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Orion Engineered Carbons SA (OEC)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Orion Engineered Carbons' Fourth Quarter and Full Year 2018 Earnings Call. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Diana Downey, Vice President of Investor Relations for Orion Engineered Carbons. Thank you. You may begin.

Diana Downey

Vice President Finance and Investor Relations, Americas, Orion Engineered Carbons SA

Thank you, operator. Good morning, everyone, and welcome to Orion Engineered Carbons' conference call to discuss fourth quarter and full year 2018 financial results.

I'm Diana Downey, Vice President, Investor Relations. With us today are Corning Painter, Chief Executive Officer; and Charles Herlinger, Chief Financial Officer. We issued our earnings press release after the market closed yesterday and have posted a slide presentation to the Investor Relations portion of our website. We will be referencing this presentation during this call.

Before we begin, I'll remind you that some of the comments made on today's call, including our financial guidance, are forward-looking statements. These statements are subject to the risk and uncertainties as described in the company's filings with the SEC. Actual results may differ materially from those described during the call.

In addition, all forward-looking statements are made as of today, March 7, 2019. And the company does not undertake to update any forward-looking statements based on new circumstances or revised expectations. Also, non-GAAP financial measures discussed during this call are reconciled to the most directly comparable GAAP measures in the table attached to our press release.

I will now turn the call over to Corning Painter.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Thank you, Diana. Good morning, everyone, and thank you for joining us for our fourth quarter and full year earnings conference call. We appreciate your time. I'd like to start today's call by providing the highlights from the fourth quarter and full year of 2018. Then, I will provide an update on what we are seeing in the market and update on our capital deployment. And I'll share some insights from my first six months as the CEO of Orion. Our CFO, Charles Herlinger, will then provide detail on our financial results and discuss guidance for 2019. After that, I'll come back and share some closing comments. Then, we will be happy to take your questions.

Turning to slide 4. We delivered solid results for the fourth quarter and delivered another record EBITDA for the full year 2018. In the Specialty segment, with the strength of our product portfolio and execution of our marketing programs, we delivered significant year-on-year growth in the first half of 2018 before trading conditions began to soften, particularly in the automotive segment.

In the Rubber segment, we went from strength to strength as we enjoyed last year's pricing gains and good execution. In 2018, we also positioned ourselves for the future by consolidating our Korean facilities to one site, adding acetylene carbon black to our portfolio and successfully negotiating rubber price increases for 2019. I would like to thank the Orion team for their hard work and dedication to achieve these outstanding results.

Please turn to slide 5. I believe capital allocation is a key responsibility of a CEO. I will not read the whole slide. But the point is, that after paying our dividend and addressing a few must-do categories, we strike a balance amongst growth, M&A and opportunistic buybacks.

In 2019, we will accelerate our must-do U.S. environmental spending, as our first plant that requires enhanced sulfur removal capability must be on stream by April 2021. Based on current conditions for construction in the U.S., we estimate our total EPA CapEx through 2025 to be roughly around \$190 million. This is before reimbursement from Evonik. Other priorities for us include safety, maintaining our plants, the expansion of Specialty production with the new line, in addition, in Ravenna and we identified a high-return cogeneration opportunity.

As a result, in 2019, we expect total CapEx to be roughly \$80 million for EPA-related investment and roughly \$100 million for base projects and the expansion in Ravenna. We expect our leverage to stay within the 2 times to 2.5 times range.

To further emphasize the importance of capital spending, we just modified our long-term incentive plan metrics to now be split between ROCE and TSR. Annual bonus metrics remained primarily based on EBITDA. Last quarter, we announced the acquisition of Specialty Black capacity, an acetylene carbon black business in Europe. We're pleased with the people, the asset, the pace of the integration and our improved view of the opportunity in front of us.

I'd like to share some of my observations of being the new CEO at Orion and expand on my comments from last quarter.

First, the people here are passionate about Orion and Carbon Black, and they know their stuff. That is essential. Second, we have ample opportunity in our core business of carbon black. Third, in Specialty, those opportunities include new applications such as lithium-ion batteries, adding new products to our portfolio of existing applications like coatings, improving product quality and strengthening our overall applications capability, particularly in the U.S. Fourth, we talked a lot about Specialty, but the Rubber business is core to us also. We have numerous opportunities in upgrading our production facilities, variable cost productivity and implementing a win-win contract structures.

We are taking action in each of these areas. For example, starting with what's most important, our people. Our 2019 annual incentive plan offers greater line of sight for our employees by moving from using corporate performance across the board to local EBITDA and balance sheet metrics.

Now, turning to slides 6 and 7. I am pleased to say the Q4 adjusted EBITDA was \$64.4 million for the quarter and adjusted earnings per share rose to \$0.48 from \$0.42 in the last year. These results were driven by a strengthening Rubber segment due to solid execution and strong spot pricing supported by robust market conditions. Total volumes were down by 6.1%. But this was mainly due to the plant consolidation in Korea and some year-end softening in China. EPS benefited from improved financing costs and a lower effective tax rate. On Slide 7, you can see the relative strength of our Rubber business in Q4. On a full year basis, Specialty gross profit per ton developed nicely. We'll look at the current trend on the next slide.

Moving to slide 8. You can see our Specialty business results for the fourth quarter. Revenue grew 10% to \$126.9 million, reflecting the pass-through of higher feedstock cost to customers and base price increases, partially offset by lower volumes, product mix and foreign exchange translation effects. Volume was down 2.9%, reflecting a mix of inventory destocking and softening demand. Destocking by its nature tends to adversely impact mix and the slowdown in China automotive and other markets did as well. We also shifted some capacity to higher margin technical Rubber Carbon Black grades versus Specialty volumes in our production slate in certain circumstances. As a result, gross profit per ton was \$643.6 per ton, down 2.6% from prior year and below our target range.

Turning to slide 9. Our Rubber Black business delivered robust results in the fourth quarter. Overall, Rubber volume was down by over 7.1%, reflecting the plant closure in South Korea and MRG sales to the automotive OEM, particularly in China. Gross profit per ton grew 15.3% due to improving mix and base price increases, the timing between quarters of pass-through of feedstock cost and increased cogeneration income. This gross profit improvement flowed through to a 14.1% increase in adjusted EBITDA per ton. I am once again pleased with the performance of our Rubber Carbon Black business.

Fundamentally, manufacturing capacity for tires and mechanical rubber goods has been growing more rapidly than global carbon black capacity. Accordingly, we see this in an improving market environment for Orion. Pricing negotiations through 2019 are complete and will deliver strong pricing gains, despite the fact that a large rubber customer is covered by a multi-year contract that will not reset until 2020. In addition, our focus on technical rubber grades and productivity measures will continue to contribute to the strengthening segment.

Now, I'd like to turn the call over to Charles, who will discuss our financial results in more detail.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Thanks, Corning. Good morning, everyone. By way of reminder, the fourth quarter and full year results with comparatives we're presenting today are prepared on the basis of U.S. GAAP, consistent with the timetable we previously outlined to convert our financial statements from IFRS and euros to U.S. GAAP and U.S. dollars during 2018. As expected, the impact on our operating results of the conversion to U.S. GAAP from IFRS is immaterial. You will, however, find, for the sake of completeness, a detailed analysis of these impacts in our annual filing on our website.

By way of reminder, with the U.S. dollar and U.S. GAAP conversion now behind us, we continue to be on track to be admitted to the Russell Indices latest by Q2 of 2020. As previously discussed, we currently have effectively no passive investor ownership of our stock rather than the industry norm of roughly 25% to 35% of such ownership. With admission to the Russell Indices, we expect to address this ownership imbalance.

Starting on slide 10 and our consolidated fourth quarter results; overall volumes decreased by 6.1% or 16,700 metric tons from the prior year's quarter to 256,200 tons, largely reflecting the impact of the plant consolidation in Korea and the softening of demand in China. On a like-for-like basis, that is excluding the impact of the Korean plant closure, rubber volumes were essentially flat, largely reflecting the high capacity utilization within our system.

Revenues increased by 13.6% to \$386 million in the quarter primarily due to the pass-through of higher feedstock costs as well as base price increases and favorable product mix, offset somewhat by foreign exchange translation effects and, to a lesser extent, volumes resulting from the Korean plant consolidation.

While our total contribution margin decreased, reflecting the impact of the volume decline stemming from the plant closure in Korea and the consolidated development of our two segments, our overall contribution margin per ton increased by 3.7% in the fourth quarter to \$505.1 versus \$487.2 in the prior year's period, reflecting the underlying improved profitability mix of the business as a whole.

For the full year 2018, our basic EPS and adjusted EPS both increased strongly from the prior year by 87% and 42%, respectively. Basic EPS reflects the boost to our net income from the land sale in Korea, lower financing costs due to the successful re-pricing of our debt during the year as well as the reduction in our effective tax rate to 28%, confirming a further improvement in 2018 of this key metric, partly as a result of the lower than average tax rate associated with the taxation of the gain on the sale of the land.

Now, turning to slide 11. Referring to the top waterfall chart on the upper left-hand side of this slide, the decrease in contribution margin is mainly driven by the volume reduction in large part associated with the plant consolidation in Korea, as well as foreign exchange translation impacts, partly offset by increased base pricing and mix improvements and the efficient pass-through of higher feedstock costs.

The second waterfall chart on the upper right-hand side shows the drivers of the change in adjusted EBITDA from \$65.9 million to \$64.4 million with the decline of the contribution margin and increase in manufacturing costs being partially offset by lower SG&A costs and a favorable foreign exchange impact on fixed costs. The waterfall chart along the bottom of the slide analyzes net income development, which increased slightly to \$20.1 million. The one-time benefit of last year's U.S. tax reform comprising \$8.8 million included in Q4 of 2017 and the decrease in adjusted EBITDA of \$1.5 million were offset by a lower underlying tax charge of \$2.7 million, a \$6.3 million reduction in finance costs as well as a reduction in depreciation expense of \$1.8 million.

Now, turning to slide 12 showing our cash flow dynamics and our key balance sheet metrics as of December 31, 2018. For the year, we generated a strong \$122 million in cash from operations, despite the cash consumption

impact of \$65.6 million associated with higher net working capital in large part as a result of higher raw material costs. This cash generation, together with gross proceeds of \$64.7 million from the sale of our former plant site in Korea, comfortably supported our cash – CapEx investment program at a level consistent with our expectations and the purchase of the acetylene black acquisition, SN2A.

Other uses of cash over the same period included dividend payments of \$47.7 million and the opportunistic repurchase of shares totaling \$4.9 million. As a result, our cash position at the end of 2018 was \$57.1 million. The company's non-current indebtedness as of the fourth quarter end was \$643.7 million with net debt at \$635.5 million, taking our Term Loan B debt and local debt into account, which represents a leverage ratio of 2.2 times LTM adjusted EBITDA, down from the comparable leverage ratio of 2.3 times at the end of last year.

Now, turning to slide 13. We are introducing our 2019 adjusted EBITDA guidance of \$280 million to \$300 million. This outlook is based on the assumptions that oil prices, exchange rates and feedstock impacts will not materially change from levels seen in the latter part of Q4 of 2018. In terms of other areas of guidance, we expect capital expenditures for 2019 to be around \$100 million, comprising base CapEx of \$70 million and the already announced Specialty line investment in the Ravenna, Italy. This excludes EPA-related CapEx, which is expected to be around \$80 million before any reimbursement to us by Evonik for this expenditure.

As for the remainder of our guidance metrics, we expect depreciation and amortization to be approximately \$90 million to \$95 million with our tax rate expectation for 2019 on pre-tax income at around 29% to 30%.

I will now turn the call back to Corning, who will wrap up our prepared remarks before we head to Q&A.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Thank you, Charles. There has been a lot of news and comments regarding automotive OEM in China in the media. I would like to take a few minutes to share what we are actually seeing on the ground and why we are confident in our guidance. We see a few macro trends playing out in our business.

First, business confidence is a bit subdued presently. In terms of our markets, this is most true in China, less so elsewhere. We see this in our volumes. For example, comparing volume trends over several years leading up to and following Chinese New Year, we see a weaker trend this year. This reflects Chinese customers taking longer shutdowns around the holiday.

Second, the automotive segment has been under some pressure, again most significantly in China. We've seen this play out in our business, as weakening specialty demand both from destocking and slowing underlying demand. Automotive OEM demand impacts several specialty markets, including coatings, adhesives and ceilings and engineered plastics.

In contrast, our Rubber segment, carbon black for tires has held up well, as you would expect, since about 75% to 80% of global demand for rubber black is for replacement tires. About 3/4 of our MRG carbon black goes into new cars, and this has been impacted particularly in China where our rubber sales are heavily weighted towards higher margin technical rubber grades used in MRG. We are currently reviewing our MRG channel management systems around the globe and expect to see improvements in them over time.

A third trend that is a small impact today but will be more impactful in the medium to long term is electric vehicles. While we are not internally planning on a second half rebound in China automotive OEM, we could see continued momentum in their EV segment. The rise of EVs will be good for the carbon black industry and Orion.

I'm confident in 2019 for several reasons. First, while it is quite possible the conditions will pick up in the second half, we at Orion are not going to rely on that. We are basing our guidance and our internal plans on what we can clearly see today. We are going to be agile and adjust our plans as needed.

Second, the fundamental market dynamics that have been the foundation of our Specialty business remain intact and continue to provide solid conditions for long-term growth. The quality of our specialty business execution remains strong, despite some softening market conditions which as you may recall we've seen before and from which we've seen a solid recovery before as well. The dip in our Specialty margins reflects some market factors impacting mix more than price reductions for like-for-like grades. We intend to preserve the value of our business and not chase growth in a soft market.

Third, we expect to have another strong year in our Rubber business. We are well positioned with our pricing agreements for 2019 on the rubber side, which will offset the MRG mix impact. Also, it's not going to happen overnight, but we will get back on track in China MRG. Keep in mind that China is a relatively small market for our Rubber business. Our key markets of North America and Europe are much stronger. If our Specialty business remains on the trajectory we're seeing at the start of 2019 and the economy in China remains subdued, we'll find ourselves towards the bottom end of the guidance range.

On the other hand, robust performance in the rubber segment coupled with a pickup in the Specialty business in the second half of 2019 particularly in China will position us towards the higher end of this guidance range.

If I take you back to the start of the call, one of my key learnings from the last six months is that we have ample opportunity in our core Carbon Black business. We have a huge list of opportunities, such as new product introductions, continuous improvement projects, cogeneration opportunities, technical innovations, application sales development and we will prioritize amongst these according to customer needs and market conditions. We had a great 2018, setting yet another record for the business based on a solid strategy and good execution. We are prepared for whatever market conditions emerge in 2019.

In Specialty, we have a broad portfolio and we will put an emphasis on maintaining quality, strengthening our capabilities and integrating the acetylene carbon black acquisition. In Rubber, we will execute our most impactful productivity projects and position our plants to produce the most critical products in a tight market. We're going to be agile in our production planning and stay close to our customers.

Thank you. Now, we will be delighted to take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we'll be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Michael Leithead with Barclays. Please proceed with your question.

Michael Leithead
Analyst, Barclays Capital, Inc.

Q

Good morning, guys.

Corning F. Painter
Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Good morning, Mike.

Michael Leithead
Analyst, Barclays Capital, Inc.

Q

Good morning. I guess, first, on the guide, I was a bit surprised with the emphasis on China on the range as I thought China was, call it, 5% of your business. So, could you maybe help clear up why China is so important to next year's performance? And with that, maybe touch on what you're seeing in your two biggest regional markets, U.S. and Europe.

Corning F. Painter
Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Okay. Yeah. So, China is, for us, if we focus on Specialty and I think that's really where the emphasis is. We gave some disclosure on Rubber around MRG. But I think the bigger impact for us is in the specialty area. China is about 15% market for our Specialty products. So, we make about 20% of that 15% there, but the balance we export, so it's an end destination for directly-made carbon black, that's an impact for us. And beyond that, some of our customers where we're selling them carbon black in Europe or even in the U.S., their end market for their product is going into China as well. That's a little bit harder to measure. But that's a significant issue as well.

Michael Leithead
Analyst, Barclays Capital, Inc.

Q

That's helpful. And then, Corning, could you maybe give us little bit more details on the revamped incentive program you're working on? And is it fair for us to assume it kind of follows on from what you learned at your former company when they realigned compensation structure?

Corning F. Painter
Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Yes, you could make that second assumption. So, in similar to both companies, moving from where you used a company-wide number for performance, let's say, EBITDA and instead moving it to something that gives employees more of a line of sight. So, let's imagine you're in a plant and you're talking to the team and you're saying, look, we're going to reward you for good work, for hard work. When they're incented around the whole company, I mean, we could say that and I mean it and it's all true if everybody in every plant does it. But it's just a little less immediate for the people at that site.

And so, the concept here is we give people greater visibility between their action going to a smaller pool and it's going to affect their bonus more directly. That's all about the annual incentive plan the – for the long-term incentive plan, what we put in there was just an ROCE component because I think capital spending is just critical for our shareholders, for our company, for your long-term trend and I wanted to make sure we have that in our incentive thoughts.

Michael Leithead

Analyst, Barclays Capital, Inc.

Great. Thank you.

Q

Operator: Thank you. [Operator Instructions] Our next question comes from the line of John Roberts with UBS. Please proceed with your question.

John Roberts

Analyst, UBS Securities LLC

Thank you. Can you hear me okay?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Yeah.

A

John Roberts

Analyst, UBS Securities LLC

China was buying a lot of feedstock globally a couple of years ago and increasing the basis on your [ph] raws (00:27:23) beyond just oil prices. Is this the opposite currently and is there a very favorable basis versus oil on the [ph] raws (00:27:33) that you're purchasing?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

I would say – so, I think the question in the broadest sense is, kind of what's the trend on differentials right now and do they trend up or down? And I'd say, in the current market and now even talking about going into 2019, differentials continue to trend up. And I would say I think there are some imports – exports of CBO from the U.S. heading towards Asia as well.

A

John Roberts

Analyst, UBS Securities LLC

Okay. Why do you think that is? Why wouldn't the weakness in China have made the differentials more favorable?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Well, so I think that there's continued challenge in a place like the U.S. with shale gas, which is a lighter oil. I think just simply the availability of the heavy oil feedstocks continues to get tighter. And then, for a company like Orion, we're focused very much on the specialty area, so that also means that many sites were looking really for high quality, meaning, also clean CBO. And that just becomes scarcer and more competition for it.

A

John Roberts

Analyst, UBS Securities LLC

Q

And then, if you back out the Korean closure, it sounded like Rubber Black was essentially flat year-over-year in volumes.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Right.

John Roberts

Analyst, UBS Securities LLC

Q

What do you think the industry was down?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Well, I think, if you looked at overall tire, you'd have a look at that. I'm just – I think from memory, I think, in January, it was down 1%-ish in terms of OEM portion of that. And then, you have to figure that's only a portion of the overall tire market.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

But, I mean, as far as the whole of last year, John, goes, it's probably the range we've talked about before, 1% to 2%. Obviously, your question is more directed to going forward. That is – it's too early for us to say. But, certainly, we think our performance was a little bit behind the market growth only because we're focused on maximizing mix. And we're at pretty high capacity utilization levels certainly in Europe and the U.S. and our other South Africa and business in Brazil.

John Roberts

Analyst, UBS Securities LLC

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Jeff Zekauskas with JPMorgan. Please proceed with your question.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Thanks very much. Your outlook for next year is for pretty flat EBITDA. In rough terms, do you expect EBITDA growth in Rubber Black offset by some contraction in Specialty Blacks? Is that the general arc of your change?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Pretty much.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Yeah.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Yeah.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Can you talk about the pricing dynamics in Rubber Black for 2019?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So, the prices for 2019, for those who are new, are largely set the year before certainly for Europe and for North America. And the pricing dynamic was positive, probably the biggest gains scored in North America than in Europe. These are areas where the pricing had been, I would say, below cost of capital. So, it's only logical and natural that those numbers would go up. And they moved up for us. We haven't really disclosed what we would expect. Obviously, we're going to have some mix effect with the MRG impact in all of this. But I would say we would see our gross profit per ton moving up next year, let's say, low-double digits.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Okay. I think you said at the beginning of the call that your EPA expenditures were \$190 million through 2025 and they're \$80 million for 2019. Roughly, what are they in 2020? Is that also another...

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

It's another heavy year.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Yes.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Yes. And simply because we want to get on top of these projects, get them behind us for all the obvious reasons. Quite frankly, when we come to manage the spend as you'd expect, we might find that to keep leverage on some of the vendors, although we have the commitment out there, the actual cash flow extends out a bit into the later year, in other words, into 2021. That's certainly likely. But in terms of CapEx commitment, the next two years, 2019 and 2020, they will be the heavier years, certainly.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Right. And the EPA spending bears on both your Rubber Black operations and your Specialty Black operations in the U.S. Is that fair?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Much more on the Rubber.

A

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Yeah.

A

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Much more on the Rubber? Do you have any rough estimate of when you might get some reimbursement from Evonik? Like, do you think it's a 2019 event or a 2020 or 2021? Or if you had to put a probability on those three years, which year would have the higher probability?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Yeah. So, this is one of these things where I think it's obvious to say we have some level of discussions with Evonik. And I think, when you're in an negotiation like this, your best shot at keeping that moving forward to a good outcome is just not to negotiate it in public. So, I'd really like to not move forward – or not really comment a lot on where that's there, obviously if one can't agree, one goes through a dispute resolution process, which can drag it out. So, that on the table is a possibility, naturally.

A

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Sure. And then, lastly, with all of the EPA spending, is that capital that you think you'll get a return on? Or it's just kind of a cost of doing business?

Q

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Well, it's the old way you do the calculation, John. I don't mean to be flippant about it.

A

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

It's all right.

Q

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

I mean, that is necessary just to do the business – stay in business...

A

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Sure, sure...

Q

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

On one hand. On the other hand, it is expenditure that doesn't have a sort of incremental directly attributable return to it. I would say, however, the market – the moat around the business is going to increase the whole environmental requirements and the knowledge how to do that and the ability for us to then of course, through the scrubbing process, use the higher sulfur feedstocks. So, there are some – depending on how you do the calculation, you can come up with some pretty meaningful benefits in that regard.

Now, in our case, as you've already alluded to with your question on Evonik, the investments needs to be considered on a net basis. So, when you start factoring those altogether, it is not an uninteresting project, curiously enough.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Right. And then, lastly, raw materials went up for you in 2019. So, all things being equal, should you have – should you use less working capital in 2019 than you used in 2018? And will there be any net raw material price relief for you through your income statement in 2019?

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

To your first point, yes, you're a betting person, so to speak. We certainly would not expect to see the same hit by any means in 2019 and we may claw some of it back in terms of working capital consumption. In terms of relief, I think, again, it's a function of oil price and as your question alludes to on the Specialty side, our margins will be boosted by a fall in oil prices.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Yeah.

Jeffrey J. Zekauskas

Analyst, JPMorgan Securities LLC

Q

Yeah. Okay. Great. Thank you so much.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Chris Kapsch with Loop Capital Markets. Please proceed with your question.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Q

Yeah. Good morning.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Hi, Chris.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Good morning.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Q

So, my question was a follow-up to the first one about just trends geographically and sort of the emphasis on China as a key variable in terms of hitting the low-end or high-end of your guidance. So, just want to make sure I understand that because you have the one plant in China, which I believe is technical and MRG grades, which therefore flows into Rubber Black and – but your answer to the prior question was more about specialties and presumably weakness in China showing up in other regions that you export to, to China.

So, I'm just wondering if you could actually talk about the geographic trends in other areas and where some of that China weakness is showing up indirectly. And then, if you could also just talk about – I'm guessing there was precipitous weakness for the technical and MRG grades in China may be very late in the fourth quarter and through the first couple of months of this year. Can you just talk about how that's trended and what you think is influencing that obviously weak automotive but is there also how vicious is the destock tied to those grades? And is any of it also tied to the notion that, in China, going into the winter, you -- the supply chain anticipates shutdowns and therefore had built extra inventory and so there's almost an exaggerated effect associated with the destock in the channel?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Okay. So, let's start with the first part of the question. Where in the world are we exporting into China effectively? And we export into China from the U.S., from Germany, from Korea and actually from Sweden would be the primary locations. And so, those are areas where those plants get a little bit less load when this plays out. And then, if we move to the issue of MRG in China, so you're absolutely right, that became more clear as time went on. And you could look at what's happened right now. When you say, hey, look, we're down more in our volumes than, let's say, China tire is down – China – this China automotive, excuse me, OEM is down. So, how can that be?

And you can explain it away with saying it's a destocking, and I'm sure there's some destocking in that number. But the challenge with destocking is it is hard to put precise understanding on how much destocking is. And I fear, at times, it's a little bit like just hoping, hoping it's destocking and therefore it's going to come back quickly. And we don't want to hope. I don't want to ever hope in business, right? We want to know. We want to work on things.

And so, as we dug into the whole issue around MRG, we started feeling that there were some issues in our channel management approach that maybe we were being impacted more than our fair share. So, then, once you see that, okay, this is something we now – once you understand it, you can go after it, you can go and work, and when I talk about self-help, sorting this thing out is an opportunity for self-help. Exactly how much is this an issue versus how much was destocking? To be honest with you, it's very hard to say. But that's what we're after. And I don't think we're chasing the shadow. I think there is an opportunity there.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Q

Got it. And, Corning, just following up on that dynamic, has it also undermined the pricing and therefore contribution margin for that particular piece of business, the technical MRG, into China automotive OE?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So, I would say that was – so, MRG by its nature is more attractive than tires. So, when you when you lose that, right, in terms of your mix, it's definitely a drag. To get back in, once you're out there, price might play a part in that. But I don't think that's going to be primarily a price story. But it is going to be there in our mix.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Okay. And then...

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

I mean, if I'm going to pull back, if I think about us versus other people in China, the impact to us is much smaller because China is just much smaller. But we were almost all MRG in technical rubber grade material. So, what we lose in China is probably a little bit more painful, let's say, on a per ton basis than if we had – if we were just playing the broad field in China. And in terms of getting back our volume and reloading that plan, I mean, worst comes to worst, I can put that stuff in a tire. It's just we don't really want to give up the differentiated position that we've established.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Got it. And then, I guess, if you just look at the numbers in the 10-K and say, okay, as a percentage of sales, China is X. It understates, given the indirect exposure through exporting of specialties from other regions which you mentioned, you're understating really the ultimate exposure to China. So, do you have a – I know it's not precise. But you do have a better feel for what that percentage of exposure to China is?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Yeah. I would say we have a sense of the range of how high that could be, which I would say it could be another 50% to 100% of the volume that we sell into China, for Specialty that is.

Chris Kapsch

Analyst, Loop Capital Markets LLC

No. I meant, like, as a percentage of overall Orion sales, do you have a sense for – if we just look at the – yeah?

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Chris, it's difficult for us to tell. There are pieces, right? There's a piece that we make and produce in China. So, in China, it's easy. This is stuff that we sell from Europe or – the U.S. into China, we obviously know what that is. And those two numbers get us to about 15%, okay, of our total volume. The piece that you – the third piece is what customers are buying presumably from us in Europe say and – which then ends up in their products going into China. That is much more difficult for us to know from obvious reasons. And that is certainly from seeing the reaction of our customers in Europe. The slowdown in China, that is significant. Is it as much as what we sell indirectly and directly into China? Who knows? But it's significant.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

So, if you say what we sell, making there and exporting in if we say that's 15%, I'm going to say I would think that our overall into China is at least 20%. And at the absolute upper end, in my opinion, don't have it nailed, it would be in the high-20s, maybe even 30%. But it's in that kind of a range where our customer products are running. And I think for some of our customers who make masterbatch and so forth, there's some momentum over how they shift around where their products are going.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Okay.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

That would be the three pieces together.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Yeah. Thank you. And then, I guess, finally, just a question on something we hadn't heard a lot about in maybe the last couple of few years. But feedstock differentials, they've been benign when there are some alterations to the supply agreements in the Rubber Black for not just you but really most industry players, I believe, but – so most – in this formal comment, there is a mention of adverse differentials.

Just wondering, like, what's baked into your guidance for 2019 in terms of feedstock differentials? And also, if I understand what you're commenting, Charles, earlier about once the scrubber equipment is in and you're able to use higher sulfur feedstock, then is it – is that – does that represent a potential inflection for maybe what might be a feedstock differential headwind in 2019 could turn to – flip the other way in 2020?

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Yeah. Your first question; factored into our guidance are the differentials we had in late stage of Q4 2018. In terms of the ability to use higher sulfur feedstocks in – once you've got the scrubbing in place, that is certainly a potential advantage. But what we've done, Chris, and we've talked about this previously – is, in all our contracts, we have a clear provision for us to recover IMO 2020, if you want to call it that, increases in feedstock due to the new sulfur content rules.

And so, I think that cuts both ways. So, if we're looking to recover those costs which we are in our contract and then later on we can use cheaper or lower – higher sulfur feedstocks because we've got scrubbing in place, then we're going to be having a sort of open communication at that time with our customers. It certainly makes us more competitive. That is the agreement we have in place. So, we are insulated pretty much on the downside that we shouldn't expect to have a big windfall on the upside.

Chris Kapsch

Analyst, Loop Capital Markets LLC

Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Kevin Hocevar with Northcoast Research. Please proceed with your question.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Hey. Good morning, everybody.

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Good morning, Kevin.

A

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Can you – it sounds like a lot of different moving pieces in terms of volumes, how to think of volume by the tire side of the rubber, the MRG side of the rubber and then Specialty. Could you kind of lay out what's your expectation for volumes if we kind of break it out into those three categories? What's your expectations for volumes for those here in 2019?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

So, if we start then on tire, that's probably the most predictable baseline that we have. We see right now some very strong demand in North America and in Europe, actually, in Brazil as well. And we don't really – we see that continuing. And I really see that continuing almost regardless of minor variations in OEM manufacturing of automobiles just because, in those markets, the replacement market is so very significant. So, I think that's a pretty solid program for us. If we think about MRG in those two markets, so we have little more exposure there to what we see in automotive OEM manufacturing. But I'd say, in general, we see that as largely holding up for us. And what we might expect to happen in OEM, that's all in our guidance.

A

For China, we're currently at a low number and we're looking to, over the course of this year, sort of rebuild what we've got in that market. If I just shift to Specialty, so we look at where our current kind of rates are, as we look at our run rate going into this quarter, what we've seen January, February, making adjustments for Chinese New Year and so forth, we're looking at basically a trend line off of that. And we want to be clear. We are not going to make guidance based on a hockey stick. What we're giving you guys is guidance that's based on what's real, what we see; we look at how December went year-on-year compared to other years, how we see January and February. And so, we see these things going on, let's say, a trajectory from where they are now. That's what you might expect. But not like some kind of gigantic hockey stick in the second half. I hope the world economy changes and all that plays out. But I just don't think that's a basis for guidance.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Okay. Got you. And then, as we – obviously, we just kind of kicked in the 2019 contracts here earlier in this calendar year, what do you need to see as we go through this year to be able to get pricing again in 2020. I don't think that there is too much in terms of capacity coming online. It sounds like, at least from the tire side, you expect some volume growth. So, I guess, what do you need to see is the position you guys well to get pricing again in next year.

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So, I think if things simply continued as they are it would be another good pricing year. And I'm talking about Europe and North America because that's where this contract structure is in place. It's a little bit different in Asia. We see – even right now, when there's glitches in the supply chain at someone's location, there is a real struggle to get the spot opportunities for them. I'd also say, during the course of this year, different plants – carbon black plants are going to be taking outages to set things up for their EPA work. We'll have a short one coming up later this month. So, that's going to impact capacity as well.

So, the truth is not much has to change. It just – I think carries on and it's just a natural and logical consequence of many years of [indiscernible] (00:49:48) investment in Carbon Black, investment in the tire and now, building on to that, let's say, people who used to export into the U.S., tires that is, who are now building facilities to manufacture in the U.S. And those simple trends that are out there and they're playing out and we're getting qualification volumes right now for new lines, that's just setting the stage for this.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC



Got you. Okay. Thank you very much.

Operator: Thank you. Ladies and gentlemen, this concludes our question-and-answer session. I'll turn the floor back to Mr. Painter for any final comments.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Thank you, all, for joining us today. We appreciate your valuable time and that you gave us this time. We hope you all have a great day and a wonderful weekend. Thank you very much.

Operator: Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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