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GRA - Q1 2012 W. R. Grace & Co. Earnings Conference Call

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OVERVIEW:

GRA reported 1Q12 sales of $754m and adjusted diluted EPS of $0.88.

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CORPORATE PARTICIPANTS

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

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

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Rob Walker *Jefferies & Company - Analyst*

Mike Sison *KeyBanc Capital Markets - Analyst*

Chris Shaw *Monness, Crespi, Hardt & Co. - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the first quarter 2012 W.R. Grace & Company earnings conference call. My name is Keith and I will be your operator for today. At this time all participants are in a listen-only mode. Later on, we will conduct a question-and-answer session.

(Operator Instructions)

As a reminder, today's conference is being recorded for replay purposes. And I would now like to turn the conference over to your host for today, Mr. Mark Sutherland, Vice President, Investor Relations. Please go ahead, sir.

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

Thank you, Keith, and good morning, everyone, and thank you for joining us today, April 25, 2012 for a discussion of Grace's first quarter 2012 results released this morning. Joining me on today's call are Fred Festa, Grace's Chairman and Chief Executive Officer; and Hudson La Force, 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 hand corner of the page. As you know, some 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 detail on the risks that could impact Grace's future operating results and financial condition. 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 question-and-answer. 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 will turn the call over to Fred.

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

Good. Thanks, Mark. Hello, everyone. Thank you for joining us this morning. We are off to a good start in 2012. We performed well in the quarter, led by the results in our Catalysts Technologies and Construction Products segments. For the quarter, sales increased 8% to $754 million, gross margins improved 40 basis points to 36.7%, adjusted EBIT increased 16% to $111 million, and adjusted EBITDA margin improved 70 basis points to 18.7%. We also saw good sequential improvement across our businesses. Hudson will walk you through the details shortly.

It was a busy first quarter. First we divided the Grace Davison business into two operating segments, Catalyst Technologies and Material Technologies. We are now reporting our financial results in three operating segments, these two plus the Construction Products group.

Catalyst Technologies is now the home for all of our catalyst businesses, including refining catalysts and additives, polyolefin catalysts, and chemical catalysts. Our hydroprocessing joint venture is managed in this segment as well. By combining all of our catalyst activities into a single unit, we have enhanced our critical mass in terms of research, innovation, and customer reach. And this will enable us to do what we do best -- anticipate customer needs and increase the value of their business. Additionally, we believe this will increase the public recognition of Grace as the industry leading innovator and manufacturer of specialty catalysts.

In moving from two segments to three, we are actually simplifying our Organization as well. We are moving to a more closely integrated operating structure we call it One Grace, where our manufacturing, supply chain, and functional support services are being consolidated. As a result, we have taken a restructuring charge this quarter of approximately $3 million, as we eliminate some redundancies. This restructuring will provide cost savings of just under $6 million this year and about $10 million in annual savings in 2013. These savings were anticipated in our 2012 outlook and the 2014 target.

I am challenging our leaders to continue to find ways to move the business forward. We have had some good examples to share from the past quarter. We signed a memorandum of understanding to form a joint venture in Abu Dhabi to build a new catalyst and additives plant for Middle East and South Asian opportunities. We project growth of $150 million over the next five years from new refineries in the region. We established a partnership with Dow which includes licensing to develop new polypropylene catalysts, which will enable producers to improve plastic performance, including clarity, stiffness, and impact strength. We announced a successful clinical trial for a novel use of silica for drug delivery. The innovation came out of our Discovery Sciences product group, a component of the Materials Technologies segment. This development showcases how we apply our historical silica applications expertise to new and potentially large addressable markets. These are all exciting developments. You will be hearing about more opportunities like these in the future as we continue to advance our business.

I would also like to update you on the bankruptcy. We are currently in a delay due to the courtroom tactics of one of the appellates. This appellate filed a motion with the US District Court requesting the judge to take a third look at their appeal, which has all -- already been denied by two federal judges. The filing of this appellate's motion had the effect of suspending the 30 day clock during which further appeals to our plan of reorganization must be filed. The judge, as is his prerogative, has elected to hear oral arguments on the motion on May 1. Once he issues his opinion, 30 day clock will start for any further appeals. There have been two appeals filed to date. One is by the creditor group over the default interest issue and the other is by the Canadian government. We will wait to see all the appeals before assessing whether we can emerge with appeals outstanding.

Separately, we have finished the definitive agreements on the settlement with the Libby claimants and related parties. We filed the motion with the bankruptcy court for their approval, which is fully expected. On our last call, we noted that this settlement eliminates any further appeals from the Libby-related parties. While these delay are frustrating, please be assured that it has minimal impact on how we run our business. We continue to grow through new product innovation and increased presence in emerging regions. We are investing capital for business growth and productivity improvement and we have a good pipeline of bolt-on M&A candidates.

In closing, I am confident in our Company's ability to grow earnings this year, as well as meet our longer term goals. With that, I will turn the call over to Hudson.

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

Thank you, Fred. Please turn to page 5 and we will start with a quick review of Grace's overall results for the quarter. Sales increased 8% due to improved pricing and higher sales volumes while currency translation was unfavorable. Six points of the improved pricing was due to base price increases achieved across all three of our businesses with two points due to the rare earth surcharges in our Refining Technologies product group. This was one of the strongest pricing quarters we have had in some time. Gross profit increased 10% year-on-year and gross margin was 36.7%, up 40 basis points year-on-year and up 180 basis points sequentially. Adjusted EBIT increased 16% to $111 million, driven by higher sales, improved gross margins, and higher equity income from our ART joint venture.

Adjusted EBIT margin increased 100 basis points to 14.8% and adjusted EBITDA margin improved to 18.7%, an increase of 70 basis points year-on-year and 190 basis points sequentially. Adjusted free cash flow was $32 million for the quarter compared with a $20 million use of cash in the prior year period. The year-over-year increase in cash flow was due to lower income tax payments, improved working capital performance, and increased earnings. Adjusted EBIT return on invested capital was 35% on a trailing four quarter basis compared with 28% in the prior year quarter. Adjusted EPS increased 13% to $0.88 per diluted share. As detailed in the appendix to this presentation, we adjusted EPS for Chapter 11 and asbestos-related costs and for restructuring charges incurred during the quarter.

This is the first quarter we have reported results using our new operating segment structure. We provided an 8-K on April 2, which included quarterly and annual financial results for 2010 and 2011 for the new segments. We provided a minor update to this information in an 8-KA filed April 19. This information is the basis for all prior period comparisons in our discussion today. So, let's begin with Catalyst Technologies on page 6.

Catalyst Technologies includes the Refining Technologies product group and the Specialty Catalysts product group. Our share of ART's earnings is included in this segment. First quarter sales for Catalyst Technologies were $313 million, up 14% from the prior year quarter. The increase was due to improved pricing, which more than offset lower sales volumes and currency. Our FCC catalysts business achieved a double increase in sales, driven by higher base pricing for our lower rare earth FCC catalysts. As you know, these products have higher base prices and better margins than the products they have replaced. We saw weaker volumes in refining catalysts due to the slow downs in North American refinery operations during the quarter, particularly on the US East Coast and some lumpiness in customer order patterns. We also had a tougher than usual compare against 11% volume growth in the prior year quarter when we launched our lower rare earth FCC catalysts.

Sales volumes and pricing for our polyolefin and chemical catalysts business increased during the quarter. Polyethylene catalyst sales volumes increased 5% with strong demand in all regions. Polypropylene catalyst sales volumes increased 13% due to increased penetration with key customers. Our hydroprocessing catalyst joint venture performed very well in the quarter. Demand for ART catalysts was strong, driven by continued diesel demand and increased processing of resid feedstock. ART sales, which are not consolidated, increased 19% due to better sales volumes and product mix. Our share of ART's net income grew to $6 million, up $2 million from last year. Catalyst Technologies gross profit increased 19%. Segment gross margin was 42% compared with 40% last year and 38% in the 2011 fourth quarter. Segment operating income grew 27% on higher sales and improved gross margin. Segment operating margin was 31.7%, an improvement of 340 basis points compared with last year and 530 basis points sequentially.

Let's turn to page 7 to discuss the impact of rare earth on our catalyst sales for the rest of the year. The chart on the left shows the average China export price for rare earths and the chart on the right shows the year-over-year change in rare earth prices. As we said in our February call, lower rare earth surcharges will be a headwind to sales this year. Based on current rare earth prices, we expect the full year sales headwind to be about $170 million and we expect Q1 to be the last quarter of favorable impacts to sales from the surcharges. Starting in Q2, we expect the surcharge to be unfavorable to sales and significantly so in Q3. As a result, it is possible that we will report negative year-on-year sales growth for Catalyst Technologies in Q2 and it is likely that we will do so in Q3.

With the decline in rare earth costs, we are often asked about customers switching back to previous generation product technologies. We have not seen this yet. Approximately 85% of our customers continue to use at least one of our lower rare earth products. While rare earth costs have declined, they are still three to four times their previous levels. Also, customers are reporting performance improvements from the new products compared with the previous generation technology so there are performance reasons to continue with the newer technologies.

Let's move to Materials Technologies on page 8. Materials Technologies includes three product groups -- Engineered Materials, Discovery Sciences, and Packaging Technologies. First quarter sales for Materials Technologies were $213 million, an increase of 0.2% compared with the prior year quarter. Improved pricing offset lower sales volumes and unfavorable currency translation. Packaging sales increased approximately 11% due to improved pricing and increased sales volumes in closures, can sealants and can coatings. Packaging volumes increased in all regions. In Asia, rapid adoption of the Company's non-PVC closures and can coatings helped increased sales volumes. We had lower sales volumes in Engineered Materials particularly for matting applications in Asia.

The China coatings market slowed late last year and into this year and we have seen some destocking of our products as a result. Segment gross margin was 31.7% compared with 33.8% in the prior year quarter and 31.9% in the 2011 fourth quarter. The decrease in gross margin compared with the prior year quarter primarily reflected lower volumes in Engineered Materials and higher manufacturing costs. Segment operating margin was 16.8%, a decrease of 220 basis points compared with the prior year quarter which showed an increase of 70 basis points sequentially. We are not satisfied with the results in our Materials Technologies business and we have a detailed improvement plan in place, including targeted sales increases and improvements in margins. We expect Materials Technologies sales and earnings to be up for the year and we expect sequential improvement in sales and earnings in Q2.

Please turn to page 9 for Construction Products. First quarter sales for Construction Products were $228 million, an increase of 10% compared with last year. The increase was due to higher sales volumes and improved pricing, partially offset by unfavorable currency translation. Last year's third quarter acquisition of De Neef Conchem Group contributed $8 million to sales, which more than offset a $5 million decline in sales due to the Q4 2011 divesture of the vermiculite business. Construction Products achieved its sixth consecutive quarter of year-on-year sales growth. Sales in the emerging regions, which represented 33% of sales in Q1, increased 24% due to strong sales performance of our concrete chemicals in Latin America, the Middle East, and emerging Asia. Sales in North America, which represented 41% of sales, increased 6%. Western Europe, which represented 16% of sales, declined 2% compared with the prior year quarter.

Segment gross profit increased 12%. Segment gross margin of 34.2% improved 50 basis points compared with the prior year quarter and 150 basis points sequentially. The increase in gross margin compared with the prior year quarter was due to higher volume, improved pricing and favorable product mix. Segment operating income was $20 million, compared with $16 million for the prior year quarter, a 26% increase due to higher sales and improved gross margin. Segment operating margin improved to 9% compared with 7.9% in the prior year quarter and 8.4% in the 2011 fourth quarter. This was the segment's fifth consecutive quarter of year-on-year improvement in operating income. The mild winter in North America was clearly favorable to Q1 construction activity. As always, we won't have a good read on the full year until later in Q2 when we can assess the strength of the traditional construction season. We will certainly give you that update in our next call.

A few final notes before we open the call for your questions. On taxes, our book ETR for the year is estimated to be 33% but we focus more on our cash tax rate, which was 9% in the first quarter. We expect US taxable income to continue to increase over time, which may increase our ETR, but will maximize the present value of the NOLs we generate at emergence. Adjusted free cash flow improved more than $52 million from last year, primarily reflecting lower cash tax payments, improved working capital performance, and higher earnings. Our inventory days increased during Q1 as we prepared for significant scheduled maintenance turnarounds in Q2. We fully expect inventory days to return to target levels over the course of the year. Our year-end target for net working capital days is 53 days, down 10% from year-end 2011. In February, we made the planned accelerated contribution of $83 million to our US pension plan. As you may recall, this contribution provides significant immediate cash tax benefits and a very attractive IRR. The benefits of this accelerated contribution were anticipated in our February outlook.

Last, I want to give you some additional detail on our quarterly earnings profile for the year. As you know, is it not our practice to provide quarterly guidance or to update our annual guidance each quarter but we want to be transparent about a change we were expecting in our quarterly earnings pattern. Our outlook is unchanged from our February call. We continue to expect adjusted EBIT in the range of $510 million to $530 million and adjusted EBITDA in the range of $630 million to $650 million. But our quarterly earnings profile will be different this year than in 2011. Our earnings typically rise from Q1 to Q2, peak in Q3, and decline in Q4. Because of various factors, including year-over-year currency differences and the way rare earth impacts our financials, we currently expect earnings to rise from Q1 to Q2 as usual and then be approximately equivalent from Q2 to Q3 and Q3 to Q4.

As Fred said early in our call, we feel good about the quarter, and we like how we are positioned at this point in the year. We saw good sales growth from improved pricing and volumes and are expecting better volumes as the year progresses. We saw good margin improvement year-on-year and sequentially, and characteristically, we had good cash flow performance and high returns on invested capital. Our investments and productivity efforts are producing the results we wanted and our innovation efforts continue to produce new opportunities for us. With that, we will open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Laurence Alexander with Jefferies.

Rob Walker - *Jefferies & Company - Analyst*

This is Rob Walker on for Laurence. (multiple speakers) I guess the first question, just to clarify -- and thanks for the color on the seasonality -- do you still expect Q1, though, to be -- typically it's been around 20% of annual earnings, is there any reason that should not play out this year as well?

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

Well, Rob, we have our Q1 actuals and we have given you the full year outlook. I honestly haven't done the percentage math myself but the full year outlook is the $510 million to $530 million.

Rob Walker - *Jefferies & Company - Analyst*

Okay. And then qualitatively on that outlook, it sounds like raw materials might be slightly higher headwind than you expected, but pricing this quarter seems to be stronger than your expectation for the year?

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

Yes, Rob, this is Fred. I mean, we are getting a little of that headwind from the petrochemical base as a result of oil. But our position and our value based pricing is -- was very good in Q1. So there is no reason to think that we will not be able to sustain that going through the year.

Rob Walker - *Jefferies & Company - Analyst*

Okay. And then on the Refining Technologies side. I guess, do you still expect, I guess in terms of volume growth do you expect to see volume growth in FCC this year? And do you think the base pricing increases you are seeing are sustainable over the course of the year in terms of percentage?

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

Yes. On a volume basis, again, as you know that the first quarter has been a tumultuous quarter, and we will see what happens in the second quarter based on the refinery turnarounds and shut downs and so on. But we are expecting the global -- our global FCC volume to increase year-over-year. It would be in the single digit range. And we expect the base pricing to continue to increase as well as we continue to roll out these new products that are having better performance, and we have got that factored in, in our thinking and our outlook.

Rob Walker - *Jefferies & Company - Analyst*

Great and then just the last question I had was on Materials Technologies kind of weakness this quarter, I guess how much profit growth roughly are you expecting from new wins in the life science area this year and next year? And I guess, are those being offset by increased competition? Is that why we are not maybe seeing those right away?

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

No. What you are seeing in the materials side is you are seeing some of the -- especially in the silica side -- what you are seeing is the result of two factors. One, we saw some softness coming out of the year in Asia around that whole coatings and matting segment. That coupled with -- through the second half of last year, we brought on three major new capacities. We increased our Sorocaba engineered material silica volume. We increased our Guangdong facility and we increased our Duren facility. Those cost additions that we brought in and with the softness in volume are exasperating the margin side. As we are going into the second quarter and as we look throughout the year, as Hudson said on the call, we think we are going to be able to grow the Materials earnings this year versus last year. And we think there is going to be a recovery in both the silica volume as well as the profitability.

Rob Walker - *Jefferies & Company - Analyst*

Great. Thanks.

Operator

And your next question is from the line of Mike Sison with Keybanc. Please go ahead.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Nice quarter. (multiple speakers) In terms of the normal seasonality 2Q versus 1Q, it's tended to have pretty strong growth over the last couple of years. Is there any reason that delta -- that type of strength would not occur or maybe could it be stronger? Can you give us a little bit more of a feel how 2Q versus 1Q will be?

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

Mike we have said what we were are going to say this morning. It's -- we are not expecting anything changing in terms of our business operations. But the way currency and rare earth is running through the P&L it is causing a different pattern. But it's about these kind of non-operating factors, not operating factors.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Got it. No. And I understand. In terms of, in Catalyst Technologies, the base pricing continues to be pretty impressive there in the first quarter. When does that start to see the sort of tougher headwinds? Is that in the second quarter? And third quarter?

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

On base pricing?

Mike Sison - *KeyBanc Capital Markets - Analyst*

Yes.

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

We don't expect to see headwinds on base pricing.

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

I mean, Mike, this is Fred. I mean, it really is about the technology. We really, truly believe that the value that we bring to these new catalysts and continued development of these new catalysts, we can continue to increase our base price for these catalysts. Now, as Hudson said, you have this big whipsaw on the revenue side on the surcharge, particularly in the third quarter, but on the base price, no, we think there is still opportunities.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. So that will still remain a positive as the year unfolds?

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

Yes, it will, Mike.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. And then in terms of Grace Materials Technologies, Fred, when you think about that business as we head into the next couple of years, where would you like to see those margins improve to, based on what you are trying to do this year to right size some the cost?

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

Yes, it's really not even about right sizing the costs. It's really about growing the volume into the expansions we have had. Historically, this business has been in the 34% to the 36% margin -- gross profit margin range. I would expect us moving toward that path by the end of this year.

It's a couple of factors. If you look at it on the renewables where we put in the volume expansion in Sorocaba. I mean, in Brazil, as you know, they cut back on the bioethanol dramatically as the sugar cane crop was curtailed last year. That's had an impact. However, in the first quarter the Brazilian government announced they will subsidize to get the anethanol back in February. So it's a timing of those events. I'm not concerned about the first quarter. We have got good products. We have got good applications. The investments are put in there. And we will catch back up.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Right. And last question. On the last call you noted 2014 goal of $850 million of EBITDA. Based on what you're -- I know it's a little bit early -- but based on what you did in the first quarter and your outlook for the rest of the year, do you still feel pretty good about that progression over the next couple of years?

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

Yes. I mean, we do. We feel very good about it. I mean, we put that out there with all the insight that we had at that point in time. Listen, as you know, as we go through the year, we will continue -- we will give you updates on how we feel. It's traditionally in the third quarter. So, but, I like how we started. There is still a lot of volatility out there, as you know, in the general economic climate. But I like how we started.

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

There are a lot of the long-term growth opportunities that are starting to come together for us, Mike. And some of those you saw this quarter with the catalyst joint venture in the Middle East and some of the other things we have talked about.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Great. Thank you.

Operator

(Operator Instructions) And your next question is from the line of Chris Shaw with Monness, Crespi, Hardt. Please go ahead.

Chris Shaw - *Monness, Crespi, Hardt & Co. - Analyst*

I guess the first question, outside of Construction Products whose margins I would expect to increase sequentially. But are the margins you saw in the other two segments -- Catalysts and Materials -- do you believe they are sustainable throughout the year?

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

Yes, this is Fred. And Hudson, I will ask you to jump in if you want. Yes, I mean, in the Catalysts business absolutely. And we are expecting to increase our margins throughout the year in the Materials segment.

Chris Shaw - *Monness, Crespi, Hardt & Co. - Analyst*

Okay. And then I guess talking about FCCs again and the new products. The pricing seems like it is coming from the new low rare earth and such. But are there new products again for this year? Or is just that family of low rare earth is sort of flowing through this year or new ones that are coming on as well?

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

Obviously, the lower rare earth products were a major new product launched last year, but the business model we have in this business is continuously improving our product portfolio. And so there is a constant introduction of new products and new formulations for individual customers, and that engine is working very well for us right now.

Chris Shaw - *Monness, Crespi, Hardt & Co. - Analyst*

So you would just tweak them again this year and improve the efficiency and then you'd be able to price them higher again?

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

It's a continuous process. And we do use that as an opportunity to keep our technology fresh and we do use that as an opportunity to sustain our margins.

Chris Shaw - *Monness, Crespi, Hardt & Co. - Analyst*

Okay, and then just finally, what is the Canadian government's appeal on the bankruptcy?

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

Oh, it's more of a procedural appeal on how much recovery they can get initially from the trust on their claims. So it's, as I said, it's really a procedural appeal. What percentage of a claim they can get reimbursed immediately versus over time.

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

It doesn't affect, economically, Grace, but it is a process issue that we are having to deal with.

Chris Shaw - *Monness, Crespi, Hardt & Co. - Analyst*

Okay, great, thanks a lot.

Operator

And ladies and gentlemen, we have no other questions. So I would like to turn it back over to Mr. Sutherland for closing remarks.

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

Thank you, Keith. And I just wanted to thank everyone who dialed in this morning, and remind you that if there are any follow-up questions, my contact information appears on our website and on the -- one of the pages of our PowerPoint presentation. So thank you very much. And we will be glad to wrap up this morning's call.

Operator

All right. Ladies and gentlemen, that concludes today's conference. Thank you for joining us today and you may now disconnect. Everyone have a great day.
