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GRA - Q4 2012 W. R. Grace & Co. Earnings Conference Call

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OVERVIEW:

Co. reported 4Q12 sales of $798m and adjusted diluted EPS of $1.11. Expects full-year 2013 sales to be $3.2-3.3b.

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CORPORATE PARTICIPANTS

Mark Sutherland *W. R. Grace & Co. - VP of IR*

Fred Festa *W. R. Grace & Co. - Chairman and CEO*

Hudson LaForce *W. R. Grace & Co. - SVP and CFO*

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Mike Ritzenthaler *Piper Jaffray - Analyst*

Chris Kovacs *Robert W. Baird - Analyst*

Laurence Alexander *Jefferies - Analyst*

Mike Sison *KeyBanc Capital Markets - Analyst*

Jim Barrett *CL King & Associates - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter 2012 W. R. Grace & Co. earnings conference call. My name is Jasenia, and I will be your operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. (Operator Instructions). As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the conference over to your host for today, Mr. Mark Sutherland, Vice President of Investor Relations. Please proceed, sir.

Mark Sutherland - *W. R. Grace & Co. - VP of IR*

Hello, everyone, and thank you for joining us today, February 6, 2013, for a discussion of Grace's fourth-quarter 2012 results that were released this morning. Joining me on today's call are Fred Festa, Grace's Chairman and Chief Executive Officer, and Hudson LaForce, our Senior Vice President and Chief Financial Officer.

Our earnings release and the corresponding presentation are available on our website. To download copies, go to Grace.com and click on Investor Information. Links are available on the upper-right corner of the page.

As you know, some of our comments today will be forward looking and are made under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those projected or implied due to a variety of factors. Please see our recent SEC filings for more details on the risks that could impact Grace's future operating results and financial conditions.

We will also discuss certain non-GAAP financial measures, which are described in more detail in this morning's release and on our website. Reconciliations to the most directly comparable GAAP financial measures and other associated disclosures are contained in our earnings release and on our website.

Our comments on forward-looking statements and non-GAAP financial measures apply both to the prepared remarks and to the Q&A. We want to remind everyone that this webcast contains time-sensitive information that is accurate only as of today . Any redistribution, retransmission, or reproduction of this call without Company consent is prohibited.

With that, I'll turn the call over to Fred.

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Thanks, Mark, and good morning to everyone. I am pleased with our results for the fourth quarter and our strong finish to the year. Our year-over-year and sequential quarterly performance was good and positions us very well for 2013. Hudson will discuss the fourth quarter in more detail. My comments will focus on 2012 in general.

Organic sales increased 7% in a tough macroeconomic environment, and adjusted EBITDA margin increased 160 basis points to 20.2%, confirming the strength of Grace's earnings potential. We made great progress toward our vision of being the premier specialty chemical company.

In January, we introduced a new operating structure -- three business segments, each run by proven leaders, reporting to a Chief Operating Officer whom I have great confidence in. By leveraging this one Grace platform, we are able to reduce costs, improve productivity through the use of common management systems, business processes. Our structure is an important enabler for driving growth for each business.

In 2012, we took additional action to expand the Company's presence in emerging regions. We announced a joint venture in Abu Dhabi to manufacture refining catalysts. We acquired catalyst manufacturing assets in China, which gives us a foothold to better supply refining catalysts in China and East Asia.

We also acquired a concrete admixture supplier in Brazil and expanded our presence and capabilities in one of the fastest-growing construction markets in the world. We've invested capital to strengthen our technology base and to improve manufacturing productivity.

We completed several key capital projects at manufacturing facilities in North America and Europe that will support growth in our faster-growing polyolefin catalyst business. These projects include capacity for growth as well as new product technology.

2012 was also a challenging year in many ways. It was a year marked by volatility and uncertainty as manufacturers faced a recession in Europe, lower growth in emerging regions, and uncertainty in the US. We saw significant volatility in currency and rare earth costs. This environment pressure-tested our management systems and processes as each segment faced its own challenges.

Catalysts Technologies managed through refinery closures, rare earth volatility, lower polyethylene demand, to post a year of almost 10% organic growth. Materials Technologies overcame a weak first quarter, improved throughout the year, and exited the year at its target margins for 2013. And Construction Products delivered its best performance since 2008, as strong growth in emerging regions offset still weak construction markets in North America and Western Europe.

Our 2012 financial performance is a clear testament to the focus and execution of our employees globally and the strong positioning of our product technology. And looking ahead, 2013, our outlook for adjusted EBIT is $560 million to $580 million, an increase of 8% to 12% compared with 2012. We expect our businesses to manage well in a global economy that may have slow or uneven growth.

We remain confident in our 2014 goal of $850 million of adjusted EBITDA. But we are tempering our topline goal to $3.8 billion from the $4 billion. The macroenvironment has not been as strong as we have expected, but we have the business levers to keep earnings growing. We're also confident in our three-year adjusted free cash flow goal of more than $1.2 billion.

I'll turn it over to Hudson, who will provide more specifics on the quarter and our 2013 outlook.

Hudson LaForce - *W. R. Grace & Co. - SVP and CFO*

Thank you, Fred. Please turn to pages 5 and 6 and we will start with a quick review of Grace's overall results for the quarter.

Sales were $798 million, down 3% from last year. Solid organic growth of 8% was offset by lower rare earth surcharges of 9% and unfavorable currency translation of 2%. For the full year, organic growth was 7%, consistent with our recent growth track record. Emerging region sales grew 16% for the quarter and 15% for the year.

Adjusted EBIT was $133 million, up 23% from last year. Adjusted EBIT margin increased 360 basis points to 16.7%, and adjusted EBITDA margin increased 370 basis points to 20.5%. Improved pricing, productivity, operating leverage, and expense control all contributed to the growth in margins.

Adjusted free cash flow was $421 million for the year, up 51% from last year, driven by reduced working capital requirements and lower required pension contributions.

Adjusted EBIT return on invested capital increase to 36% from 35% last year. Adjusted EPS was $1.11 based on diluted shares of 76.8 million.

Let's turn to Catalysts Technologies on page 7. Fourth-quarter sales from Catalysts Technologies were $328 million, down 11% from last year. Sales volumes and base pricing increased 12%, but were more than offset by lower rare earth surcharges and unfavorable currency translation totaling $82 million or 23% of sales. Sales volumes in base pricing of STC catalysts increased 12% year on year and 2% sequentially, largely due to strong growth in emerging regions. Sales of refinery catalysts in emerging regions increased 29% year over year.

Polypropylene catalyst sales grew strong double digits. However, polyethylene catalyst sales decreased due to continuing weakness for polyethylene plastics in Europe. Chemical catalyst sales, primarily for BDO production, were also strong contributors to segment growth.

Catalysts Technologies' gross margin was 41% for the quarter, an increase of 300 basis points, primarily due to improved base pricing and lower manufacturing costs. Segment operating margin increased 490 basis points to 31.3% due to higher gross margin, lower operating expenses, and higher earnings from our ART joint venture.

Our share of ART's net income was $5 million, up approximately $3 million from last year. For the year, ART's net income was up more than 20%, in line with our 2012 plan.

Looking ahead, we expect STC catalyst sales volumes to continue to grow in line with the historical growth of transportation fuels of 2% to 3%. Sales headwinds from rare earth will total almost $120 million in 2013, mostly in the first half. Polyolefin catalyst volumes are projected to grow in the mid- to high single digits as our customers with favored feedstock positions in North America and the Middle East continue to gain share with their customers.

Let's move to Materials Technologies on page 8. Fourth-quarter sales for Materials Technologies were $210 million, an increase of 3% from last year. Organic growth totaled 6%, partially offset by unfavorable currency translation. Sales in emerging regions increased 7% in the quarter to 43% of segment sales. We saw strong demand for engineered materials in China and Latin America, and increased demand for packaging technologies in developing Asian countries and Eastern Europe.

Gross margin was 34.3%, up 240 basis points, due to improved operating leverage and lower manufacturing costs. Segment operating margin was 18.9%, up 280 basis points, due to higher gross margin and lower operating expenses.

The Materials Technologies leadership team has made good progress improving the fundamentals of this business, and it is well positioned to deliver good sales and earnings growth in 2013.

Please turn to page 9 for Construction Products. Fourth-quarter sales for Construction Products were $259 million, an increase of 2%. Sales in North America declined 4% in total, with a 9% sales increase in specialty construction chemicals offset by a decrease in specialty building materials.

Sales volumes in Western Europe were down more than 10% due to continued market weakness and our earlier decisions to exit low-margin businesses in that region. Our restructuring actions over the past several years have reduced sales in Western Europe to less than 14% of total segment sales and improved gross margins and earnings in the region. We expect 2013 to be another down sales year in Western Europe and continue to focus on reducing costs in this business.

Emerging region sales grew a strong 20% year over year and now total 37% of segment sales. Latin America, the Middle East, and emerging Asia all posted double-digit sales growth in the quarter. In addition, the emerging regions in total are now accretive to segment operating margin.

Segment gross margin improved 340 basis points to 36.1% due to success recovering raw material cost increases as well as benefits from volume leverage and productivity gains. Segment operating income was up 53% year over year, and operating margin improved 410 basis points to 12.5% due to gross margin improvement and strong expense control.

2012 was Construction Products' best year for segment operating income since 2008, despite the slow recovery for North American construction spending and chronic weakness in Europe. We have improved operating margins to their 10-year average, although our US sales are still 29% below their peak. With continued improvement in North American construction spending and further penetration in the emerging regions, we believe this segment is well positioned for new levels of earnings.

Let's turn to our outlook on page 10. Our outlook for 2013 adjusted EBIT is $560 million to $580 million, an increase of 8% to 12% over 2012. We expect adjusted EBITDA to be $685 million to $705 million.

We think this is a balanced outlook. Our intent is to incorporate our best judgment about the opportunities and risks we have and to provide an outlook that is neither aggressive nor conservative. Here are some of our assumptions.

We expect full-year sales to be $3.2 billion to $3.3 billion, with organic growth of 6% to 8% and $120 million of sales headwinds, primarily from lower rare earth. Volume is expected to be a bigger component of organic growth in 2013 than pricing. We may see a tougher pricing environment in 2013 and are focused on productivity and supply chain actions to continue to improve margins.

We expect gross margin to be in the range of 36% to 38%. This is a 100-basis-point increase in our target range, driven by good results from our productivity initiatives. Similarly, we expect adjusted EBIT margin to improve about 100 basis points this year. We've planned for an average euro exchange rate of $1.29 for 2013, flat with our 2012 average. Currency may be less of a headwind in 2013, but currency volatility will still impact our results. The yen and real have weakened, which reduces the value of our sales and earnings in those currencies, and we have exposure to the Venezuelan bolivar. If the bolivar devalues in Q1 or Q2, as markets expect, we could have an impact of $2 million to $3 million to adjusted EBIT in that quarter. Obviously, we are trying to mitigate this, but options are limited.

Turning to taxes, we expect our 2013 effective tax rate (technical difficulty) with a cash tax rate of 14%. As you know, we've been working to maximize the present value of the US federal NOL will generate an emergence. We've also been able to increase the realizable value of our state NOLs based on growth in our US taxable income.

In Q4, we released $44 million of a previously accrued valuation allowance against our state NOLs. This benefited GAAP earnings in the quarter, but will increase our ETR going forward. The release of the valuation allowance had no material effect on Q4 adjusted EPS and no effect on adjusted free cash flow.

Based on assumed share price appreciation, we estimate about 78 million diluted shares outstanding for the full year. As you know, we are not able to offset the dilutive effects of our equity compensation programs until we emerge from bankruptcy.

Adjusted free cash flow should be over $400 million again, in line with our three-year target of over $1.2 billion. We expect full-year capital expenditures of $180 million to $200 million. We are investing more in our manufacturing operations, but the timing and size of those investments will be determined by our ongoing assessment of our growth opportunities. As implied by our sales outlook, we are modestly more cautious about the strength of the global macroenvironment and have adjusted our capital allocation in line with that.

Finally, we intend to make another accelerated contribution to our US pension plans. As you recall from prior discussions, this is a tax and earnings opportunity created by the timing of our emergence and is the best use of excess cash for now.

As we've discussed on earlier calls, 2012 had an unusual quarterly earnings pattern due to the effects of rare earth inventory accounting. Catalysts Technologies earnings in Q1 were significantly greater than normal, and its earnings in Q3 were significantly lower than normal.

2013 will be closer to our normal quarterly pattern. As a result, Catalysts Technologies' Q1 earnings will be down single digits from last year. For Grace, this means our first-half/second-half earnings split should be about 46%/54% compared with about 50%/50% in 2012.

Those are the details, but I want to give you a bigger picture, too. As Fred said earlier, we intend to achieve our earnings goals. Although the macroenvironment has been weaker than we expected a year ago, we have gross margin and operating margin opportunities that should keep earnings growing nicely. Our business fundamentals are solid, we're focused on our growth programs, and we're focused on our margins and cash flow.

With that, we will open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mike Ritzenthaler, Piper Jaffray.

Mike Ritzenthaler - *Piper Jaffray - Analyst*

Good morning, guys. Could you provide a bit more context around the decline in roofing materials? Was there some pull-forward from 4Q into 3Q sort of fiscal cliff related, or was it related to Sandy or something else?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Mike, this is Fred. It was really related to the past year and a half of mild winters that we had. So the inventory that was stocked at our distributors was heavy. So as they went into this cycle, they just didn't buy. Now, we will see what happens coming out of -- or going into 2013 with the superstorm Sandy and some of the ice storms that have happened, but it was really just that -- mild winter, distributors not buying as heavy.

Mike Ritzenthaler - *Piper Jaffray - Analyst*

I see, okay. And then in Construction Products, continuing to improve profitability, outpacing volumes, a phenomenon we've seen for a few quarters now, especially in Europe. How much more runway does the lower-margin pruning have? Is it something that continues to unfold through 2013?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes. I feel very good about the construction business prospects going forward, both on a margin basis as well. We tend to lag residential recovery in North America by nine months, maybe 12 months. We are starting -- as we're starting to see the residential recovery, I think that's going to bode well for 2013.

We have positioned the underlying business to continue to lever both the North America -- Europe, if there is -- I mean, we are not planning a bounce-back in European volume at all in 2013. If there's that bounce-back, we are positioned for that.

And then if you look around the globe in the emerging regions, what we have done in Brazil, what we have done in China on the cement side, what we've done in the rest of Asia, we're very well positioned there. so I feel very good. And as Hudson said in the opening remarks, on construction chemicals, we believe it's positioned to achieve new earning-type levels.

Mike Ritzenthaler - *Piper Jaffray - Analyst*

Okay. And then just one last one for me on the polyethylene catalysts. Do you think geographic exposure would be mitigated through these new products that you talked about in your prepared comments?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes. We announced -- if you look at our polypropylene side, those polypropylene sales were up significantly 2013 over 2012. And as we go into -- I'm sorry, 2012 over 2011. As we go into 2013, they become a bigger part of the overall portfolio.

I also think in the polyethylene side, we saw the phenomena, as China weakened, that polyethylene demand slowed down. And there's been a rebalancing to more advantaged feedstock regions, so -- which is North America, which we're very well positioned in on the polyethylene side, as well as the Middle East. So, again, we weathered 2012 well on that side of it, and we feel pretty good going into it, going into '13 here.

Mike Ritzenthaler - *Piper Jaffray - Analyst*

All right. Sounds great. Congratulations on a good year.

Operator

Chris Kovacs, Baird.

Chris Kovacs - *Robert W. Baird - Analyst*

Congratulations on the quarter, and thanks for taking my question. Just want to follow up on Mike's last question there. Can you remind us, I guess, how large polypropylene is today relative to polyethylene? And then your guidance I think really into next year was pretty favorable for polyolefin catalysts. So is that going to be largely polypropylene growth, or do you maybe have some more visibility into inventory levels at your polyethylene customers?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes, it's going to be both. We feel better that the polyethylene destocking has almost run its course. And so polyethylene catalyst will come back to normal type levels, as well as the acceleration in the polypropylene side. So, overall, as we look into 2013, we think our polyolefin, both polyethylene and polypropylene catalyst, specialty catalyst, will be in the range of 7% to 8% volume growth.

Chris Kovacs - *Robert W. Baird - Analyst*

Great. And then there's one more question. You kept 2014 EBITDA target the same, and then you took down revenues a little bit. And you mentioned some more opportunities maybe on the operating margin and gross margin side. Can you maybe just give us a quick overview of maybe some of the things you're looking at for 2013, some of the initiatives to cut costs even further?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes. Some of the key projects -- we spent a significant amount of our capital improving manufacturing operations in 2012. It paid even larger benefits than we thought, as referenced in that we are expanding our gross profit margin another 100 basis points from there. So as we go forward, we have a number of productivity projects on the manufacturing side that we will fund again this year. And we see from where we ended 2012 that we should be able to increase our adjusted EBIT margin another 200 basis points over that period of time. I also believe, as we look out to 2014, it should be a stronger year on the top line than we are forecasting 2013, just based on general economic conditions, as well as construction recovery in North America.

Chris Kovacs - *Robert W. Baird - Analyst*

Great. Thank you so much, and congratulations again.

Operator

Laurence Alexander, Jefferies.

Laurence Alexander - *Jefferies - Analyst*

Good morning. Two questions. First, on -- your CapEx for 2013 looks a little bit light, and you've also done a good job bringing down SG&A and R&D expense. To what extent are costs being pushed into 2014 or 2015? Should we see a bump in any of those line items?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

So for the capital in 2013, Laurence, we are up significantly over 2012. But a lot of it is the timing of projects. We are right now forecasted to break ground on the Abu Dhabi facility in the first quarter. We are doing the engineering now. That won't come online until mid-2015 or later on that side of it. So you've got a little bit of capital flowing from that side as well.

Hudson LaForce - *W. R. Grace & Co. - SVP and CFO*

Our construction cycles, just to build on Fred's point, our construction cycles are shorter than our customers' construction cycles. So we want to make sure that we are building our capacity at the right time and not too early.

Laurence Alexander - *Jefferies - Analyst*

And on the construction -- on your construction business, are you comfortable -- are you still comfortable that you will get some incremental margin expansion as we get a recovery in US housing?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes. We are. I mean, as we've said before, we are at a historical -- the historical margin levels, with volume especially in North America being down significantly. We would like this business to be in the 18% EBIT-type range, and we don't see any reason why it should not be.

Laurence Alexander - *Jefferies - Analyst*

Okay. And then finally, on your 2014 targets, you had some M&A included in that target. To what extent is that already accounted for, or is that still to come?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes, there's about in our earnings about $15 million of deals we have done already that are in the earnings so far. So the rest is to come.

Laurence Alexander - *Jefferies - Analyst*

Okay. Thank you.

Operator

(Operator Instructions). Mike Sison, KeyBanc.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Good morning, guys. Congrats on a great 2012. Just wanted to get a little bit of color on your outlook for catalyst, sort of the split between first half/second half. Is it largely due to the rare earth sort of impact in the first half? Are there maybe some customer maintenance stuff, maybe extra costs you have to do in terms of capacity expansion? Just a little bit of color there.

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes, you know, Mike, it really is. It's the inventory accounting related to rare earth on the earnings side. If you look at our FCC volume for 2012, at the end of the year, as the year shook out, we ended up just under 4% overall volume increase on FCC. As you know, we started the year a little bit slower because of the shutdowns.

As we go into 2013, we think our overall volume will be in the 5% to 6% range, which will track transportation fuels up 2% to 3%. So we are still right in that range. But what you're seeing on the earnings side, it's not turnarounds; it's really the impact of the rare earth accounting, how it's fallen out in these quarters.

Hudson LaForce - *W. R. Grace & Co. - SVP and CFO*

I'll add to Fred's comment, if I may. It's how the inventory flowed through in 2012.

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes.

Hudson LaForce - *W. R. Grace & Co. - SVP and CFO*

So, for example, if you go back to Q1 of 2011, I think Catalysts' earnings were, I want to say $73 million. Q1 last year, they were $99 million. And so as I said in my remarks, Mike, the Q1 was significantly higher than normal. Q3 was significantly lower. That's how the inventory accounting was flowing through. So when you get to Q2 -- sorry, Q1 of this year, more normal quarter, but compared to a very high quarter last year.

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Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay, great. And then your outlook on ART, what degree of growth can we see in 2013?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes, we feel good about it. Our volumes were up significantly for the year in 2012, and we think anywhere from 7% to 10% in the hydroprocessing area.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay, great. And then Materials Technologies continues to show pretty good improvement there in terms of profitability. It looks like you've gotten that business well back on track. What type of growth do you think we can see over the next couple years as maybe some of end markets start to recover?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

We've been generally a 2 times GDP, global GDP grower. And over a long period of time, that's what it averages. Last year, we suffered from -- we fell behind in Asia, as you know. We got our position back in Asia, as well as we had some operational issues that we corrected. So -- but over the long cycle, we are 2x on a global GDP grower.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay, great. Thank you.

Operator

Jim Barrett, CL King & Associates.

Jim Barrett - *CL King & Associates - Analyst*

Good morning, everyone. Fred, could you talk about your specialty chemical business for a moment in North America? Have your North American customers accepted your January price increase?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

You're talking on the construction specialty chemicals, Jim?

Jim Barrett - *CL King & Associates - Analyst*

Yes, I'm sorry, yes.

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

We are working very hard on that right now. As you know, the cement pricing has not settled out yet. Our customers went out with almost a 10%. That has not settled out. We think we will see that come to fruition by the end of the first quarter . We are, as I said, working very hard on that.

Jim Barrett - *CL King & Associates - Analyst*

Okay. And has your competition within North America followed your lead on that price increase?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

I'm not -- Jim, I really don't know where they are at.

Jim Barrett - *CL King & Associates - Analyst*

Okay. And then, sort of a related but broader question. You mentioned pricing appears to be getting more challenging in 2013. Is that confined to Europe, or could you elaborate where you see at least directional pricing pressure in your core businesses?

Fred Festa - *W. R. Grace & Co. - Chairman and CEO*

Yes, I think it's -- your instincts are correct. Europe is definitely, definitely more challenging on the pricing side, as well as Southeast Asia. As you are seeing some of the recovery come back, you're seeing some fundamental capacity come back online on the underlying raw materials, which have the effect of dampening some of the effects of the pricing. So that's the balance we are seeing. In North America, we think we are fairly well positioned.

Jim Barrett - *CL King & Associates - Analyst*

Okay. Well, thank you very much.

Operator

Ladies and gentlemen, I will now turn the call over to Mr. Mark Sutherland for closing remarks.

Mark Sutherland - *W. R. Grace & Co. - VP of IR*

Thank you to all of you who listened this morning to our remarks. I'd like to leave you my personal number for any follow-up questions or clarification. That number is 410-531-4590. And again, we thank you for your time this morning. Goodbye.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. You may now disconnect. Have a great day.
