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SYNL - Q1 2018 Synalloy Corp Earnings Call

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CONFERENCE CALL PARTICIPANTS

Charles Gold

Michael Hughes

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Synalloy's First Quarter's Earnings Conference Call. (Operator Instructions) I would now like to turn the conference over to Craig Bram, President and CEO. You may begin, sir.

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

Good morning, everyone. Welcome to Synalloy Corporation's first quarter 2018 conference call. Dennis Loughran, our CFO, is with me today as well. Dennis, will start by providing a review of the Q1 financials, and then I'll provide some comments on our business segments and the positive trends that we're seeing so far in 2018. We will 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.

First quarter GAAP-based income was net profit of $3.8 million, or $0.44 per share as compared with net income of $0.7 million or $0.08 per share, in the first quarter of 2018. First quarter non-GAAP adjusted net income was $4.3 million or $0.49 per share as compared to adjusted net income of $1.3 million or $0.15 per share in the first quarter of 2017. First quarter non-GAAP adjusted EBITDA totaled $7.6 million or 13% of sales compared to prior year's first quarter total of $3.5 million or 8.3% of sales. As pointed out in the earnings release, inventory price change gain impacted results total on a pretax basis of $2.5 million in the first quarter of 2018 compared to $0.9 million in last year's first quarter on an after-tax basis that represents $1.2 million difference between the 2 quarters.

The combined adjusted EBITDA as a percent of sales for the operating businesses in the first quarter was 15.2%, a substantial improvement over the prior year's first quarter of 11.3%. At the end of the first quarter, our outstanding borrowings against our ABL facility, totaled $34.3 million, up $8.4 million from the December 31, 2017, total. The increase is primarily related to increased working capital due to substantially increased activity as well as replacement cost increases in steel-based components of our inventory. The calculated ABL facility remaining availability as of March 31, 2018, was approximately $30.1 million.

I'll now turn the call back over to Craig.

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

Thank you, Dennis. Synalloy is off to a tremendous start in 2018, posting record sales and record net income for the first quarter. We expect the remaining quarters of the year to be even stronger than Q1, with each of our business units contributing improving performance. April kicked off the second quarter with a new monthly record for sales of $26 million. While pleased with our performance to date, there is considerable upside from here. I would like to touch on some of the primary drivers that we believe will help us build on these outstanding results. Focusing first on our stainless steel pipe and tube business, we've spoken in the past about the need for infrastructure spending in the downstream energy markets to return to normalized levels, in order to maximize profits in this product line. We are still waiting for the recovery to take hold, but believe we are on the cusp of renewed spending in this critical end market.

Earlier this year, the Petrochemical Update published our outlook for the downstream energy market, which included input from the American Chemistry Council. The U.S. chemical industry remains advantaged with access to the cheapest and most abundant natural gas in the world, resulting in the U.S. being the preferred destination for chemical investment. Over the next 4 years, capital investment in the petrochemical sector is expected to ramp by 6% to 7% annually, culminating an upwards of $48 billion in spending in 2022. This represents roughly 2.5x the spending that occurred in 2010. All sizes in alloys of welded stainless steel pipe and tube will be required to support this effort (technical difficulty) better positioned to take advantage of this opportunity. Special alloy sales with their outsized margins will be a key driver of incremental profits. In 2014, special alloy sales represented roughly 8% of the pound shipped from the Bristol facility. In 2017, special alloy sales represented less than 5% of the pounds shipped, and in the first quarter of this year, we're only 3.5% of the total pounds shipped. That said, due to current backlog has a much higher mix of special alloys, which will provide a material increase in average selling prices over the next several quarters. In the first quarter of this year, the average selling price per pound was $2.46 or roughly 21% below the average selling price realized in 2014. The average selling price and the current backlog is $2.92 per pound or 6% below the average selling price in 2014. Special alloy shipments returning to 2014 volume and pricing levels would increase annual adjusted EBITDA by $6 million over our projected 2018 levels.

The consolidation that occurred in the domestic welded stainless steel pipe and tube market in 2017, was and will continue to be transformative. Rational pricing has taken hold in the market, allowing for adequate returns on invested capital. Any doubts that domestic producers can support the demands of their customer base without the help from imports are misplaced. With combined capacity from the Bristol and Munhall facilities, including our recently purchased high-frequency auto laser mill, Bristol Metals can now produce upwards of 110 million pounds of welded stainless steel pipe and tube annually. Bristol Metals alone can supply up to 50% of the North American market demand for welded stainless steel pipe.

Turning to our storage tank business, there was a timely article in the Wall Street Journal earlier this month on the growth and resulting bottlenecks in the Permian basin. It has taken some time for the storage tank manufacturers in the Permian have finally reached full production capacity. As the article suggests, pricing for materials and services have shown healthy gains. We are quoting considerably higher prices on current bids than what we were able to realize even 3 months ago. The current backlog reflects average selling prices that are 27% higher than what was realized in the first quarter of this year. Our seamless carbon pipe and tubing product line has shown impressive growth as well. The Houston facility is seeing improved sales and margins as higher oil prices create more demand for high-pressure applications in both drilling and energy transportation. Between the Munhall and specially acquisitions, which were our 2 most recent, contributions to adjusted EBITDA was annualizing at over $17 million.

My final comment on the Metals Segment concerns surcharges resulting from rising nickel prices. On an after-tax basis, Q1 profits were benefited by approximately $1.2 million, over the first quarter of last year. Surcharges for the second quarter of this year are currently running about 25% higher than the first quarter of this year. So we do look to pick up additional inventory profits in the second quarter. Our forecast, however, for the second half of the year assumes a nickel-neutral environment with neither inventory profits or inventory losses. While we've seen nickel prices rebound from historic lows the current price of nickel still trails the average price in 2014 by 17%, and is still below the 7-year average price. With the metal in deficit mode, we expect pricing to steadily increase in the next several years.

Turning to the Chemical Segment. 2018 will be a rebound year. Increasing capacity utilization at the CRI facility is very important to incremental profits. The new business announced earlier this month is one of several projects that will move us in the right direction. This particular project was fast-tracked and was not included in our most recent forecast for the Chemical Segment. We expect second half revenue of $7 million and $750,000 of incremental EBITDA from this product line.

Our revised forecast for 2018 essentially has us achieving our 2019 target for adjusted EBITDA of over $30 million, 1 year early. This, however, excludes contributions from any acquisitions. We mentioned, our work on a bolt-on acquisition in the earnings release. At this time, Synalloy is under LOI and working through due diligence. Should we not encounter any problems, we expect to close on this deal by June 30. The acquisition would add $21 million of revenue and over $2 million of EBITDA in the second half of this year, with $45 million of revenue for the full year 2019, and $4.5 million in EBITDA. We will be acquiring this business for the value of the equipment and net working capital, and can easily accommodate the purchase price under our existing ABL funding. We expect to provide more details on this very soon.

Finally, our share prices responded favorably to the company's performance, with a year-to-date gain of approximately 29%. However, our evaluation on an enterprise value to EBITDA basis still trails the median of the companies in our peer group. Synalloy's current EV to 2018 adjusted EBITDA, excluding the proposed acquisition is about 6x as compared to the median of 8.5x for the companies in our peer group. This discount does not make sense to us, and we believe that as we continue to demonstrate the full earnings power of the company, Synalloy's valuation discount to it's peer group will disappear.

We'll now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And I am showing no further questions. I would now like to turn the call back to Craig Bram, President and CEO for any further remarks.

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

Excuse me, it looks like Mike Hughes from SGF capital is trying to ask a question.

Operator

Mike Hughes your line is now open, sir.

Michael Hughes

First -- one of the -- if there was any disappointment in the quarter, I guess it would be Palmer tank. I was a little bit surprised to see the revenue there decline a year-over-year. Was that -- I know there was some weather in the Permian in the first 2 months of the quarter, was it related to that?

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

No. It wasn't related to the weather at all. We have 2 very large customers in the Permian that had been scheduled to take some tanks from us, primarily in February and March. And because of some of the bottlenecks that I referenced in the Permian generally, and I think those are primarily labor-related, and I would say weather is a very low factor in that mix, but they were unable to take the tanks from us in February and March. They did, however, take all of those tanks in the first week of April. So our April sales at Palmer were just shy of $4 million. So there was a pickup of about $1.3 million, $1.4 million in tank value associated with the tanks that would have shipped in Q1 that got pushed into April.

Michael Hughes

Okay. And then can you remind me on the pricing? Obviously, raw materials for that business have been great. How do you protect yourself?

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

Yes. Right now we are -- our bids are only good for 30 days, and to the extent that we get any type of pricing protection on our steel -- carbon steel purchases out there, we'll extend that to our customers but currently that's at the 30-day mark.

Michael Hughes

Okay. And then on the Chemicals business, the margins have been a little bit light the last couple of quarters in a row, so is the mix shift in that business something permanent? I know you kind of addressed the range of Chemical margins historically in the press release, but can you just elaborate on that?

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

The mix has changed a little bit but not certainly permanent. If you look at the -- at our range of margins in that business, they're moving around all the time. I would say that some of the business that we currently have in the pipeline for both MC and CRI are higher-margin businesses -- higher-margin product lines, so we would expect those to show some decent improvement over in the next couple of quarters. The product that I mentioned in the earnings release and that we did an announcement on about a week back, that product is going into road construction, we're pretty excited about the potential of that with infrastructure spend but that product got fast-tracked over about 60 days, and we've got a significant number of purchase orders, some that actually got produced in the latter part of April but May, June, and July are going to be very strong shipments of that road construction product.

Michael Hughes

Okay. Are there any start-up costs related to that new business or should it come on at a pretty healthy margin right away?

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

No start-up cost at all. We don't have to add equipment, we don't have to add personnel. So it's going to have a major impact immediately on our margins.

Michael Hughes

And you said that's not in the guidance that you issued on April 10, is that right?

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

That's right.

Michael Hughes

Okay, and then one last question on the Chemicals business. You brought on some new business in the second half of last year, has that ramped? And is it as profitable as you had expected?

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

Yes. It's done very well and the volume is now at the level that we expected going in. The customer is very happy with the quality of the product and it's going very, very well right now.

Michael Hughes

Okay. And then you referenced the potential for a bolt-on and you have an LOI in place. Can you say, is that in the Metals business or the Chemicals business?

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

No, right now I can't mention that. Hopefully, within a couple of weeks we'll have potentially more to share on that. But I will tell you it's a business that we understand very well. It's a very, very nice fit, I think when people see the details on it, they'll say wow, that makes a lot of sense and it's something we can hit the ground running with. So we're excited about it.

Michael Hughes

Okay. And is that unrelated to the public's equities that you've been purchasing over the last 2 quarters?

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

Yes. Currently unrelated.

Michael Hughes

Okay. And then just on the guidance for the full year, the EBITDA. If the number falls out at roughly $30 million, you just did, I think $7.6 million, but there was a roughly $2.5 million inventory -- I guess, yes, $2.5 million inventory gain in the quarter. So I know you indicated that in the June quarter there'll also be an inventory gain, but it does imply in the back half that there'll be a pretty good step up in what I call, core EBITDA. I know you stopped adjusting, taking that out of your adjusted EBITDA number because of some of the feedback from the SEC. But can you just address how you're going to step up from roughly a -- kind of clean number of I call 5 point -- a little over $5 million in the first quarter to probably happen to do $7.5 million, $8 million by the third, fourth quarter.

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

Yes. In the second quarter Mike, we do expect some inventory profits. I would expect them to be a little bit more than they were first quarter, but if you're thinking about the breakdown over the next 3 quarters, I was looking at that this morning. The second quarter EBITDA would probably be somewhere in the range of $8.5 million to $9 million and that would include inventory profits. Then you get into the third and fourth quarter and as you say, we have projected those at nickel neutral, so we're looking at core contributions. And this would assume completing the acquisition at the end of June, we would expect to see in the neighborhood of $8 million of EBITDA in Q3 and Q4. So if we actually get the acquisition done, we would expect the EBITDA for the year to come in between $32 million and $33 million. Without the acquisition we're in the $30 million range.

Michael Hughes

Okay. Just 2 more for you. Sorry for so many questions. Do you think that there were some potential customer poll in just in front of the tariff activity or is this kind of genuine demand? I'm just basically asking, do you think it's sustainable? Or is there kind of some channel fill?

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

I think it's very sustainable. We actually -- I was looking at the import numbers, we don't have March as yet, but in January and February, if you think about the countries that historically have been dumpers and we'd had dumping suits against Korea, China, India, Vietnam, Malaysia. If you look at that core group of countries, in 2017, they exported into the U.S., a total of about 40 million pounds of welded stainless steel pipe. In the first 2 months of this year, they did over 9 million pounds. So they were front-end loading their shipments in anticipation of what may happen with Section 232. So we got 0 benefit in the first quarter from Section 232 tariffs. How it's -- some of the exemptions as you know have been stretched out a little bit. Right now where it stands is, Taiwan, which is the biggest importer is looking at a 25% tariff, they're trying to get an exemption, Korea is the second largest exporter into the U.S. They have received and reached an agreement where they will reduce their shipments into the U.S. of pipe by 30%, so their quote is set at 70% of the last 3 years' volume. And then the rest of the Asian countries are still looking at a 25% tariff and I don't imagine any of those companies -- countries, excuse me, receiving an exemption for any reason. So we expect to start seeing the benefits, and as I mentioned in my remarks, we're well positioned because of the excess capacity that we have. I think some of these countries will try and make the case that the vesting producers are not in a position to absorb all this work but we -- we're certainly going to counter that argument because we're -- we've got another 40 million pounds of capacity that we believe we can handle over the coming years.

Michael Hughes

Okay. Last one for you. You say that revenue -- unaudited revenue in the month of April is $26 million. Is that correct?

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

That's right.

Michael Hughes

Okay. So is April typically an exceptionally strong month? Or I'm just thinking about the second quarter, that be north of $75 million or is that not the way to think about it?

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

Well it's -- there's nothing exceptionally unique about April. We did have about $1.3 million of that $26 million that was carryover for Palmer, but everything else was just solid demand, it's a reflection of the bookings that we've had in the past quarter. And all of our business units were reporting very strong increase at this point. And so we certainly expect Q2 to be a stronger revenue month -- excuse me, stronger revenue quarter than the first quarter, but do we hit $75 million? That's not likely at this point but I would say, $70 million is probably in the ballpark.

Operator

(Operator Instructions) Our next question comes from Charles Gold from Scott & Stringfellow.

Charles Gold

Congratulations on a wonderful quarter, but more importantly, putting the company in a position to strut it's stuff now going forward. So we really appreciate all the hard work over the last couple of years.

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

Thanks, Charles. We appreciate that.

Charles Gold

I got dropped off the call right when the questions started. So I hope I'm not repeating anything but you have been buying an insurance policy of puts on stainless steel for quite a while and you made a fairly positive comment about what you thought the metal might do in the foreseeable future. Are you going to continue that? Or if you are, might you continue it at a lower level with your -- to reflect your optimism?

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

Charles, this is Dennis. I'll reply to that. We, at the -- in the fourth quarter of last year, we reviewed our policy after having been in the hedging platform for the last 2 years. And we went to a sort of a tiered decision process, we had always been layering on puts on a monthly basis looking out into the next month of receipts. So since the board approved that the 3-level decision process, we have not added any layers and we currently do not have any open puts extending out forward. So as the price of nickel goes up and the potential for downside risk leveling out versus the upside. We may get into a position where we look at layers being added but -- yes, currently we don't have any exposure. We haven't paid any premiums this year for any new layers.

Charles Gold

Thank you for the answer and look forward to seeing more quarters like first. It feels like the first of many and I agree with you, the stock price doesn't reflect what you just laid out as our path. So -- and we just opened at 18:50, so somebody likes it this morning.

Operator

And I'm showing no further question at this time. I would now like to turn the call back to Craig Bram, President and CEO for any further remarks.

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

As always, we appreciate your support. We're happy to be able to report some very positive news in Q1 and very excited about what we see for the balance of the year. So we appreciate your support and your patience as we've been waiting for some of these initiatives to bear fruit. Thank you very much.

Operator

Ladies and gentleman, thank you for your participation in today's call. This does conclude today's program. You may all disconnect. Everyone, have a great day.
