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Orion Engineered Carbons SA (OEC)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

Diana Downey

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Corning F. Painter

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John Roberts

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Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Michael Leithead

Analyst, Barclays Capital, Inc.

Christopher Kapsch

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings. Welcome to Orion Engineered Carbons' Second Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] Please note, this conference is being recorded.

I would now turn the conference over to Diana Downey, Vice President of Investor Relations. 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 second quarter 2019 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 the 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, August 2, 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 on our Second Quarter 2019 Earnings Conference Call. I'll start today's call by providing general comments on our performance and the industry backdrop. Our CFO, Charles Herlinger, will then provide detail on our financial results and related matters for 2019. Then, I'll come back and share some closing comments. We will then be happy to take your questions.

Turning to slide 3. We saw solid performance in the second quarter, which was in line with our expectations when we issued our last release. April, as we said previously, was an improvement from March. May was stronger yet, but in June, particularly in the second half, volumes weakened in many of our end markets. During the quarter, we drew down our inventory levels, which contributed to a lower overhead absorption and thus a negative impact in our P&L of \$4.8 million. Despite this, our adjusted EBITDA improved \$6.9 million or 10.8% from Q1. Despite Q2, looking forward now to the rest of the year, we see uncertainty in trading conditions affecting demand generally and with customers continuing to be conservative about their stocking of the more premium grades of our Specialty business as they continue to manage their own supply chains with caution.

While Q2 results improved substantially over Q1, we were down on a prior year record quarter, reflecting the challenging overall market environment for the industry, particularly in the Specialty business. While we saw an increase in Specialty volumes both year-over-year and particularly versus the first quarter, mix continued to be weaker than our norm for the reasons just mentioned. In contrast, our Rubber business delivered a significant increase in adjusted EBITDA both compared to the prior year, as well as the first quarter, reflecting the impact of the 2019 pricing cycle, coupled with excellent operational performance and stable demand. A continued healthy supply-demand balance in the rubber markets, coupled with a stable replacement tire market, along with improved volumes, particularly in China, contributed to this positive development. In support of these developments, we remained very focused on actions within our control, such as channel management, closely managing inventory, stepping up our efforts to qualify our products with customers, progressing a number of key marketing programs and tightly controlling costs.

In addition, we continued to strengthen our management team, having added new leaders to strengthen our Americas business, Global Operations and the HR function. Most importantly, we continue to focus on being cash-positive for 2019 and beyond by managing our capital investments and working capital levels in line with the trading environment, with our strong balance sheet underpinning our commitment to the dividend. To cap the quarter off in a positive note, Orion was admitted to the Russell 2000 Index on July 1, 2019, a year ahead of the originally planned date. This was a result of a lot of focused work to convert our financial statements to U.S. dollars and U.S. GAAP and thus make Orion more accessible to a broader investor base.

Looking at the regional markets, our Specialty volumes in Asia were up significantly versus the first quarter, reaching levels comparable to a year ago, although this recovery in volumes from the first quarter was concentrated in some of our lower margin products as customers continue to be cautious with stocking their supply chain with our premium grades and due to some weakness in OEM automobile markets. In EMEA, Specialty volumes held up well compared to the prior year with some local variations, although the coatings

markets continue display softness in line with this dampened OEM demand. In the Americas, trade tensions contributed to weaker volumes destined for export compared to last year and unfavorable product mix.

We executed our action plan to improve certain sales channels in China and rubber MRG related volumes rebounded well from Q1, reaching levels broadly consistent with prior year levels. Our Rubber Americas business remained strong in Q2, with volumes again above prior year levels. We continue to however be impacted by worsening unfavorable feedstock differentials in 2019, particularly in this market. These unfavorable feedstock impacts, combined with the costs associated with compliance investments our whole industry is making in the U.S. to comply with EPA requirements, means that our rubber pricing levels continue to be below those needed to earn a satisfactory cost of capital, as we've previously discussed.

In Europe, we saw some softening in volumes towards the end of the quarter and we now expect these softer market conditions to continue in the second half of this year. Annual rubber contract price negotiations for 2020 and in some cases later years as well are underway with some customers, underscoring the healthy supply-demand dynamics in our industry as summarized for your reference in the appendix on slide 20.

As mentioned earlier, to deal with the unfavorable feedstock impacts and supported by high levels of utilization, we are taking actions and in July, we announced price increases of \$0.08 per pound for Rubber grade Carbon Black, and \$0.07 per pound for Specialty grade Carbon Black in North America and an enhanced price list for certain services.

The Rubber grade price increase is structured as \$0.04 base price increase and \$0.04 to account for CBO differential surcharge. Despite being encouraged by the sequential improvement we have seen as the year progressed and with it our performance in the second quarter, the macroeconomic environment remains more challenging than we had anticipated at the end of last quarter, especially in the automotive markets. Therefore, for the second half of the year, we anticipate that customers will continue to be running at conservative production and inventory levels for the remainder of 2019, with the usual seasonal effects in the fourth quarter. Given this change in outlook for the second half of 2019, we are trimming our guidance for the full-year adjusted EBITDA for 2019 to the range of \$265 million to \$285 million from our previous guidance of \$280 million to \$300 million. Our revised guidance for 2019 also takes into account a continued negative effect of product mix in Specialty as well as the negative impact of feedstock differentials in both Rubber and Specialty.

Please turn to slide 4, clear; measured and efficient capital allocation remains a top priority for Orion as we continue to utilize all the levers at our disposal to deliver on our commitments to shareholders. Specifically, we continue our strong commitment to the dividend at current levels. Our consistent track record on this from our IPO to-date is summarized on the table on this slide. At the same time, we will continue to invest in must-do safety, maintenance and compliance projects to strengthen the foundation of our business. The U.S. EPA-related investments that we and the entire U.S. carbon black industry are committed to over the next few years represent the largest portion of our compliance projects by far, with the bulk of these expenditures expected to be incurred in 2019 and 2020. While these one-time capital expenditures could make us a bit more selective regarding other value-enhancing investments, we continue to be confident that a significant portion of these outlays will be reimbursed to us by Evonik under the provisions of our agreement with them.

Due to the length of arbitration, which we have commenced in the second quarter, reimbursement could well exceed two to three years. While we would rather invest in additional high value-added projects, which abound in our core business, these outlays on complex compliance projects do in fact continue to strengthen the moat around our business, the two main impacts being increased technical knowhow needed to efficiently compete in

our market and the considerable upfront cost outlay necessary and thus sharply increased cost of capital associated with adding capacity.

In summary, we remain focused on maintaining a sensible balance between competing uses of capital to underpin our dividend. In times of increased economic volatility, we will proactively manage our discretionary capital spend and working capital investments to balance the competing needs of our business. In practice, this means that during the course of the year, we'll periodically review our opportunities and pace our spending accordingly.

With the ample runway in our core Carbon Black business, I'm especially pleased to have enhanced our leadership team by bringing on strong operational talent with the recent management hires. These new leaders position us well to go after the healthy backlog of value enhancement opportunities, including the development of new products, exploiting new applications, improving product quality, debottlenecking in-demand plants and improving our overall efficiency.

A slide 5 shows, we have a pathway to deliver strong cash performance, while continuing to service our dividend and operate within our guidance range assuming there is no reimbursement under the Evonik indemnity this year and that swings in working capital balance out over the short to medium term. This shows the ability of our business to front EPA-related compliance costs and at the same time continue to move the business forward, while navigating a relatively challenging trading environment.

Please turn to slide 6, this year-on-year EBITDA log provides key insights into the underlying drivers of our business. Most importantly, you can see the significance of the base price increases mainly in Rubber more than offsetting negative product mix in Specialty. This analysis also shows the impact of both worsening foreign exchange translation impacts as well as the absorption of increased negative feedstock differentials. These two factors accounted for nearly all of the overall deterioration from last year's strong quarterly performance at the total group level. This slide also quantifies the year-over-year earnings impact from the inventory drawdown I mentioned earlier. While this was a headwind for the quarter, we believe it was the right decision as we proactively manage our business, while taking advantage of our improved operational reliability. Having dissected the second quarter in this manner, you can see that our overall business on an underlying basis remained healthy and developed largely consistent with our expectations. This analysis does, however, also underscore the importance of us recovering the negative impacts of worsening feedstock differentials. Our recently announced price increases and the CBO differential surcharge are a step in this direction.

Before I pass the call over to Charles, I would like to share that he has decided to retire at the end of this year. I would like to take a moment to thank him for the critical role in the company's development and his many contributions. Charles will continue until the end of the year and will support the search for a replacement and the transition. Speaking personally, Charles has been a tremendous guide for me since I joined Orion. Charles, thank you for all you have done for the company and for being an exceptional colleague.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Thank you very much, Corning. Now turning to slide 7, year-on-year volumes were up by 1% adjusted for the plant consolidation in South Korea and up fully by 2.9% on a sequential basis, driven mainly by our Specialty business. Our adjusted EBITDA was \$71.5 million for the quarter, with basic EPS and adjusted EPS at \$0.41 and \$0.53 respectively, with our basic EPS a year ago benefiting by \$0.35 as a result of the land sale in South Korea. The development of our adjusted EPS versus the prior year, as well as the first quarter this year, is essentially in line with the development of our adjusted EBITDA. It's also important to point out that a large part of the decline in

our overall contribution margin per metric ton was attributed to unfavorable foreign exchange translation effects, mostly related to the strengthening of the U.S. dollar versus other key OEC currencies. Similarly, to underscore Corning's comments made already regarding the development of our business in the second quarter, we would've been at \$76 million of adjusted EBITDA rather than the reported \$71.5 million had we not seen a strengthening of the U.S. dollar versus other currencies in which we trade.

On slide 8, on the top left hand side, the main drivers of the changing contribution margin from Q2 of last year are summarized, with the net impact of positive price/mix associated mainly with our Rubber business, eroded primarily by negative FX translation impacts, negative feedstock differentials and inventory movements as previously commented on by Corning. Although the Rubber segment continued to achieve the pricing levels as in the first quarter, this was in large part eaten away by having to absorb worsening negative feedstock differentials. Recovery of these negative feedstock differentials is key to ensuring that we have a stable Rubber business platform and indeed consistent with the long-established general principle that we pass onto our Rubber customers both positive, but also negative developments in the pricing of our feedstocks we use to manufacture our products.

Moving further down the P&L, it can be seen that the change in contribution margin was also the main driver of the change in adjusted EBITDA, although with some offset by favorable FX impacts on our fixed costs. The waterfall chart along the bottom of this slide shows that the change in net income, which is mostly driven by the absence in the second quarter this year of the gain on the South Korean land sale included in 2018. The development of our adjusted EBITDA as well as a reduced tax impact mainly associated with the absence of the land sale gain round out the main drivers of the development of our net income versus last year.

Now turning to slide 9, showing our cash flow for the first half of 2019 as well as an expectation of cash flow within the provided guidance. For the first half of the year, our cash flow from operating activities totaled \$74.1 million, which included an increase in working capital of \$5.2 million, associated primarily with changes in our feedstock costs as well as an increase in cash due to net financing activities of \$19.4 million, which supported our cash CapEx investment program of \$60.9 million at a level consistent with our expectations for the timing of this spend for the first half of 2019.

Other uses of cash over the same period included dividend payments of \$23.9 million. As a result, our cash position at the end of Q2 2019 was \$53.2 million. The right-hand side of this slide shows details underpinning our strong cash performance during the first half of this year, together with the expected development for the remainder of this year.

Now turning to slide 10, showing our key balance sheet metrics as of June 30, 2019. The company's non-current indebtedness as of the second quarter was \$638.3 million, with net debt at \$651.8 million, taking our Term Loan B debt and local debt into account, which represents a leverage ratio of 2.39 times LTM adjusted EBITDA. Due to our refinancing activities in recent years, interest costs, which are largely [ph] kept (20:08) on the Term Loan B instrument, remained very competitive.

With my retirement date now formalized for the end of 2019, a core element of my final phase at Orion is to help support a well-orchestrated transition. This obviously starts with ensuring that Corning and the board have all the support they need in selecting a qualified candidate and then ensuring that there is a smooth handle. In my time at Orion, it has been gratifying to see the continued evolution that the commitment of our entire workforce has delivered.

I will now pass back to Corning.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Moving to slide 11, showing our key quarterly Specialty metrics. Volumes improved year-over-year as well as sequentially, although gross profit per ton remained around the level of Q1, with mix being the main challenge followed by FX translation effects. Excluding the FX effects, compared to last year, adjusted EBITDA and gross profit per metric ton were \$33.4 million and \$680 respectively.

On slide 12, we take a deeper look at the main drivers in the Specialty business year-over-year, with higher volumes only partially offsetting the negative impact from significantly weaker mix, with unfavorable FX impacts, negative feedstock differentials and increase in fixed costs and some energy impacts further impairing performance. Global trading conditions are quite volatile and we believe mix will remain somewhat of a headwind in the second half of the year. The appendix to our slide presentation includes a summary of the key metrics we have used to derive our expectations for the remainder of the year with a particular focus on changes in these metrics since the last quarter update.

Please now turn to slide 13. Rubber volumes were up 0.9% sequentially and up 5.3% year-on-year when adjusted for the plant consolidation in South Korea taking place at the end of Q2 last year. This growth should be seen within the context of a healthy overall tire demand, driven in large part by replacement tire demand, but with a more challenging trading environment for our MRG products, where demand in large part is linked to OEM automobile activity. Having said this, MRG volumes improved compared to the first quarter of this year, largely due to the channel management actions recently taken. Gross profit per ton was up \$34 per ton from a year ago on the back of pricing gains, despite significantly negative FX and feedstock differential impacts. Our adjusted EBITDA reflected the progress made at the gross profit level and we hit our expectations for this quarter at \$40.5 million.

Without the negative FX translation impacts compared to a year ago, our GP per metric ton and adjusted EBITDA would have been \$311 per metric ton and \$42.6 million respectively. On slide 14, we provide more detail on these changes versus last year, highlighting the favorable development of pricing and mix with unfavorable FX effects and negative differentials being offset by improved fixed cost levels and energy-related items.

On slide 15, you can see the forward rates for the U.S. oil market, with this graph being, as you would expect, largely similar for other regions. Compared with the projection of the forward curve at the end of Q1, the pricing spread between high and low sulfur grades has increased. We continue to work hard to raise our non-indexed prices to recover these costs. We remain confident that we will be able to recover these MARPOL-related 2020 costs, although we may experience some fluctuations between our quarterly results relating to timing effects.

Please now turn to the next slide where we've summarized the various initiatives that are well underway or indeed already ticked off the list, with a reminder that despite progress recently made, we believe our Rubber segment has a lot more opportunity.

Next, I would like to briefly update you on some governance initiatives we have completed. From an ESG perspective, we added sustainability to the charter of the Board Committee we now call the Nominating, Sustainability and Governance Committee. We established long-term environmental sustainability targets for the company and we issued our first Sustainability Report, which I invite you to download from our webpage. We also adopted shareholding requirements for key executives and board members. I would like to thank the sustainability team for leading the charge on this important topic. Thank you.

Turning to slide 17, we summarize key assumptions upon which our guidance is based, especially given the current economic backdrop, we continue to focus on actions within our control, making progress on our profit improvement program, continuing to work on pricing excellence, utilizing this time to gain qualifications on new products and entering new markets, like lithium-ion batteries. Our outlook is based on assumptions that oil prices, exchange rates and feedstock impacts will not materially change from the average levels seen in the second quarter of 2019. Other elements of our guidance are noted in the appendix section of our slide presentation.

We're currently pacing our non-EPA capital expenditures for 2019 to be in the range of \$75 million to \$80 million, comprising of base CapEx and the already announced specialty line investment in Ravenna, Italy. We expect U.S. EPA settlement-related CapEx to be in the range of \$60 million to \$65 million before any reimbursement to us by Evonik for this expenditure. As we actively evaluate our capital allocation strategy, we are committed to keeping our dividends stable, as our strong and efficient financing structure provides necessary support.

Now, I would like to move to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question is from John Roberts with UBS. Please proceed with your question.

John Roberts

Analyst, UBS Securities LLC

Q

Thank you. And Charles, it's been a pleasure to work with you and you set the bar high through your successes.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Thank you very much, John. Really appreciate that.

John Roberts

Analyst, UBS Securities LLC

Q

I'm suspecting that the automotive engineered plastics area was among the weaker areas in the Specialty Black area. I wonder if you could compare and contrast that with the Manufactured Rubber Products area, so I would say they normally [indiscernible] (27:35) with each other, but it sounded like you had more self-help with some channels, management issues in Manufactured Rubber that at least maybe has delayed the effects on Manufactured Rubber into the second half.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

John, it's Corning, let me respond to that. So you might recall that earlier in the year, we talked about how we were making some changes in channel management, particularly in China and that that was a headwind at that point, but we were – felt this was the right thing to do for the long term. So more than just demand, our numbers were impacted negatively by taking those actions. And I think what we're saying at this point is we've got those actions behind us. We've recovered that volume. So that was sort of getting back to where we were detached from really the market values. So I would say in general, our MRG, it obviously outpaced what you'd see for OEM production or Engineering Plastics going into new cars.

John Roberts

Analyst, UBS Securities LLC

Q

[indiscernible] (28:32), you'd expect them to roughly track Engineered Plastics and MRG Rubber on a [ph] solid (28:38) basis?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Right. So, the majority of Engineered Plastics are really going into consumer goods, appliances, consumer electronics, that sort of thing, not automotive. So the one sector of that that is automotive, that should track long-term with MRG. But generally speaking, it's only that one segment of Engineered Plastics.

John Roberts

Analyst, UBS Securities LLC

Q

Got it. Thank you.

Operator: Our next question is from Mike Leithead with Barclays. Please proceed.

Michael Leithead

Analyst, Barclays Capital, Inc.

Q

Morning, Corning and Charles...

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Good morning.

Michael Leithead

Analyst, Barclays Capital, Inc.

Q

...again it's been great working with you since the IPO and best wishes on your retirement.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Thanks Mike.

Michael Leithead

Analyst, Barclays Capital, Inc.

Q

First, on Specialty, it looks like you saw a bit of a pickup in demand sequentially, but GP per ton remains pretty challenged, actually maybe a little bit below the past two quarters. So can you just maybe peel back the composition a bit of that, I'm guessing it's primarily a mix situation that's still weighing on gross profit per ton there?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Yeah. So I'd say there's maybe three ways to look at this and not just what's happening, but what can we do with it. So number one, FX is a pretty big impact and in time where we can shift as appropriate, where we have U.S. dollar feedstock to move our selling prices into U.S. dollars, I see that as a positive. Obviously we want to drive

the more premium market, so think of coatings and it's everything from auto, but also marine coatings, protective, decorative, that kind of thing, we were just talking about Engineered Plastics, things like that.

One of the long-term drivers in this business though is that some of the lower margin end markets for us, let's think about Black Pipe, they are in general growing at a higher rate than some of our premium ones. And so that's a drag on this. However, it's still a lot higher than Rubber Carbon Black. So for us as a group, I mean we want that business. We're going to continue to drive it, but that's going on. And I mean, if you think about net EBITDA for the company, that's a good thing.

Michael Leithead

Analyst, Barclays Capital, Inc.

Q

Got it. Okay. That's helpful breakdown there. And then on cash flexibility, obviously you've [ph] based on (30:54) CapEx a bit the past two quarters. Can you maybe just talk through what has been either moved out or canceled in your capital plan and also what further flexibility you might have on cash management, if conditions don't improve much over the next couple quarters?

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Mike, Charles here. We really have – we've just faced it, as we thought we would do pretty much. We didn't think it would be evenly distributed over the year. We do have some flexibility to manage some projects, but we're basically on track with where we expect it to be on the EPA work and indeed with the other major initiatives that we're undertaking.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

I mean, we have a backlog of projects of good things that would add to EBITDA, whether it's through productivity or debottlenecking and it's a matter of just prioritizing that. And to be clear, the EPA work is heavy spend this year, next year. Next fall, we are mechanically complete in Ivanhoe, we have the vast majority of this behind us.

Michael Leithead

Analyst, Barclays Capital, Inc.

Q

Got it. Thank you.

Operator: Our next question is from Kevin Hocevar with Northcoast Research. Please proceed.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Q

Hey, good morning, everybody, and I'd also like to extend my congrats, Charles, it's been a pleasure working with you these last several years.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Thanks so much and I'll be around for a while.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Q

Yeah. I'd like to stress that also.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Thank you.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Yeah. And in terms of the – you call out the differential impact in the quarter, could you give us a little bit of color there? Did that get worse as the quarter progressed and how you've kind of seen it since here in July? And it sounds like you expect, correct me if I'm wrong, that that kind of remains stable, but obviously IMO is still kind of developing there. So could you give us just a little bit more color on that, kind of how that's trended, what it's like now and expectations here as we go forward?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Right. So [Technical Difficulty] (32:58) as we've gone through the year, we see [Technical Difficulty] (33:03) demand. I think we'd look for that to be more stable as we go through the rest of the year.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Got you. Okay. And then you're taking pretty significant pricing actions here in the U.S. Can you give us some thoughts there on what's baked into guidance from those actions? And do you need to – is the U.S. where you're seeing it the most and that's why we're seeing action there or are the other regions also being impacted and you might have to take action in those regions at some point as well?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Well, so I would say the U.S., in Europe, we have some of the CBO pass-through mechanisms already in place. So that in particular is more of an opportunity for the U.S. That said, we see [indiscernible] (33:56), as Charles said in the prepared comments, it's that sort of the deal between us and our customers that we're not in the [ph] overall (34:04) business that we absolutely [Technical Difficulty] (00:34:06-00:34:14) go through to the customers and we're committed to driving that hard.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Okay. Got you. And then last question, on the Rubber business, usually if I look back seasonally, the first quarter EBITDA isn't all that different than the second quarter. But this year, there was pretty meaningful improvement there from 1Q to 2Q. So what drove that improvement sequentially?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Well, so, as I mentioned earlier, we made a big recovery in our MRG position in China, and I'd say that was an important part of it.

Kevin Hocevar

Analyst, Northcoast Research Partners LLC

Got you. Okay. All right. Thank you very much.

Q

Operator: Our next question is from Jon Tanwanteng with CJS Securities. Please proceed.

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Good morning. Thank you for taking my questions, and congrats again, Charles, on the retirement plans.

Q

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Thank you.

A

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

My first question is, what are your expectations for feedstock pressure heading into the second half at this point? Did you increase prices in line with that expectation or just to catch up to where inputs have gone to-date only?

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

So, I think exactly where we are in pricing and how all that works out is sort of commercially sensitive, and you can imagine, we've got these discussions going on.

A

Our view is that as those move, we should be able to recover those from customers, different contracts with different mechanisms. And if you look our price increase formula or the announcement that we made, we talked about adjusting that going forward to exclusively have a differential surcharge.

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Okay. Got it. And then, have you contemplated the impact with even more tariff and trade headwinds? They have been threatened by the White House just yesterday.

Q

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Yeah. Yeah. So we noticed that tweet as well. So those specific tariffs, they don't really hit materials that we trade in. They do affect obviously overall global economic volatility and to a degree, that's why we came out with a range. We hadn't anticipated that tweet obviously when we put this all together. But we continue to believe we can make this guidance.

A

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Okay. Got it. And then finally, SG&A was a lot lower than we expected. Can we expect that run rate to hold or will it move up and down appreciably from these levels as we go into the second half?

Q

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

No, it should be pretty much around where it is now. I mean, we benefit on our fixed costs through FX. Those costs, those are not denominated in dollars and with the strengthening dollar, it's not set to the FX-negative impact at the contribution margin level. But generally where we are at the moment, it's a pretty good representation.

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Q

Got it. And then finally, I don't know if you mentioned it earlier, but was there an update on the Evonik negotiations at all?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Well, just to say that we mentioned last time we were likely to file for arbitration and indeed we did in the last quarter.

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Q

Okay. Understood. So moving forward, but no definite timeline.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

No, no, and I think again we run this business as though that's not coming in tomorrow. We're highly confident we're going to make a substantial settlement with these guys in the fullness of time, but we just run this company as though that's not coming in tomorrow.

Jon E Tanwanteng

Analyst, CJS Securities, Inc.

Q

Okay. Fair enough. Thank you.

Operator: [Operator Instructions] Our next question is from Chris Kapsch with Loop Capital Markets. Please proceed.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Yeah, good morning. So question following up on the discussion around differentials, just so the greater magnitude of adverse differential that you're seeing, how much would you attribute that to this ongoing transition to – the refinery industry's ongoing transition to IMO 2020?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Well, we see a substantial portion in that. Things like as they make that transition, shifting over to diesel, which makes CBO, our feedstock material less available. So from our perspective, there is a strong linkage there.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Okay. And then if I look at the differential headwind by segment, I think it's more pronounced and it's not just because the Rubber segment's bigger, but it's more pronounced, actually it's more pronounced in the Specialty segment and vis-à-vis the Rubber segment and that's a little counterintuitive because more of your business on the Rubber side is under contract and I thought under contract, you have a little bit more coverage in terms of some of the clauses that – and you just referenced some in Europe, but some of the clauses that have been baked in to try to address when these disconnects happen in terms of feedstock differential. So I'm just wondering why is it that you're seeing more of an issue here on the Specialty side for differentials vis-à-vis the Rubber Black...

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So without...

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

...Sorry, why do you see more of an issue on the Rubber Black vis-à-vis the Specialty side?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So let me just speak to both groups, okay. So in Specialty, we tend to be using more of lower sulfur feedstock, so the exact dynamics with that are a little bit different than what we see in the Rubber, where we tend to use the higher sulfur feedstocks, particularly in the United States, so they have a slightly different, let's say, underlying dynamic, underlying differential.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Got it. So you -okay. So that makes – you're more dependent on the higher sulfur feedstocks [ph] in rubber black than more carbon black (39:59)?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Absolutely. Yes.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Okay. That explains. And then, so you talked about, I mean there is a pretty substantial degradation in the profitability in the Specialty side and you talked about a couple of things that you're trying to do internally. What – just more generally, what would be sort of inflections, in which end markets which would help that overall mix for that business to recover as you see the macro playing out over, not so much the balance of 2019, but maybe into 2020? Thank you.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Right. So I think the way to think of that is, if you were picturing a graph of our profitability and thinking like where is the midpoint, like GP per ton and then what products are, let's say, on the good side of that midpoint, it's moving those. So that is almost anything in coatings. So it could be auto, it could be decorative, happy homeowner, marine, protective, whatever. It's pretty much anything in Engineered Plastics, areas like adhesives and sealants beyond automotive in particular, because that's a pretty large volume for them. It's inks and think about toner cartridges and I hope you all own toner cartridges that are high quality and don't jam. It's a range of those [ph] end marks (41:15) that would be an improvement for us, as well as them simply having a higher growth rate than some of the lower ones.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Thanks for the color.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Thank you, Chris.

Operator: [Operator Instructions] Our next question is from Laurence Alexander with Jefferies. Please proceed. Hello, Laurence, go ahead.

Laurence Alexander

Analyst, Jefferies LLC

Good morning. So, three questions related about the Specialty Carbon Black business. First, can you talk a little bit about structural changes that might take several years to implement, but that could help improve the baseline for the business? Secondly, given this description of the business is having like the good versus bad margin portions, what's the difference in the growth rates that you're seeing there? And then third, the discussion around gross profit excluding FX, is that intended to signal or reflect customer psychology that margins cannot improve unless the dollar moves in the right direction?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

Okay. So, let me take those starting from the top. On structural, I think just for sensitive reasons, we don't necessarily want to go into everything in there, but it was – amongst the things are making sure you've got the capacity for your higher-margin products. It's making sure you've got the ability to sell them and support that with your customers. It tends to be more differentiated products, a more differentiated engineer-to-engineer sort of sale. In terms of growth rates, well, we'd have to look at one for each end market and we see that as somewhat commercially sensitive. But in general, it's sort of looking at the aggregate, we would say the lower margin ones have been growing at a higher rate. And FX, we put that in the report really just for the investor community just to give a sense of, so what's business performance, what's really translational FX.

Laurence Alexander

Analyst, Jefferies LLC

Have you looked historically at how the business has done catching up to the FX effect? I mean, what's the lag effect?

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

So that's an interesting question. I think most of this has been the FX simply moving – it bouncing in a range. If you're going to look back over now several years though, generally speaking, we've seen a U.S. dollar strengthening and that's been a challenge. I think the thing for us in this is to look at where we're especially using dollar-denominated or dollar-driven energy prices as our feedstocks and then moving those customers into a dollar-denominated sales price and that would take this out or dampen this at least going forward.

Laurence Alexander

Analyst, Jefferies LLC

Q

Thank you.

Operator: We now have a follow-up question from Chris Kapsch of Loop Capital Markets. Please proceed.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Yeah. Thanks for explicitly talking about the walk on the different contributors to the EBITDA bridge. On the inventory penalty and I'm focused on Specialty segment in particular. Just wondering is – so the inventory drawdown affected absorption variances \$4.8 million I think you said in this quarter. What are the – what do those variances look like over the balance of 2019? Has that inventory hit had been taken and now your production rates should flow through in cost accounting on a more normalized basis or is this going to drag on profitability for the balance of 2019 until we have a stronger demand environment.

Operator: Hello? Please check to see if your phone is muted. We're unable to hear you.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Can you hear me now?

Operator: I can hear you, Chris. I can't hear the speakers.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Did they hear the question? Sorry.

Operator: I'm not sure. Hello, sir, are you there? We're unable to hear your speaker line. Please check and see if it is muted.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Yeah. I'm here.

Operator: We are having technical difficulties. Please stand by for one moment. Once again, thank you for your patience, while we reconnect the speakers. [audio gap] (47:15-47:49) Okay. Speakers, you are back into the conference. Please proceed.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Hey, Chris, sorry everyone for that. I'm not sure what happened, we had to shift rooms. But the short answer is, and so we think we took out most of what we needed to do in terms of volume in the second quarter. If we see trading conditions move or whatever, we'd of course then take actions again, but I think we've seen the majority of it.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Okay. So the penalty to – on the cost accounting standpoint has been confined to the second quarter essentially in the Specialty segment?

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

A

Yes. Correct.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Got it.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

A

Yeah. There was an impact in both segments in the quarter just for the record. But, yeah, we've made the adjustment we think we need to make.

Christopher Kapsch

Analyst, Loop Capital Markets LLC

Q

Thank you.

Operator: [Operator Instructions] Okay. There are no more questions at this time. I would like to turn the conference back over to management for closing remarks.

Corning F. Painter

Chief Executive Officer & Director, Orion Engineered Carbons SA

So first of all, just thank everyone for the time with us, sorry for the interruption to the phone connection and then one more time just personally in life, thank you, Charles, for all your work to Orion. Charles will be with us through this year, but nonetheless, we've just made an announcement and just want to express my great appreciation for your guidance and driving this company forward over so many years. Thank you so much.

Charles E. N. Herlinger

Chief Financial Officer, Orion Engineered Carbons SA

Thanks a lot, Corning, and thank you, everyone.

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

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