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Q2 2019 Synalloy Corp Earnings Call

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Dennis M. Loughran *Synalloy Corporation - Senior VP & CFO*

CONFERENCE CALL PARTICIPANTS

Charles Gold *Scott & Stringfellow*
Michael Kucera

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Synalloy's Second Quarter Earnings Conference Call. (Operator Instructions)

I would now like to introduce your host for today's conference, Craig Bram, President and CEO. You may begin.

Craig C. Bram *Synalloy Corporation - President & CEO*

Good morning, everyone. Welcome to Synalloy Corporation's Second Quarter 2019 Conference Call. Dennis Loughran, our CFO, will provide a review of the Q2 financials and then I'll provide some comments on our business segments. We'll then open the call to questions. Dennis?

Dennis M. Loughran *Synalloy Corporation - Senior VP & CFO*

Hello, everyone. As usual, the financial results will be presented using 3 different methods: first, GAAP-based EPS; second, adjusted net income, a non-GAAP measure as defined in the earnings release; and third, adjusted EBITDA, a non-GAAP measure also defined in the earnings release.

Second quarter GAAP-based income was a net loss of $0.3 million or $0.03 per diluted share as compared with income of $3.7 million or $0.41 per share in the second quarter 2018.

Second quarter non-GAAP adjusted net loss was $0.3 million or $0.04 per diluted share as compared with adjusted net income of $6.3 million or $0.71 per diluted share in the second quarter of 2018.

Second quarter non-GAAP adjusted EBITDA totaled $3.4 million or 4.3% of sales compared to the prior year second quarter total of $10.3 million or 14.4% of sales.

As pointed out in the earnings release, inventory price change losses impacted results, totaled on a pretax basis $1.8 million in the second quarter 2019 compared to a gain of $1.1 million in last year's second quarter. On an after-tax basis, that represents an unfavorable $2.3 million difference between the 2 quarters.

The combined adjusted EBITDA as a percent of sales for the operating businesses in the second quarter was 6.3% compared to the prior year second quarter of 17.1%. The primary factors in the decline being the inventory price change differential mentioned above, the average pricing declines experienced in the welded stainless pipe and galvanized tube operations described in our press release and the June 19th guidance update as well as inclusion of the more commodity volumes brought in with the Galvanized acquisition that were not in our prior year second quarter.

At the end of the second quarter, our outstanding borrowings against our ABL facility totaled [$67.7 million] (corrected by company after the call), down $9.1 million from the December 31, 2018 total. The decrease is primarily related to decreased working capital, basically inventory. The calculated ABL facility remaining available as of June 30, 2019 was approximately $20 million. In addition, the balance of the $20 million term loan drawn on January 1 to support the acquisition of ASTI stood at $18.3 million.

I will now turn the call back over to Craig.

Craig C. Bram ***Synalloy Corporation - President & CEO***

Thanks, Dennis. The company experienced what we believe to be temporary headwinds in our welded stainless steel pipe business in the second quarter. This is primarily responsible for the downward revision in our annual forecast, which we reported in our press release on June 19.

Before sharing some details on this product line, I'd like to comment on our other businesses. The addition of ASTI and its ornamental tubing products in January has made a solid contribution to overall results. Sales and profit margins are equal to or better than our original forecast and the order book remains strong. The more consumer-oriented end markets for this product line have been an excellent complement to the heavier industrial markets served by our welded stainless steel and seamless carbon pipe and tube product lines. In June, we implemented the company-wide ERP system for this unit and the transition has gone very well.

Our storage tank business in West Texas produced much improved results in Q2 and year-to-date. Revenue and profit margins exceeded the original forecast for both periods. However, new order activity in July has been slow and several customers have reduced the number of tanks on previous orders.

Oil production growth in the Permian has slowed considerably over the pace of 2018. The Energy Information Administration projects that oil production in the Permian will grow by only 34,000 barrels per day in August with legacy wells seeing a decline of 268,000 barrels per day and production from new wells coming in at 302,000 barrels per day.

The oil rig count in the Permian peaked in the second quarter of 2018 and has been on decline ever since. In response to the slowing activity, we have started to rationalize production and cost and we'll monitor this closely in the coming weeks. Our customers have indicated that new orders will be released later in Q3. There have been several recent mergers announced involving companies with significant acreage in the Permian. We expect to benefit in the long term as we have excellent relationships with the controlling companies.

I would also add that there are now over 4,000 drilled but uncompleted wells in the Permian Basin alone. The number of DUCs has doubled from just 3 years ago and serves as a good indicator of potential tank battery demand in the future.

Turning now to our heavy wall, seamless carbon pipe and tube product line. 2018 was an exceptionally good year as distributor inventories have been drawn down to very low levels. We anticipated a decline in pounds shipped and lower contribution margins during 2019. That has proven to be the case. However, the decline in year-over-year performance has been most evident at our Houston distribution facility. The Houston operation is almost exclusively focused on the energy market, particularly offshore drilling. Order activity has been on the light side all year, particularly for higher grade alloys and larger OD sizes.

On the other hand, the Ohio facility, which serves the general industrial market, has maintained a steady performance year-to-date with revenue flat with 2018. We look for this location to post stronger second half results as they begin to ship mechanical tube orders for the Dubai solar field, which we reported on earlier this year. July order activity for both facilities was higher than the revised forecast.

Let me comment on the Chemicals segment before turning to the welded stainless steel pipe business. In the second quarter and year-to-date periods, revenue reflects a greater percentage of tolling business than contract manufacturing. Tolling does not include raw materials which are provided by the customer. The result is lower selling price per pound and associated revenue. However, year-to-date pounds shipped for the Chemicals segment were up 10% over last year. As the pounds increase, we expect to see continued improvement in overhead absorption and operating profits.

Excluding the receipt of last year's legal claim, operating profits are holding steady with 2018 levels. Many of our chemical customers are reporting flat-to-marginal year-over-year growth, which has an obvious impact on the intermediate products that we manufacture for them. That said, we have enough products coming online in the second half of the year that we expect to meet or exceed our original forecast for the Chemicals segment.

Turning back to our welded stainless steel pipe business. The first half of this year has been challenging on several fronts. The headwinds that I mentioned have been difficult to overcome, but we do believe they are temporary in nature.

Let me touch on each of these. Section 232 tariffs, which were implemented during the first half of 2018, distorted the buying patterns throughout the supply chain, resulting in excess inventory at the distributor level. Both imports and domestic producers of welded stainless steel pipe enjoyed a surge in artificial demand in the first half of last year.

Reports from the Metals Service Center Institute show that for the first 6 months of this year North American shipments of welded stainless steel pipe were down 24% over the same period last year. True end-market demand should be growing in low single digits, so the decline in pounds shipped year-over-year speaks to the level of excess inventory created by the tariffs.

Number two, there has been a recent consolidation in the master distribution segment of the supply chain. Ta Chen International acquired Global Stainless in the fall of last year and MultAlloy, a division of FloWorks, has been for sale since beginning of this year. They were recently acquired by Texas Pipe. The integration of these companies and their inventories across multiple distribution facilities has reduced the frequency and size of inventory stock buys from mills like Bristol Metals.

Consolidation coming on the heels of Section 232 tariffs has created a situation where inventories are well above historical levels. We do expect inventory levels to return to normal over the balance of this year.

Third and final, nickel prices and associated surcharges have been a big negative as well. Surcharges in the first half of this year were down over 14% from the same period last year. With visibility into falling surcharges, there has been no incentive for distributors to purchase now rather than later. The swing from inventory price change gains in the first half of 2018 to inventory price change losses in the first half of this year combined for almost $9 million on a pretax basis.

Recently, nickel prices have turned favorable. Nickel prices in July were up 17% over the second quarter average and in the last several days have climbed above $7 per pound. Should nickel prices hold at current levels, we will see inventory profits returning in Q4.

Looking out over the next 3 to 5 years, we do believe that there is a bias for nickel prices to increase due to strong demand for stainless steel and increasing demand from electric vehicle batteries.

I believe that we've managed the welded stainless steel pipe business through these challenges as best as we can. Our market share in the first half of this year increased by 200 basis points over last year. Pounds shipped in the first half of 2019 were down 12% over last year, considerably better than overall North American shipments, which were down 24% during the same period.

As you would expect with lower buying activity comes more aggressive pricing. Pricing for larger OD pipe sizes and special alloys has held up reasonably well. However, prices for the smaller sizes have been under severe pressure as these sizes are often sold as loss leaders in a low-demand environment and compete more directly with imports.

While project buys have not been as strong as they were in the peak demand year of 2014, they have been relatively solid. We have increased our share of this work as well. July bookings included several projects and pricing for smaller OD sizes have been higher than what we realized in the second quarter.

Another unexpected hurdle for this business was presented in the latter part of Q2. Our heavy wall press was experiencing some problems and it was determined that one of its 2 hydraulic cylinders was cracked. The cost to replace the cylinder is less than $200,000, however the lead time to added machine and install will keep that equipment out of commission until mid-November. We've decided to have the supplier produce a second hydraulic cylinder at the same time so we have a backup available in the future.

A final comment on this business unit. We've reached agreement with the Bristol Union for a new 5-year contract, which started this month.

With all the difficulties experienced in the welded stainless steel pipe business, it's easy to lose sight of the improved earnings power of the company. Adjusted EBITDA in 2018 was over $34 million. Had we owned ASTI last year, adjusted EBITDA would have been almost $41 million. This does not include any of the improvement that we've witnessed this year in our storage tank operation. We continue to look at potential acquisitions in the metals and chemicals space, but no transactions are imminent. We remain focused on cash flow and reducing our debt. Targeted net debt by the end of the year will be less than $65 million.

As mentioned in our June 19th press release, we opened a data room to provide Privet with additional information on the company. Over the past 8 weeks, we've had several follow-up calls with Privet and their adviser. At this time, we've not received any further comment or offers from Privet. Should Privet decide to move forward, the company is asked that they provide a formal offer and evidence of funding by close of business on August 19.

We'll now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Kucera. He's a private investor.

Michael Kucera

My question has to do with the tax rate in the second quarter and first 6 months of this year. There was some explanation in the press release. I'm wondering if you could elaborate a little bit more about why it was as high as what it was?

Dennis M. Loughran ***Synalloy Corporation - Senior VP & CFO***

This is Dennis Loughran. With the income figures being so low -- relatively low, the discrete items, which were only a few hundred thousand dollars, had a fairly significant impact on the overall effective rate. If income and the tax were higher at the statutory rate, it would have been spread over much larger tax base. So that's basically it.

Operator

(Operator Instructions) And we have no questions in the queue at this time.

We do have a follow-up question from the line of Michael Kucera, the private investor.

Michael Kucera

Another question is with the possible new tariffs on Chinese imports starting as early as September 1st, I'm wondering if you could elaborate a little bit upon the impact of additional steel imports if they're coming in rapidly to beat that possible tariff increase?

Craig C. Bram ***Synalloy Corporation - President & CEO***

Yes, Michael, those -- the tariff increase you're speaking to would not impact any steel products.

Operator

And we have no further questions at this time.

Craig C. Bram ***Synalloy Corporation - President & CEO***

It looks like there is a question from Charles Gold.

Operator

With Scott & Stringfellow.

Charles Gold ***Scott & Stringfellow***

It looks like your forecast is for roughly $14 million of EBITDA in the second half. Is that right?

Dennis M. Loughran ***Synalloy Corporation - Senior VP & CFO***

Yes.

Craig C. Bram ***Synalloy Corporation - President & CEO***

That's right.

Charles Gold ***Scott & Stringfellow***

All right. So you said last year would have been $41 million if the acquisition had been there all year. Is $28 million a better current run rate or the first half was $8 million, obviously $16 million is not the run rate. I know you're not ready to put out 2020 forecast, but it looks like the revenue is in the $320 million to $350 million range. And is it fair to say we are operating in a run rate of 25 to 35 EBITDA as sort of where we are?

Craig C. Bram ***Synalloy Corporation - President & CEO***

If you exclude metal profits and losses, Charles, yes, that's a good estimate.

Charles Gold ***Scott & Stringfellow***

Yes. I guess I've been fixated too much on the nickel price making a one year high and it has been holding here and when you look at the London inventory, that number just keeps on coming down. So it looks like the [winds] that your back a little bit?

Craig C. Bram ***Synalloy Corporation - President & CEO***

If those prices hold, we'll definitely start to see some pickup in some inventory profits, probably towards the end of Q3, but definitely into Q4.

Operator

(Operator Instructions) I would now like to turn the call back to Craig Bram for any further remarks.

Craig C. Bram ***Synalloy Corporation - President & CEO***

Thank you for your interest in Synalloy and we look forward to hearing from you in the future. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day.