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KEMIRA.HE - Q3 2020 Kemira Oyj Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2020 / 11:30AM GMT

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PRESENTATION

Mikko Pohjala *- Kemira Oyj - VP of IR*

Good afternoon, and welcome to Kemira's Q3 results webcast. My name is Mikko Pohjala, and I'm from Kemira's Investor Relations. We continue our social distancing measures today. And as in the previous quarters, we only have a webcast from our headquarters here in Helsinki. And here with me, I have our President and CEO, Jari Rosendal; as well as our CFO, Petri Castrén.

Earlier today, we published our Q3 results for the January-September period. And in addition, we announced that the Board has made a resolution on the second installment of the dividend.

During the webcast, Jari and Petri will go through Q3, the main events, after which you'll have the chance to ask questions either via the teleconference or then via the webcast, too. But without much further ado, Jari, please go ahead.

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

Okay. Thank you, Mikko. Good afternoon from my side also. As you've seen from our numbers, we have continued performing well despite the special circumstances of the COVID-19 and the economic downturn it has caused.

Q3 operating conditions was mainly a continuation of Q2. But now we are operating more steadily, as in Q2, we were still learning the new circumstances. Unfortunately, after the summer, the pandemic situation around the world has, again, gone to the wrong direction, except in China. So these conditions will prevail for some time to go. But all in all, I'm pleased how we have been performing during these special times.

So some of the Q3 highlights, as said, continued operating all our plants, and there has been no disruption in supply chain or raw material availability. Our revenue has come down, but mainly from oil and gas and printing and writing applications. And those have been hit most by the pandemic effects. Profitability, however, was good as some raw materials helped us, but also majorly, our own self-help actions have been helping us.

We've been doing a lot of self-help during the last years, and that's now carrying and contributing and helping our profitability. We reached an operating EBITDA of EUR 113 million and 18.9% of revenue, which I'm really pleased about. We also updated our outlook in early October and basically returned to the original outlook for the year.

And as Mikko mentioned, the Board decided on the second installment of the dividend.

So let's look at the main figures of Q3 on a group level. Revenue, EUR 597 million, down 13% year-on-year. And as said, mostly from oil and gas and printing and writing applications.

Without Oil & Gas, the organic drop of revenue was 5%. And as said, operating profit strong. Even if the revenue dropped, we got some help. And really, the efficiencies also from our new investments that started late last year and early this year, are really contributing now, and the ramp-up is going well. Earnings per share, EUR 0.24 and strong cash flow.

Wanted to talk about a bit of the longer perspective. We have done a lot of self-help actions during the past years, and many actions have small increments. It takes time to get into run rate profitability.

During the second half of 2019, most actions started to be in or just coming in, and that got us to a good run rate start from the beginning of the year, which was good and supporting this difficult situation that started then in March.

Progress is clear, what you can see from the graph, and there are seasonalities between the quarters. And -- for instance, the last quarter of last year, we had some start-up cost of new plants. So some fluctuations sometimes, but you can see the clear trend in profitability developed.

Then looking at Pulp & Paper, had a strong quarter. Demand has continued fairly resilient in the big picture, especially pulp, packaging and tissue is resilient. And as I said, printing and writing down 16% year-on-year as people are working remotely and newsprint and advertising papers are down.

Revenue, EUR 352 million, only 5% down organically. Also, there were maintenance shutdowns by the customers in Q3, which normally hits Q2, but now they were delayed because of COVID-19.

The new plant, AKD plant, in China continued to ramp up well and is contributing nicely to the bottom line. Our AKD business before this plant was not very profitable and not meeting our targets. But with this investment, we now get it to a reasonable level, not stellar, but reasonable level. And that's now part of the improvement compared to last year.

It's also a bio-based sizing product, so it's in the heart of our strategy.

As a reminder, with this new plant, we in-sourced some manufacturing steps that we were buying from outside, which created more cost for us. And now the -- this benefit is shown in the variable cost.

We also, in Q3, received a emission trading right compensation that then benefited this quarter more than normal.

Looking at Industry & Water, water treatment chemicals are always needed that supports IMW, even if the oil and gas demand is down. Municipal water treatment demand remains steady, actually up year-to-date a couple of percentage points. Industrial water treatment recovered some from Q2, also some recovery in shale in Q2, not huge, but still the right direction.

Organic revenue down 18%, most drop from oil and gas. Still operating EBITDA reached EUR 47.6 million and 19.5% from revenue. And the new line for special polymers for CEOR applications in Netherlands is running now nicely and contributed to the profitability as we, again, in this case, in-source and outsourced steps earlier. And that is going according to our investment plan as designed.

Then a bit deeper look into Oil & Gas. Shale demand, as said, still low, but recovered some from Q2. You can see that we bottomed at EUR 27 million of revenue in Q2 and now EUR 41 million in Q3. But then you compare it to 2019 run rate level, still low, but going to the right direction.

Oil sands tailings treatment demand also down compared to 2019 as customers were saving cash this year, and that's because of the oil price real volatility in the first quarter. This should -- the oil sands demand should return to normal next year, and it's a long-term thing. They need decades to treat those legacy tailings.

The tailings treatment season has now ended as winter is coming. The next season starts in April when the snows and ice melts. CER, no changes in demand. Actually, year-to-date, we are even up 3% in revenue, even if the pricing has gone down due to formula pricing in those contracts.

And we signed a multiyear continuation in CEOR with Ithaca Energy that operates at the North Sea. This secures good volumes for us for the next years to come and good load to the new line that we have in Botlek.

Short term, we continue to focus on mitigating the effects of the pandemic. And so far, we have succeeded well. When things allow, we start gradually returning to office, however, during last weeks, as you have seen, the situation has worsened in many countries, and we are being conservative and staying safe.

Tight control on cost and running operations and realize the benefits of our new investments. Medium to long-term focus areas: keep meeting our financial targets, focus more on profitable growth, continue to construct the polymer plants in U.S. and in South Korea, and then the expansion for reaching capacity in Uruguay to support the European new mill.

Our customers are placing increasing focus on sustainability in their operations and in their products. We have increased Kemira R&D focus on value-based products going forward and supporting recyclability.

Finally, I'd really like to thank the Kemira staff for a good quarter. That's my summary for Q3. Next, Petri will give some more color on the financials.

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

Very good. Thank you, Jari. Really, the quarterly report for Q3 has a lot of the same themes as we had in Q2, meaning strong profitability, and I'll talk about the drivers behind that; lower value -- lower volumes, on the other hand, obviously, driven by the COVID-induced economic downturn; and then our group cash flow and capital efficiency.

I will also touch on the outlook and then assumptions behind it for the full year and the second half of the year.

Looking at this traditional profitability bridge, Revenue declined 13%, as Jari mentioned, mostly due to lower volumes. However, with the 3% impact from FX, and the currency impact is primarily because of the weakening U.S. dollar during the quarter. And as Jari mentioned, main customer segments were the -- where volumes declined were Oil & Gas, particularly shale and oil sands, then Printing & Writing and then within the water treatment to some lesser extent in Industrial Water Treatment.

Average prices held very nicely in this environment. Top line was impacted by less than 1 percentage point from price reductions compared to a period a year ago. Big picture continues to be the same, decline in sales volumes primarily due to this COVID and related economic downturn as well as the benefit that we have been able to secure through variable costs.

Now, Jari talked about the self-help items. So let me spend a bit more time in what all goes into this outline item variable costs. So we -- I can categorize them into 4 categories: one, our own actions, like the efficiencies that we are getting from China and in Netherlands from these new investments. Then second item that is visible in this variable cost is the pass-through items. And we sell caustic with a pass through pricing. And then also, we have some items like electricity costs, which are really passed on to the customers in short order.

Then, of course, the raw material -- raw material price fluctuation. And then there's always the Other. And the Other has some items like change in bad debts, inventory accruals and other. Own actions give typically permanent, long term health. And now we can say that the combined annual cost saving from the 2 investments, that Jari talked about, is now EUR 5 million compared to a year ago. So obviously, if you analyze that by simple math, it's a run rate of about EUR 20 million benefit, and obviously, Q3 last year was also a good year from the profitability point of view.

Then on the other hand, these pass-through items do not really help us as the benefit is passed to the customer either immediately or with a very short time lag.

Raw material prices, obviously, they tend to fluctuate, and this fluctuation has been favorable to us recently. And now what we were seeing, we're seeing the biggest benefit in oil-based raw materials, and that's visible in the polymer prices, and Jari gave an example of already formula-based pricing in CEOR.

And then other parts, they are something that has items that we can impact. For example, now we are having lower inventory write-offs compared to the period a year ago. And if you remember, a year ago, we were starting up both the Netherlands and the China investment. So initially, we actually had some inventory write-offs. So that's helping us as well.

There's also another positive one-off type item benefiting this quarter, and this is the emission compensation payment in Finland, and this was, obviously, booked as a reduction in variable costs. This helps our Pulp & Paper segment as really the big electricity consumer in Finland is the chlorate plants in Finland.

And also, this is one of the reasons why we are calling Pulp & Paper quarterly performance are exceptional from a profitability point of view. There were also some other items like interestingly, medical cost reversal as people seemingly are going to doctors less often. And this is actually something that we saw during the quarter as well.

Fixed costs, we're getting a nice benefit here as well. Travel savings is something that most companies, if not all global companies, are reporting as a savings item. For us, that's about half of the EUR 10 million fixed cost saving, that you see in the picture, is just simply reduced travel because of the various travel restrictions during this pandemic.

And then on top of that, we are, obviously, doing our own actions on fixed cost side as well. Particularly in Oil & Gas, we have done headcount reductions, and elsewhere in the company as well. We have deliberately slowed down replacement hiring, and as a result, our permanent headcount is now almost 100 employees down from 6 months ago.

So obviously, that is starting to show in the costs. The drivers behind these charts were already quite well discussed. Variable costs came down and the net impact from these drivers continue to be nicely positive. And obviously, this is the one big driver supporting the profitability during the quarter.

Backward integration benefits from our -- from the AKD and specialty polymer investments, and we expect them to continue to contribute in the coming quarters before they then established a steady run rate and then the year-on-year comparison becomes less significant, but still, we expect that to continue for a few quarters.

Talking about raw material costs. Currently, we expect that the outlook for raw materials is now towards slightly increasing raw material costs, nothing dramatic, but still a small increase in the costs for '21. Obviously, during this time, quite a bit of uncertainty regarding the economic activity and the raw material costs.

Jari talked about the supply chains. So yes, they have continued to work very well. And obviously, the increase in number of COVID cases will raise the risk again. But I think us and the whole industry has learned to manage the supply chains quite well.

Hard Brexit is, obviously, a risk for us in the coming quarter, and we expect that if the hard Brexit really takes place, there will be some local disruptions, but in the sort of a group level, the impact is not expected to be material.

Moving to cash flow, Q3 cash flow was good. And year-to-date, we're now approximately at the same level with last year if you ignore the EUR 15 million onetime capital return that we received from our pension fund nearly last year. Also, I may be repeating my comments from Q2, but I'm also very pleased -- continue to be very pleased about our receivable management. We have been able to maintain our receivable turnover ratio constant, or actually even slightly improved during the Q2, even as the sales volumes have come down.

Inventory levels, which were flat at Q2 were at somewhat high level, they have come down during the quarter according to our plans. Finally, I also, at this time do intend to remind that our net working capital and capital expenditure cycles make us -- make our cash generation typically second half weighted, particularly Q4 weighted.

This year, I don't quite expect the same type of a big cash release that we saw last year, but still expect that the positive cash flow will continue at the good level.

For example, one example, why this release will be smaller is that we are building some inventory buffer in preparation for a hard Brexit.

CapEx, no -- nothing particular there. It's going as planned. And with full year CapEx likely to then around EUR 200 million. Where it exactly lands, obviously, depends on the timing of some of the bigger expansion projects that have underway now.

A little bit on the balance sheet gearing. Due to good profitability and good cash flow generation, net debt is down some EUR 80 million versus a year ago, versus last year, and at the same time, leverage ratio has now fallen below 2x, first time for some years. And cost of borrowing, particularly in higher cost bases like in China, has come down, and that is reducing our borrowing costs or interest expense.

Again, finally, a reminder of our FX position as we now saw some FX impact in our numbers. And now there has been quite a bit of a more focus on where the U.S. dollar and euro rate will fall. So first of all, as you can see, we have a pretty good natural hedge in our business. If you look at the revenue cost breakdown of our currencies, for example, it is 34% of our revenues, which are derived in U.S. dollars, but so is 32% of our costs. So from that perspective, we have a nice -- pretty good natural balance there.

So the U.S. dollar weakness or strength, but this time, it's more weakness recently, comes through primarily through the translation of the U.S. profits generated, as we're generating fewer euros.

Year-to-date, the negative FX impact is EUR 4.6 million and about EUR 3 million of it came now in the third quarter. And then if you sort of try to project into the future, and so sort of a rough rule of thumb, EUR 0.01 in the exchange rate, euro to U.S. dollar, is roughly EUR 1 million bottom line impact on an annual basis for us. And that's the rough impact before hedging. So hedging activities may smoothen it a little bit, so it doesn't always immediately come through the P&L, but that's roughly the type of exposure that we have to that currency payer.

Like Jari mentioned, we updated the outlook on October 9. And due to the lower costs and improved outlook for shale business, we also revised our own estimates for full year 2020. And that outlook now states as operative EBITDA higher than the EUR 410 million that we had in 2019.

And why we did? By our own interpretation, the market has sort of taken our earlier withdrawal of the original outlook as placing a cap on the profitability at EUR 410 million, and therefore, we felt it was prudent to update the market as soon as the quarter was closed and the full year forecast was reviewed -- and revised and reviewed.

However, environment still continues to be difficult and uncertainties. So we expect H2 EBITDA will continue to be -- will be lower than the H1 level. And we felt that it was also important to leave that part of the guidance in place.

Already mentioned the one change in the assumptions from Q2, meaning somewhat improved market for shale oil and gas. Otherwise, we expect that the overall demand for Kemira's end markets during the second half will be very -- will be approximately at the Q2 level.

Good. Then I would like to, again, invite you all to our Capital Markets Day. So we will host a virtual Capital Markets Day in less than one month's time. So please do join us in a virtual session, November 19, starting at 2:00 p.m.

With that, I think we're ready to move to the Q&A session. So operator, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have a question from Martin Roediger from Kepler Cheuvreux.

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

I'll start with two questions. Maybe then I will queue up again. The first question is on the emission rights compensation. Can you mention the magnitude of it in Q3? And will this effect repeat in the quarters to come? And since when did you benefit from that emission rights compensation? Is it the first time or not? And the second question is actually on the selling prices, actually. Because you mentioned that in CEOR, you had a pass-through of low raw material costs. So when I look at your chart on Page 12, and it seems to be that the same prices have been stable, overall, which means that it's some other activities you have increased your selling prices sequentially. So can you help me to understand in which business units you did increase your selling prices sequentially?

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

Yes, I'll let Petri answer the first question, but maybe I'll answer the second one. So in our CEOR business, we have such big volumes that the contract is based on a formula pricing. So some feedstock prices that we have coming into our raw materials, that goes as a formula to the customer prices. If feedstocks increase, our sales prices increase, if feedstocks come down, our sales prices go down. Same thing we have in oil sands, polymers and in North American electrical prices for bleaching chemicals. So that's the effect.

There are some benefits also on sales prices, but that's more of a run rate comparison. So we were still working on some delayed price fixes this time of last year. And as I said that, at the end of 2019, we got our run rate into the right shape with various things. And that small delta is visible now.

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

Okay. I'll try to cover this quickly so -- the emission cost. So obviously, in EU, you either -- industries are either required to buy carbon credits, or then they need the certificates of origin for the electricity that you are consuming if it's fossil free. And then and as you may have seen, the carbon credits have gotten more expensive over the last few years. And obviously, the EU allowances, is -- the idea is that the industry within EU can compete efficiently against the industries -- against the competition that comes outside of EU. And Finnish government is giving some compensation for industries in Finland or -- under this, actually, to a less extent than in many other European countries. And so that's the underlying regulatory framework quickly discussed.

And we have received this now for a few years, but as the price of carbon credits has increased, the compensation has also increased, and we do recognize that and during the quarter received. So that's why we received those in -- most of them in Q3. There was something received also previous year quarter 3, but the magnitude was smaller last year, and that's why we highlighted it this year.

This [just came out] or subsidy will last next year, but then the political environment has sort of made the decision to fade this subsidy away, and there will be sort of other ways of using or promoting sort of efficient and fossil-free energy.

And that sort of a framework, I think, is still a bit up in the air, how it will work in Finland. But nevertheless, we will see this benefit next year as well.

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

And the effect in Q3 was how much?

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

Roughly $3 million.

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

And why it's Finland is that it's happening elsewhere also in Europe, but our electricity consumption, due to our bleaching capacity here in Finland is -- we're a fifth biggest electricity user in Finland. So maybe that gives you the sort of the size of it.

Operator

(Operator Instructions) We have a follow-up question from Martin Roediger from Kepler Cheuvreux.

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

I'm obviously the only person who's in this call. I apologize for that. But maybe then I have 2 follow-up questions or 2 additional questions. And the first one is on bio-based products. You mentioned that on Page 9. Can you elucidates, what is the exposure today? And what is your expectation of this -- of the bio-based products exposure in 5 years' time so that we get a feeling of how important that could be?

And the second question is on the outlook. You -- just to clarify, all else equal, is there any reason why the seasonality in Q4 this year should be different to the seasonality we are used to see at Kemira over the last couple of years?

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

Well, probably the seasonality is pretty similar. The oil sands season is over and the winter and snow and ice coming affects some of the water treatment volumes. But probably last year, the shale drop from Q3 to Q4 was more significant. And now that comes from a small base, so most likely, it then continues at a flat rate, let's put it this way, if the weather allows.

The other thing is that then the holiday season, there might be some extra stoppages, we don't know, by the pulp and paper companies and potential shutdowns. But we are informed of those only days before if they do take a downtime during the holiday. So other than that, last year, there were no major downtimes from the Pulp & Paper as demand was good. So that's the situation.

And on the buyer base, we have a portfolio already. AKD in China is one of those. And that AKD product is shipped all over the world. And then -- so it's our global base. We have others also, and we intend to threefold that business in the next 10 years, but that's a topic that we'll be talking more in the CMD.

Mikko Pohjala - *Kemira Oyj - VP of IR*

Maybe now we can take a question from the webcast too. Two questions here. This -- you briefly touched upon this already, but could a bit more elaborate, Jari, how do you see the maintenance outlook for the Pulp & Paper paper customers in Q4 as prediction?

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

Basically, it's possible. I mean, we saw maintenance shutdowns in Q3 they've announced a few in Q4. And then the holiday season is a question mark. So I can't -- it's not known to us.

Mikko Pohjala - *Kemira Oyj - VP of IR*

Yes. Indeed. One more question regarding the new investments. This may be more for Petri. So what kind of improvement do you expect to the EUR 20 million run rate from the China and Netherlands investments next year?

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

Somewhat, but not dramatic -- not dramatic anymore. And obviously, now 1 assumes that the starting point, so the comparison point is fixed. So yes, I think, it's maybe another EUR 5 million or so on an annual basis, one would expect to receive.

Obviously, both of these investments, and they also not only provide the backward integration help and the cost benefit but they both have extra capacity, so we can grow these businesses. So that's one of the reasons why we are now growing in Pulp & Paper because we have more AKD capacity. So we can grow there.

Same thing. Jari mentioned that the polymer plant now, the Ithaca provides a good baseload. And actually, it's growing baseload. But now we can actually start entertaining other customers, which we were not able to do before we have that extra capacity. So there is, also, as we hope and expect that we build the market. So this will -- we will get benefit from the expansion, but then that's on top of the cost saving that we had up to now.

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

And maybe as a reminder, the AKD plant in China, we started that up in November last year and then, obviously, have some ramping up issues in the beginning and shutdowns for maintenance and so on.

So you can imagine that it was not full run rate until after the summer. And the specialty polymer line, we started up in March. So that's the increment that is going to then be there for next year.

Now they're running well and ramped up.

Mikko Pohjala - *Kemira Oyj - VP of IR*

If we turn to the audio line for questions, if there are still.

Operator

We have a telephone question from Veikko Silvasti from Nordea Equities.

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

Could you maybe remind us, once again, how does your pricing work in an inflationary raw material environment now that we are most likely going to see in 2021?

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

Well, if it comes to the polymers and shale, you could call it frame agreements and spot pricing. And then -- obviously, then the competitive situation is a factor there, too. In the water treatment side and in the Pulp & Paper side, it's mostly long-term fixed contracts, not a lot of spot volumes. And then we have the formula pricing for CEOR and oil sands and bleaching in United States that go with input costs up or down.

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

If I continue a little bit on that. Veikko, if you flip through and go to our Q2 presentation, I had a slide on that one. And off memory, something like 80% of our business is this type of a fixed price, fixed contracts. But to be honest with you, I don't know how much that the percentage number is correct, but it's in the Q2 presentation.

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

Yes, it's about right.

Operator

There are no further questions registered, so I hand back to the speakers.

Mikko Pohjala - *Kemira Oyj - VP of IR*

Okay. This was the shortest whenever. Thank you.

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

All right. This is the shortest one ever. So but thank you for participating. If there are still questions after the audiocast and webcast, please be in touch with me, and we're happy to take your questions. But as Petri said, so we're looking forward to seeing as many of you as possible at the CMD on the 19th of November. So we'll catch up then. Thank you for today. Thank you.

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

Thank you.

Mikko Pohjala - *Kemira Oyj - VP of IR*

Thank you.
