant, the Rotterdam investment, the key ones, perhaps.



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

Return on capital is improving quite nicely, now at 11.5%. So quite a rapid increase there. This is really driven by Industry & Water improvement and ongoing investments because we do have significant investments, which are not yet yielding results. They are expected to return or improve the return once they are up and running.

Looking at the debt. The debt ratio, as we report, decreased to -- now to 2.1x. And actually, again, if we adjust it for IFRS change, it would have been roughly 1.9x. So that gives a magnitude of the deleveraging that we have done over the last year. And so it's roughly 0.5 turn of leverage reduction over the relatively short period of time. So this actually gives us some financial flexibility or optionality, not that we would have needed that or not that we would have immediate plans for that, but nevertheless, it's a positive thing.

Covering the outlook. Our year-to-date operative EBITDA on an apples-to-apples basis is now something like EUR 56 million ahead of last year. So this outlook guidance may not be hugely informative, to put a joke here. But nevertheless, for the record, we repeat it as a part of our Q3 report.

With that, I'll stop my remarks. And we can open up the Q&A session.

QUESTIONS AND ANSWERS

Olli Turunen - *Kemira Oyj - VP of IR*

Very good. Before asking a question, please wait for the microphone and state your name and the company.

You are the first question.

Unidentified Analyst

(inaudible) from Danske Bank. I would have two questions on pricing and then a third one on the demand. So firstly, on pricing, how big as a risk do you see that you need to start cutting prices if the variable costs are no longer increasing? And then secondly, how good visibility do you have to your, let's say, next year's pricing? How much of that you have already kind of negotiated? And then thirdly, on demand, you mentioned this demand softness in Pulp & Paper. So what impacts have you seen -- have you kind of seen that customers are purchasing less or demanding lower prices? Or is it something that you expect to happen only going forward?

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

Well, active price management means that when there are new tenderings or new negotiations, then we have to see how we price ourselves. And now we've been in a flat raw material environment for a while. So then it's a sensitivity game on how we want to play each tendering. On the volumes, a lot of our things are long tendered and longer contracts. So as it was tough when the raw materials went up to catch up on those, and now that we have caught up on those, then we are pretty steady going forward, especially on the municipal water treatment side, which is not very cyclical from a volume demand point of view. What then comes to the softness of the market, like I said, in July, we saw the headlines and companies talking, but we didn't really feel it ourselves. Now we felt it, not dramatic, as you can see from the numbers, but it's been some longer shutdowns and customers in Pulp & Paper, mainly in paper and board, looking at the market price rather than pushing volumes. So I guess, you get a good idea when you look at the customers announcing their tonnages that gives you good idea. Pulp side demand for us has been solid.

Anssi Kiviniemi - *SEB, Research Division - Analyst*

Anssi Kiviniemi from SEB. One question left. On Oil & Gas, what are you seeing there? I mean what are the customers talking about? And you are now being more cautious. You have been cautious for a while, but you continue to grow. So should we expect sales to decline on that segment in the future? Or how dramatic is the change?



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

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

Okay. Dramatic is not the word that I would use, definitely not. We know it's a cyclical industry. Our CEOR business and the new Rotterdam plant, that's very steady as she goes. And actually, demand is step-by-step growing by the customer once we can deliver more. The oil sands business is cyclical within the year seasonality. So that will now drop away in Q4 and Q1 and then come back in Q2 next year. So that's an obvious that we know. So don't be alarmed if you see different type of revenue numbers.

And then shale demand, a couple of things. You've seen the rig count come down, not direct for us, but means that there are less holes to be put to production. Also winter time, expenses go up. So as the WTI price is now in the low 50s, the customers are really looking at their cash flow carefully. But no dramatic drop, but there is some drop. And the visibility, at the moment, is not so good, but we sort of caution ourselves for the next couple of quarters that the demand peak is over as of July.

Anssi Kiviniemi - *SEB, Research Division - Analyst*

On the pricing situation, in the shale oil, I guess, there is a -- you are now referring to volumes when you say that there is some kind of drop that -- how does -- what's the pricing environment?

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

So far, our pricing environment has pretty much followed the raw material environment. So margins have been steady and strong. But obviously, as the demand goes down, there'll be some over supply in the market. So maybe there is a bit more fight on getting the volumes, and that's a quality issue, that's a service issue, and that's a price issue. And we are in a position where we have some differentiation on the technical characteristics of our polymers. So maybe that protects us a bit.

Veikkopekka Silvasti - *Nordea Markets, Research Division - Assistant Analyst*

One more question for me. Veikko Silvasti, Nordea Markets. Do you expect to see any additional costs from the ramp-up of the new AKD factory or the Rotterdam investments during Q4?

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

Typically, there are some added costs, especially from the polymer site in Rotterdam. So when you start up a new line, you typically have batches of production that doesn't meet the quality. Whether we can rework them or then we have to scrap them, there is some single millions that can come, hard to predict, but we know typically that this might happen.

Olli Turunen - *Kemira Oyj - VP of IR*

Are there further questions here in the room? No? Operator, please go ahead.

Operator

(Operator Instructions) Our first question is from Martin Roediger from Kepler Cheuvreux.



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

Martin Roediger - *Kepler Cheuvreux, Research Division - Equity Research Analyst*

Congrats for your results today. Just 2 questions from my side. On Industry & Water, a clarification question. Did the volumes in that segment, have they been flat? Or have they been down in Q3 year-over-year? And secondly, on the tax rate, which moved up to 26% in Q3, is that an outlier? And what was the reason for that? And what is your estimate for the tax rate, not only for this year but also for next year?

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

Okay. So volumes on Industry & Water and the shale really peaked during the summertime, and now we have come down some. And let's see how they develop, but nothing dramatic. And we were really out of capacity, also, during the summertime. So that's the situation. I'll leave the tax question to the CFO.

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

Yes. The tax rate, if I remember correctly, the effective tax rate was 24-point-something for the quarter where we -- I think we have guided 22% to 25% in that range. So somewhat on the high end of that range. I think that for the next year, I think we are still guiding that we should say that 22%, 25% type of range.

Operator

And our next question is from Ben Gorman from UBS.

Ben Gorman - *UBS Investment Bank, Research Division - Associate Analyst*

Just a few for me. First of all, on -- so a little bit of volume weakness you mentioned in the press release, process and functional chemicals, particularly in North America. Can you give more detail on what's happening here? Is there any movement from competitors? Or really is this just overall market demand is a little bit weak, as you mentioned?

And then secondly, obviously, very strong margin in Pulp & Paper as well this quarter. Any particular product groups that you can share with us that are doing well versus Q2. So anything that has got particularly better this quarter. Just those two.

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

Okay. Yes. I think it's just a general market in North America. The -- how you calculate the board and especially, printing paper production has come down some 4%, 5% this year. So it's not only us, it's affecting the industry as a whole, and we are fighting to convert our demand more towards tissue and board. So this is what the general trend is and will be. It's been bit faster than previous years, this year in the demand. Also the trade wars, there are less goods moving across the Pacific. So it does have some effect. It is very hard for us to quantify how much that then directly affects us. It's too long of value chain to get detail on that.

Our improvement during this year has really come from all of our business units. Both segments has been improved, and all regions have improved. So there's been strong improvement in the water treatment in North America and obviously. Then Oil & Gas compared to 2018, those are really strong improvements, but we've been improving on both segments in EMEA and also Asia Pacific. So it's great to see that development comes from all units.

Operator

(Operator Instructions) And as there are no further questions, I will hand the word back to the speakers.



OCTOBER 24, 2019 / 10:00AM, KEMIRA.HE - Q3 2019 Kemira Oyj Earnings Call

Olli Turunen - *Kemira Oyj - VP of IR*

Thank you very much. So this concludes the Q3 results presentation. Thank you very much for your participation, and have a good day.

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

Thank you.

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

Thank you.

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