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GRA - Q2 2013 W. R. Grace & Co. Earnings Conference Call

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OVERVIEW:

GRA reported 2Q13 sales of $803m and adjusted EPS of $1.12. Expects 2013 sales to be just over $3.1b.

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Mike Sison *KeyBanc Capital Markets - Analyst*

Mike Ritzenthaler *Piper Jaffray & Co - Analyst*

Brian Maguire *Goldman Sachs - Analyst*

Rob Walker *Jefferies & Company - Analyst*

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

Ben Kallo *Robert W. Baird & Company, Inc - Analyst*

Jim Barrett *C.L. King & Associates - Analyst*

Chris Kapsch *Topeka Capital Markets - Analyst*

Patrick Duff *Gilder, Gagnon, However & Co. - Analyst*

PRESENTATION

Operator

A very good morning, ladies and gentlemen. Thank you very much for joining us, and welcome to the second quarter 2013 W. R. Grace & Co Earnings Conference Call. My name is Lisa and I'll be your event coordinator today.

At this time all participants are in listen-only mode. Following the Company's remarks, we will conduct a question-and-answer session, and instructions will be provided at that time for you to queue up for questions. (Operator Instructions). Also, I'd like to remind you, this conference is being recorded for replay purposes.

I would now like to turn the conference over to Mr. Mark Sutherland, who is the Vice President of Investor Relations. Please proceed. Thank you.

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

And thank you, Lisa. Hello, everyone, and thank you for joining us today, July 25th, 2013, for a discussion of Grace's second quarter 2013 results, 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, 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 Security 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 condition.

We will also disclose 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 answers.

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 & Company - Chairman and CEO*

Great. Thanks, Mark, and good morning to everyone, and thanks for joining us. As you saw in our release, the second quarter came in as we expected. Sales grew organically 2%. Gross margin improved 100 basis points to 37.8%. Adjusted EBIT and EBITDA margins increased to 17.7% and 21.6% respectively. Adjusted free cash flow increased to $157 million for the -- for this first six months.

Each segment contributed and executed well in a challenging environment. Catalysts Technologies posted solid results, with segment earnings growing 22% from the first quarter. As you recall, the first quarter was impacted significantly by customer operational issues and order delays that are now behind us. Segment gross margin increased to 42%.

Materials Technologies sales grew more than 4% organically and 8% in the emerging regions. Segment margins are ahead of target for the first six months, with gross margin just over 34% and operating margin at 20%.

Construction Products continued to grow nicely, driven by improved construction spending and increased penetration of our high-value waterproofing products. Construction Products sales grew more than 5% organically and 12% in the emerging regions. Segment earnings increased 28%.

Materials Technology and Construction Products are on track to deliver mid single-digit sales increases and solid double-digit earnings growth for the year.

Unfortunately, Catalysts Technologies is not on the track we wanted. In March we announced changes to our FCC catalyst pricing, which included eliminating the rare earth surcharge pricing mechanism and increasing the resulting new base price 10% as contracts allowed.

This increase was intended to support Grace's continued investment in new product development, technical service, and manufacturing capability. We noted that this pricing initiative would be a multi-quarter process of negotiations with our customers. We projected some volume loss as customers exercised their negotiating prerogative to trial alternative catalyst.

We are now four months into the initiative, and it is clear that our objectives will not be achieved at this time. Based upon actions observed in the marketplace, we believe that industry competitors are using our pricing initiative as an opportunity to aggressively increase their sales volumes. Since the March announcement, we have lost about $60 million in annualized sales volume, or about 7% of our annual FCC catalyst sales.

This loss is more than we forecasted and more than we are willing to accept. We have not withdrawn our price increase, but it is clear that we will have to wait for the introduction and acceptance of our higher-value new products, improved industry dynamics, before we can benefit from significantly improved pricing.

We continue to expect FCC catalyst capacity to tighten in 2014 due to new refinery startups, the increased need of propylene for petrochemical feedstocks, and other actions. We think industry utilization will be above 90% next year, and expect this to be a key driver of improved industry dynamics in 2014.

We remain focused on the fundamentals that make this business so successful, and play to our strengths -- namely, providing the best product technologies and services available in the market, at prices that allow us to make long-term investments in this business.

To that end, over the next two quarters we are introducing seven new catalyst and additive technologies that target the unique performance requirements of our customers. This includes three new products targeted for shale oil feeds, two new products for heavy resid feeds, and two new products for improved propylene production.

These are significant new product technologies customers are demanding, and I am personally very excited by the value they will create for our customers and for Grace. We expect these new technologies to be an important lever for Grace to recover the sales volumes we have lost.

As you know, our refining customers face high complexity in their operating environments, with a broad range of potential crude sources and increased demands for environmentally-friendly fuels and petrochemical feedstocks. Improvement in catalyst technology are often the best solution to our customers' challenges, and we are focused on ensuring our technology provides the highest value possible.

In addition, we are taking concrete steps to optimize our catalyst manufacturing operations. Specifically, we are permanently shutting down our silica sol manufacturing capacity in the third quarter. We have advised affected customers that we will be moving them to appropriate current-generation technology.

Although we're disappointed that our pricing initiative did not achieve its objectives, our refining catalyst business remains highly profitable and strategically strong. At the end of this transition, we expect that we will have restored our historical sales volumes at higher total value, with lower manufacturing costs, and the exact same focus -- with the exact same focus on product technology and our customers.

Let's discuss how this impacts our 2014 goals. To recap, about two years ago we set a goal of $850 million in adjusted EBITDA by 2014, which included $50 million from bolt-on acquisitions.

Since that time, we have achieved many of our sales and earnings growth objectives, including completing three acquisitions. We are on a pace to achieve the goals for our growth programs, and are ahead of our expectations for productivity.

Offsetting this progress, however, has been a significantly weaker global macroeconomic environment, operating challenges in our FCC catalyst business, and headwinds from pension and currency. The new challenges in our FCC catalyst business and a downgraded assessment of the global macroeconomic environment for 2014, have eliminated all of the remaining contingency we had in our 2014 adjusted EBITDA goal. As a result, we no longer see a reasonable path to achieve this goal.

It is too early for us to give an outlook for 2014, but we think there is up to $30 million to $40 million of risk to our goal, reflecting the net effects of lower earnings in Catalysts Technology, a weaker macroeconomic environment, the benefit from the change in pension accounting, and an appropriate contingency for unforeseen events.

One final comment regarding our Chapter 11 emergence. Oral arguments for the five pending appeals were heard on June 17th before the Third Circuit Court in Philadelphia.

At this point we are simply waiting for the judges to issue their ruling, and doing what we can to prepare for emergence. In fact, just yesterday the Court ruled in our favor with respect to the Garlock Sealing Technologies appeal. We remain confident that we will receive favorable rulings on the other appeals, and continue to target emergence by year end.

I'll now turn the call over to Hudson to provide more specifics on the quarter and our 2013 outlook.

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

Thank you, Fred. Please turn to pages 4 and 5, and we'll start with a quick review of Grace's overall results for the quarter. Second quarter sales were $803 million, down 3% from last year.

Pricing decreased 2.5% due to lower rare earth surcharges, and currency translation was unfavorable 1.5%. Volumes increased 1%. Gross margin improved 100 basis points to 37.8% due to lower raw material and manufacturing costs. Adjusted EBIT was $142 million, down 1% from last year, as lower sales more than offset lower raw material and manufacturing costs.

Adjusted EBIT margin increased 30 basis points to 17.7%, and adjusted EBITDA margin increased 50 basis points to 21.5%. Adjusted free cash flow increased 6% to $156 million for the first six months, primarily driven by improved working capital performance.

Adjusted EBIT return on invested capital declined to 34% from 36%, reflecting lower earnings in Catalysts Technologies over the last four quarters. Adjusted EPS was $1.12, based on diluted shares of 77.6 million.

Let's turn to Catalysts Technologies on pages 7 and 8. Second quarter sales for Catalysts Technologies were $291 million, down 12% from last year. Pricing decreased 9%, driven by lower rare earth surcharges. Sales volumes decreased 2%, reflecting the scheduled conclusion of a multi-year toll manufacturing contract for a polyolefin catalyst customer, partially offset by higher chemical catalyst sales. Refinery catalyst sales volumes were unchanged.

Catalysts Technologies gross margin was 42% for the quarter, an increase of 170 basis points, primarily due to lower raw material and manufacturing costs. Segment operating income was $94 million, down 7%.

Segment operating margin increased 170 basis points to 32.2% as lower manufacturing costs and higher ART earnings more than offset lower sales. Our share of ART's net income was $9 million, up $6 million from the prior year quarter. Q2 will be ART's strongest quarter this year.

As Fred noted in his remarks, our FCC pricing initiative has not achieved its objectives at this time. We have lost about $60 million in annualized sales volumes since announcing the pricing initiative in March. We expect Q3 sales to be about $20 million below Q2's level.

We also expect a sequential decrease in segment operating margins of about 4%, reflecting negative operating leverage and lower ART earnings due to its lumpy order pattern. Overall, Catalysts Technologies earnings in Q3 will be below Q1 levels.

For the full year, we expect sales to be down about $130 million from lower rare earth surcharges, lower sales volumes, and lower base pricing. We now expect segment gross margin to be about 41%, flat with last year. Segment operating income will be down more than 10%.

We expect sales volumes to recover, beginning in Q4, based on the expected success of our new products and anticipated refinery startups.

Given this, we are taking specific actions to improve our returns in this business. First, we continue to drive our technology roadmap hard, and recognize this as the best driver of value for our customers and for us. The new products, designed for light feed, resid feed, resid to propylene production, and other specific applications, are exciting and are part of our strategy to recover lost sales volumes.

Second, we are permanently shutting our silica sol production capacity in Lake Charles this quarter. We expect to take a non-cash charge of $3 million to $4 million in Q3 for the writedown of these manufacturing assets. We expect to reduce total manufacturing costs by over $2 million per year as a result of this capacity closure.

Silica sol, the old products, are about 1% of our refining catalyst sales, but have been a significantly higher percentage of our available manufacturing capacity.

The catalyst business has had its share of volatility in the last three years, including the spike in rare earth costs in 2010 and 2011, refinery closures in 2011 and 2012, and the increase in competitive intensity this year.

Although this volatility has had an impact on quarter-to-quarter earnings, the business continues to produce very high returns. Since 2010, we have increased our Catalysts Technologies gross margin by more than 400 basis points, and adjusted EBITDA margin by about 600 basis points.

We remain bullish on our opportunity to further increase our returns, and will do so through new product technologies, improved pricing, as industry conditions allow, and improved manufacturing productivity.

Let's turn to Materials Technologies on page 9. Second quarter sales for Materials Technologies were $229 million, an increase of 2% from last year. Increased pricing of 2.5%, and higher sales volumes of 2%, were offset by unfavorable currency translation.

Sales in emerging regions increased 4.5%, and 8% organically, due to strong growth in emerging Asia. Sales in advanced regions were flat with last year, as 4% growth in Europe offset declines in North America.

In North America, sales of packaging products, particularly can sealants, were unfavorably impacted by lower demand for canned beverages due to the wet spring. Segment gross margin was 33.7%, an increase of 20 basis points compared with the prior year quarter.

Gross margins declined sequentially due to a purposeful manufacturing strategy adopted in the first quarter, as we noted in our Q1 commentary. Gross margin for the first half was 34.4%, an increase of 180 basis points from the prior year period, and above our current target for the business. Segment operating income was $45 million, down 3%, largely due to the timing of certain annual operating expenses and unfavorable currency impacts.

Please turn to page 10 for Construction Products. Second quarter sales for Construction Products were $283 million, up over 3% from the strong year-ago quarter. Higher sales volumes of 4% and improved pricing of 2%, more than offset unfavorable currency translation, largely from the Brazilian real and Japanese yen.

Emerging regions represented 36% of segment sales for the quarter and grew a strong 12% year over year, mostly due to growth in emerging Asia and Latin America.

Sales in North America, which are 40% of segment sales, were unchanged in Q2, as a 5% increase in specialty building materials sales offset a 3% decrease in specialty construction chemicals. Unusually wet weather in North America may have slowed construction activity and reduced demand for cement and concrete chemicals during the quarter.

Sales in Western Europe, which are 14% of segment sales, decreased 4% for the quarter; but earnings grew nicely, reflecting continued success in improving gross margins and reducing costs. Notably, sales especially of building materials increased 7% due to major project starts in the region.

Segment gross margin improved 170 basis points to 36.8% due to improved pricing and the benefits of higher-volume leverage. Segment operating income was up 28%, and operating margin increased 300 basis points to 16%. This is our highest segment operating margin since the 2008 second quarter.

One final point before we turn to the 2013 outlook. We have decided to adopt the mark-to-market accounting method for our pension plans. As you know, many of our peers have already made this change.

This change has been on our pension management roadmap since 2010, and we decided to make the change at this time for two reasons. First, with our March accelerated contribution, we have achieved much of the funding and derisking objectives that are the foundation of our pension management roadmap. And second, because of the recent change in expectations for long-term interest rates.

When adopted in the fourth quarter, this new method will reduce our 2013 pension expense, excluding the effects of the annual mark-to-market adjustment by about $45 million compared with the current accounting method. To ensure you can properly and easily reflect the change in your models, we will issue an 8-K in the fourth quarter, summarizing the effect on the 2009 to 2013 full years, and the 2012 and 2013 quarters.

Let's now discuss our updated outlook for 2013. We are updating our range for adjusted EBIT to $560 million to $570 million, and for adjusted EBITDA to $685 million to $695 million.

There are two significant changes to our 2013 outlook. First, we expect Catalysts Technologies sales to be down from our earlier expectations, due to lower sales volumes in the second half and lower realization on our pricing initiative. We expect segment operating income to be about -- to be down about $35 million from our prior outlook. Offsetting this is lower pension expense of about $45 million due to the change in accounting method in Q4.

In total, we now expect 2013 sales to be just over $3.1 billion, with an organic growth rate of about 3% for the year. The year-over-year sales headwind from lower rare earth and currency is about $130 million. The year-over-year decline from lower catalyst sales volumes is an additional $40 million.

We continue to expect gross margin to be in the high end of our 36% to 38% range. Adjusted free cash flow should be over $400 million again, in line with our three-year target of over $1.2 billion. Please continue to use a book effective tax rate of 34% on adjusted earnings and a cash tax rate of 14%.

Diluted shares outstanding at year end should be about 78 million shares.

On an operating basis, our updated 2013 outlook is clearly lower than our April outlook. We don't like lowering our outlook, but we believe being transparent with you is more important. Our intent always is to incorporate our best judgment about the opportunities and risks we have, and to provide an outlook that is as accurate and balanced as possible.

Despite the near-term challenges, our business fundamentals remain solid. We have great businesses managed by strong teams, with great growth opportunities, exceptional margins, high cash flow, and high returns on capital.

With that, we'll open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mike Sison, KeyBanc Capital Markets.

Mike Sison - *KeyBanc Capital Markets - Analyst*

In terms of the losses on FCC due to the price increases, it's pretty big. And are you suggesting to some degree that competitors are not increasing prices to keep -- to sort of -- for the new trial volumes, and that it's unlikely you'll be able to sort of get that back, into 2014?

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

Yes, Mike. This is Fred. Yes, we are. I mean, what we've seen is that -- we have seen our competitors not increase pricing, and take some volume during this period of time. I mean, what we really believe is that we need to present some new products, which we're doing. Those new products will be available for trials as well as contracts in -- over the next three- to six-month period of time. And we'll work our way back, given that.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. And, given that, I don't recall competitors having a lot of capacity. If they actually keep this business, as new business comes up for the new plants in 2014, would you be better positioned to pick that up at better pricing, given that you'd have the sort of excess supply, if you will, and that would probably be more of a positive, longer-term, for you?

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

We hope so, yes. It would be. It would be a positive from that standpoint. You know, when you look at the industry dynamics around FCC -- I mean, we've been in the catalyst business a long time. Right? And I've been at Grace ten years. And we've seen this happen one or two times before. And -- where markets get a little bit out of balance.

But generally, the suppliers of catalyst have a goal of increasing their margins over time; getting their returns up. And that's done, in the FCC business, based on value provided to our customers, and based on continuing to provide those values.

So, we believe that the share ratio will level back out. We're at our low end of our historical range for our share. We believe it will level back out over time.

But we believe that the way to do that is through acceleration of new products, which we're doing; the adoption of those new products; and then finally, the proof of the value as our customers run those new products, that allow pricing to be gained.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. And then, last question. If you're successful in terms of generating the new products and winning some of this trial business back heading into '14 as new business comes back, does the outlook that you've provided us in the past for Catalysts is that something that is achievable, let's say, in '15?

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

Yes. I mean, what's -- yes, is the answer to that. I mean, what the gating factors are, is, you know, on how quick we can get the volume back, is based on how quick the adoption of these new products are.

The other factor is, how quick can we get -- how quick can we prove the value of these new products out there, as they're in the units? That will allow us to capture the pricing and the value that our customers are getting, and that we deserve.

So, that's the accordion in this thing. How quick could it happen, and so on. And we're trying to put our best judgment out there at this point in time.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. Great. Thank you.

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

Mike, I'll just add that the other point that you made in your question was around tighter capacity going forward. We do still see that occurring, and that is all part of this improved industry dynamic that Fred's talking about.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. Great. Thank you.

Operator

Mike Ritzenthaler, Piper Jaffray.

Mike Ritzenthaler - *Piper Jaffray & Co - Analyst*

I'd like -- I'm curious a little bit about the -- how the challenges with the price increases have modulated across the various geographies, or if there is any noticeable difference.

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

Yes. I would -- Mike, I would say that it's really based -- two primary regions, one here in the US and one in Southeast Asia. I mean, that's where the biggest effects have been.

Mike Ritzenthaler - *Piper Jaffray & Co - Analyst*

Okay. But less so in Europe? I guess that's a bit surprising.

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

Yes. Yes. Yes. Less so in Europe than the Middle East. That's right.

Mike Ritzenthaler - *Piper Jaffray & Co - Analyst*

Okay. I'd like to then dive a bit into the strengths and weaknesses in Construction Products. I guess, a little surprised by poor FCC sales in North America, given some of the competitor numbers that are out there, and the number of repair projects that are ongoing.

And I guess the -- as a follow-up to that, looking at the margin improvement on the cost line, is that a fair characterization, that it's costs productivity-related, and is it likely to continue?

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

Yes. Let me put it into a couple different perspectives. We -- in Europe we do have a repair business, which is doing well. However, in North America we're really not in the concrete repair business at all. So, we haven't seen that piece of it.

We do believe that -- our volume in construction chemicals, especially in North America, is tied to a lot of commercial activity. We're seeing that pick up. That productivity that we've embedded in it, will sustain. So, those margins that we're talking about -- we feel very, very good about.

And we're -- as we looked at it, coming out of the second quarter, we do believe that the weather did have an impact, with all the rain and so on. In the regions where we're strong, there wasn't a lot of pouring. As we see the weather starting to improve, we're seeing improvements, just starting even in the third quarter, as July -- the first two weeks of July.

So, I am very bullish, and I feel very good about our construction business. Not only that we've restructured it, and from a productivity standpoint, both in Europe as well as getting the leverage in North America, the position we have in the emerging markets, and it -- the bounce-back is coming here.

Mike Ritzenthaler - *Piper Jaffray & Co - Analyst*

Okay. Just one last one from me, on the new technologies in refining catalysts, I guess in shale blending in particular. Can you describe a bit about your process for coming up with these new products, and how customers pull them in, or how you identify these opportunities? Just a little bit on the philosophy side there.

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

Yes. I mean, through this last three months, as you can imagine, we've had a lot of conversations with our customers -- probably more than we would have liked to have, given some of the losses. But through all those conversations, we asked them, what do you need? What do you want? And that prioritized down the list.

And on the shale blending, they are blending shale. They may have some straight shale that are running. And they would like to have us -- which they're not seeing out there now -- a product in the marketplace that can handle some of the metals as well as be -- as well as get the activity that they need. So, as I said, it's really been based on those discussions.

Now, why do we feel good about that? We know there are a significant amount of trials coming up in the next six months where we can introduce these products to their units, as well as other competitive bids. So, there's the combination of those two.

Mike Ritzenthaler - *Piper Jaffray & Co - Analyst*

All right. Super. Thank you, guys.

Operator

Brian Maguire, Goldman Sachs.

Brian Maguire - *Goldman Sachs - Analyst*

I was curious, on the refining volume losses that you're seeing from trialing of other competitor materials -- is that more on the low value-added, or what you'd consider the low value-added, low-margin part of the portfolio? Or is it more broad and widespread than that?

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

Well, just to recap, we did achieve some pricing. And I would call it the high value-added customers. So, we did -- even the pricing we went out with, we did achieve some pricing. Where we did see the volume loss, your characterization is correct -- it's more on less complex, less value-oriented buyers.

Brian Maguire - *Goldman Sachs - Analyst*

Does that have a -- I understand there'll be some fixed cost absorption issues. But other than that, will there be some margin benefit, then, to that volume mix shift, a bit?

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

We hope so. We hope so, for us, moving forward on this. I mean, from -- as -- well, we look at it as, we've had this underutilized silica sol asset. That's a low-value product. Customers are moving away from silica sol very quickly. They're not getting the activity that's needed out there.

For us, we want to shut that capacity down, take the financial benefit of removing those fixed costs that we had to absorb, and really move this product slate to what our customers want.

Brian Maguire - *Goldman Sachs - Analyst*

And do you have a targeted cost savings number for the rationalization of that plant?

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

Yes. I think it was $2 million to $3 million on that side of it; plus we're looking at across the system of our other assets around the catalysts from an optimization side, and there may be another $2 million to $3 million in the scheme of things.

Brian Maguire - *Goldman Sachs - Analyst*

Okay. Thanks.

Operator

Laurence Alexander, Jefferies.

Rob Walker - *Jefferies & Company - Analyst*

This is Rob Walker, on for Laurence. I guess as you think about your -- the new seven, new technologies that you've incorporated into the -- this current new line of catalysts -- as you think about that as -- collectively, how does that compare to -- in terms of, from a technology standpoint, kind of a yield uplift to -- when you guys came out with the low to no rare earth catalysts, those were clearly very favorably received. Do the new products deliver comparable yield uplifts? Are they more evolutionary?

And can you talk about the overall R&D pipeline in that business, and your confidence to be able to achieve more yield with further generations?

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

Yes. I would characterize it this way. I would say that the shale -- the lighter -- is more of an evolutionary new product that's coming out. I would look at our propylene yield -- that is truly a new product that will benefit on the yield standpoint. That activity on that catalyst will be significantly higher than our current ZSM-5-type catalysts that are out there. And we're excited about that side of it, and we're very excited to get that in the units.

On the resid -- on the cracking, the heavy, the resid -- that's just another typical product step that we make.

We -- listen, we feel good about those products. We feel confident about the products. If we could accelerate it, the acceleration's going to be based on how quickly we can get them into these units to get the trials out.

Rob Walker - *Jefferies & Company - Analyst*

And given the increased pushback, I guess relative to maybe your initial expectations, can you guys pull forward more R&D to try to create more value with -- to make the conversation easier?

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

Well, that's exactly what we're doing. I mean, we've shifted, student body right on the technology side, moving people from other business areas into the R&D technologies area for the FCC, just to do that side of it. I mean, that's been the last six weeks; as well as reconfiguring some of the operations to be able to run these trial runs very quickly.

Rob Walker - *Jefferies & Company - Analyst*

Great. Thank you. And then just briefly, any update to your free cash flow guidance? I guess, before, you talked about 2012 to 2014 being greater than $1.2 billion on an adjusted basis. Any change there? And I guess, can you talk about what allows you to keep your free cash flow guidance this year, unchanged?

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

That's still our expectation, Rob. As sales volumes come down, working capital requirements come down naturally. And we did have some -- we thought we would do better than $400 million this year. We know we'll still hit $400 million.

I guess the other thing I should say is, we are going to cut back a little bit on capital spending this year, really driven more by a reassessment of the macro environment into next year. As you know, we work hard to make sure that we're spending our capital at the right time. And so, we are going to delay some projects until we see the macro environment firm up.

Rob Walker - *Jefferies & Company - Analyst*

Thank you.

Operator

Chris Shaw, Monness, Crespi.

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

I'm going to ask about the $60 million on the catalysts again. I just want to make that's all that's anticipated volume loss -- none of it's sort of the anticipation of not getting pricing in that number?

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

That's all volume.

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

And you've characterized some of it, I think, as customers using trial volumes of competitor product. Does that -- how -- if that's the case, I mean, do the customers typically -- is there a trial period, and then they make a decision? Or the $60 million -- that $60 million number reflect that you don't think those people trialing are going to come back to you guys afterwards, or --?

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

Yes. Well, it is a combination. There are trials that are out there, but there are actual accounts that -- we had these accounts, and because of the raising of the pricing -- because of the undercutting of the pricing -- that we lost that volume.

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

Okay. And then just on the pension, is the $45 million impact -- would that be a sort of similar impact for 2014, or do you think that -- does that -- that's -- fluctuate one way or the other?

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

No, that's what we've got in our model for 2014 too.

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

Okay. Great. Thank you.

Operator

(Operator Instructions). Ben Kallo, Robert W. Baird.

Ben Kallo - *Robert W. Baird & Company, Inc - Analyst*

Hi, Fred. Overall, on the catalyst business -- I think you've touched on this all, but it sounds like it's becoming more competitive, and people are willing to cut on price. Is -- do you think this is because of your competitors', maybe, weakness -- characterize it like that -- in their business units? And do you see it persisting? Or does that just -- is it ebb and flow? And then, as I think about Al Dahra, is there any change there in how you look at expanding capacity?

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

Yes. Just to answer the second first, around the Al Dahra -- and that's the new plant in the venture in Abu Dhabi -- no, we don't see it -- this phenomenon impacting that at all. I don't know what -- we've been through these cycles before, and there's a lot of factors that move a seller of a catalyst; and some may not be related to the catalyst business at all.

So, I really couldn't speculate that. I know that catalyst suppliers want to continue to move their margins up, and the only way to do that is through value -- providing value to our customers, through -- and helping them solve their issues.

Ben Kallo - *Robert W. Baird & Company, Inc - Analyst*

I guess, big picture -- you're -- I think you're ten years deep into this bankruptcy navigation. As you think about, whether it's Q4 or Q1, or some time next year, emerging, I guess, where do you see yourself, and what direction do you think you take the Company from here?

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

Well, we've done a nice job of separating the two -- the bankruptcy side of it, from the growth. And I don't see any reason -- whether we emerge -- as we emerge here shortly, that we won't continue on the path of growing this Company, in the platforms we have. We've had nice growth in Construction by going into emerging regions with new products. We've got some new technology on the horizon on that side of it.

If you think of the Engineered Materials, it's been the same. It's been the same with some new products, as we've expanded in the discovery science of it, and the bio -- in the bioscience side as well.

And then you look at catalyst. Catalyst, where we built out our propylene -- our polypropylene franchise, where it was only polyethylene, what, a half a dozen years ago. And we have expanded the capacity on the hydrocracking side and got into that business, and run the hydroprocessing. So, I continue to see it -- we'll continue to push this playbook.

Ben Kallo - *Robert W. Baird & Company, Inc - Analyst*

And my final one -- maybe, Hudson, as I look at the construction side of the business, how much more leverage is there, if we get up to -- can you give us a little thought on where operating margins can go?

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

We've said, we think we get to high teens -- 18%, 19%-type teens, once we're back to that peak spending levels in North America. And I think I -- if you look over the last four quarters -- I might be off a quarter or two there, but the last few quarters, we've seen fantastic flow-through on the volume increase in North America. It's -- we're seeing high 30s, even 40%, incremental margins.

And we think that will continue. That's part of what we saw in Q2. And we're not back to peak. We're not going to be back to peak next year -- probably even the year after that. But that's the earnings potential in this business.

Ben Kallo - *Robert W. Baird & Company, Inc - Analyst*

Thanks, guys.

Operator

Jim Barrett, C.L. King & Associates.

Jim Barrett - *C.L. King & Associates - Analyst*

Fred, a question for you -- is the price reaction in FCC catalysts -- is it one competitor who is reacting, or is it two or more?

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

Well, I think there's only three basic competitors.

Jim Barrett - *C.L. King & Associates - Analyst*

Right. Only three. Understood. Yes. So, that way -- I guess, then, it would be the -- have two competitors not followed your lead, or just one?

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

No, it's -- I mean, Jim, it's generally the industry. I'm not going to single out anybody on this call.

Jim Barrett - *C.L. King & Associates - Analyst*

Well, I was really more interested in whether it was multiple competitors or just one competitor who is not following your lead. But, sort of a related question -- of your seven new products, if they meet your sales targets, can you give us some general sense of what percentage of your sales they would represent on a normalized basis as we look to 2014, maybe 2015?

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

Jim, we're not going to be that specific. But I will tell you, these are more significant new product introductions than we typically have. More -- you know, much more. Significantly more than we typically have; but not nearly the impact that we saw from the rare earth catalysts a couple of years ago.

Jim Barrett - *C.L. King & Associates - Analyst*

That's helpful. And the final question, Hudson -- if I'm reading the comments on the pension accounting correctly, I understand it's non-cash; but should I conclude that, going forward, your GAAP pension expense will fairly approximate your cash pension expense going forward in '14, '15?

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

It will -- yes. There will still be some differences, Jim. But the two numbers will be much, much closer.

Jim Barrett - *C.L. King & Associates - Analyst*

Okay. Okay, well, thank you both very much.

Operator

Chris Kapsch, Topeka Capital Markets.

Chris Kapsch - *Topeka Capital Markets - Analyst*

Just -- don't want to beat this one to death, but did want to follow up on the competitive dynamic in the FCC space, given what's happened on your pricing initiative. So, just curious if the -- if -- based on what you're saying, if you're sort of abandoning the price increase initiative on your core products, notwithstanding your comments about positioning newer products later in the year to try to regain some of this lost market share?

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

I mean, Chris, we're not. I mean, the -- we've initiated some product pricing; we have got some of that product pricing. I think it's a matter of timing. So, that's not off the table. But to achieve that product pricing, our customers want to know, okay, give me additional value then. Give me -- what's that value play I'm going to get? And that's got to -- that's through the products -- the new products.

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

We've tried to be very clear that we remain focused on improving the returns in this business. We're doing it the way that we've done it for 70 years, which is to drive value for our customers through new products. And we're also reducing our manufacturing costs at the same time. That's the equation.

Chris Kapsch - *Topeka Capital Markets - Analyst*

Got you. And then -- so, one of the innovations that you've brought to the table over the last couple of years, when rare earth prices went through the boom/bust cycle, was the reduced lanthanum content products, which you migrated your customers to.

And so, I'm wondering, now that lanthanum prices have sort of more normalized back to historic levels, is there any demand or mix shift from your customers, trying to shift back towards the sort of older or higher lanthanum containing products as a way to -- for them to achieve higher activity levels or better yields?

And then I'm wondering if that's playing into the dynamic whatsoever, in terms of the increased competitiveness that you've alluded to, or any of the share shifts that are taking place?

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

Yes -- no. I've -- some have requested products that contain a higher level. But we really don't believe that that has any impact on the share loss that has occurred. It's in specific isolated accounts, and so on.

Chris Kapsch - *Topeka Capital Markets - Analyst*

Okay. And then if I could just follow up on -- the contribution from ART in the quarter was -- just wondering if that strong earnings performance from the JV -- was that more seasonally related, or -- obviously, that business, more hydroprocessing tends to be lumpier and not consumable like FCC.

So, I'm wondering if the performance there was just some lumpiness in order shipments, or -- I think you called out that being down sequentially for the balance of the year, versus these second quarter levels. Could you speak to that in any way?

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

It's a combination. It's a combination, Chris. There is a lumpiness to this business, as you pointed out. And that was -- that's part of what we're seeing. This Q2 was the -- will be the strongest quarter for this year. I think we were comparing to the weakest, or maybe one of the weaker quarters last year, on the base business.

We're also seeing very nice progress with our commercial agreement on hydrocracking catalysts.

And we -- and when we look at ART for the full year, we see it up strong double digits. I think we've said, up 20% for the year. We're having a good HPC catalyst year, and the hydrocracking agreement -- commercial agreement, is working well for us.

Chris Kapsch - *Topeka Capital Markets - Analyst*

Okay. Thanks, guys.

Operator

Mike Sison, KeyBanc Capital Markets.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Just a follow-up. I guess if you had a do-over, would it have made sense to maybe raise prices a little bit less on the FCC business, versus what you did? Or -- to sort of protect some of that volume?

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

Yes. It was -- yes is the answer to it. I mean, if I had a do-over, I would do it a little bit differently. Maybe I would have brought out some of the new products first. But, yes is the answer.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Is there a change in the way customers -- I mean, because I can't imagine the trialing products are better -- superior than yours, for what it's worth. In addition, given you're the incumbent, you tend to have the better sort of feel, if you will, in terms of how to optimize the plants. Are they willing to take maybe a slightly less good catalyst for a better price?

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

No, I don't really think there was -- there is any change in the customer behavior. I think this is an abnormality that manifested itself at a higher degree than -- these happen all the time. I think it just -- they've happened in the past. I think it just manifested itself at a higher level than it has in the past, just because of certain circumstances. That's all. But the customer behavior really hasn't changed.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. So, the bottom line is, as you roll out these new products and you start getting some trialing of some of these incumbent business, or maybe some other areas -- as we head into '14, if you're successful we should see maybe a similar commentary that you have volume winds that could carry some growth next year.

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

That's what we believe, and that -- we will -- we believe that we will [reap] -- the share levels across the industry will come back to equilibrium, and our share will be based on what it's been.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. And then on the bankruptcy, you had one win. The -- any update on the timing, judging, going forward?

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

No. I mean, we were surprised -- not by -- not surprised by the result; just surprised by the timing. As you know, the opinions on these appeals have been all coming at once. And we're cautiously optimistic that maybe the judges are working on them all. And they make -- they may not wait for them all to be done, and they may come out this way. So, this -- so, it's encouraging.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Great. Thanks, guys.

Operator

(Operator Instructions). Patrick Duff, Gilder.

Patrick Duff - *Gilder, Gagnon, However & Co. - Analyst*

Most of the questions I was going to ask, I think have been addressed. Just a couple of, I mean, small things here. Any update or insight on the Lummus joint venture that was announced last year -- how that's going so far; what results you're seeing in the market with the enhanced relationship with them?

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

Pat, this -- when -- I referred to it as the commercial agreement on hydrocracking when we were talking about ART. But that's the agreement that we're talking about. It's going well. It's an important part of our ART earnings growth this quarter. We're off to a good start. We're quite pleased with it.

Patrick Duff - *Gilder, Gagnon, However & Co. - Analyst*

Right. Great. And this might not be the forum, but I'm just going to take the opportunity to ask, considering the continued buildup of the free cash flow, and you've all been public about how you plan to use your balance sheet post-emergence -- I'm just wondering if you've considered, similar to the arrangement that you struck with the warrants, whether or not you have considered having any discussion with any financial intermediaries for -- I mean, I know you cannot go in and do any repurchases of the stock. But, whether or not you've considered doing any kind of phantom repurchases through derivatives or what have you, to try and set up a predetermined price at which you might repurchase stock in the -- post-emergence?

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

Pat, it's a fair question. We look at a lot of different things to optimize our balance sheet, our operations, our capital structure; but nothing that we could comment on at this point.

Patrick Duff - *Gilder, Gagnon, However & Co. - Analyst*

Okay. And then just lastly, I mean, you -- Fred, you touched upon the fact that you were a little bit surprised with the timing of the Garlock ruling. And, to the best of my knowledge, I don't believe -- as you said, they've always been blanket rulings.

I don't want to be any kind of pessimist, but is there any reason to think that any of the other rulings are getting enhanced scrutiny by the Third Circuit as opposed to earlier courts, to -- any cautionary thoughts about this?

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

I -- we don't think so. I mean, we really don't. We think -- as we've said before, we thought these opinions would take three months to come out. This one came out in four weeks -- five weeks. So, we look at that as an encouragement, that these -- that judges are working on these.

Patrick Duff - *Gilder, Gagnon, However & Co. - Analyst*

Okay, great. All right. Thanks a lot, guys. Good luck.

Operator

Chris Shaw, Monness, Crespi.

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

Just one follow-up, just to continue to beat the FCC dead horse. But, do you think -- was there -- was the price negotiation any trickier because of getting rid of the metal surcharge? And I'd actually somewhat thought, maybe because, with metals prices coming down, that overall pricing was coming down, and that they wouldn't be as sensitive to your price increase. But, was there any dynamic there with the metal surcharge and all, that you could see?

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

I don't think so, Chris. It's -- we've been pretty transparent with our customers on this over the last few years. They're sophisticated. And there's a careful communication, careful analysis, that has to happen. But I don't think it affected decisions.

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

Thanks.

Operator

So, ladies and gentlemen, that now concludes your question-and-answer session. I would now like to turn the conference over to Mr. Mark Sutherland for closing remarks.

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

Yes. So, thank you, Lisa. And I'd just like to say thank you to all of you who signed on this morning and heard our comments. I'm available for direct follow-up. My direct line is 410-531-4590. And we'll be in touch with you throughout the quarter. Thank you.

Operator

Thank you very much. Ladies and gentlemen, that concludes today's conference. You may now disconnect your lines. Have a good day. Thank you.