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GRA - Q4 2015 W. R. Grace & Co Earnings Call

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OVERVIEW:

Co. reported 4Q15 sales of $759m. Adjusted diluted EPS for 2015 was $4.78 and 4Q15 was $1.40. Expects 2016 adjusted EPS to be $3.02-3.21.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the W. R. Grace & Company's fourth-quarter 2015 earnings conference call. (Operator Instructions) As a reminder, today's call is being recorded.

I would now like to introduce Tania Almond, Investor Relations Officer. You have the floor, ma'am.

Tania Almond - *W. R. Grace & Co. - IR Officer*

Thank you, Andrew. Hello, everyone, and thank you for joining us today on February 11, 2016. With me on the call are Fred Festa, Grace's Chairman and Chief Executive Officer; and Hudson La Force, currently our Chief Operating Officer and Chief Financial Officer.

Our earnings release and corresponding presentation are available on our website. To download copies, go to grace.com and click on investors.

Some of our comments today will be forward-looking and are made under Section 27A under the Securities Act and Section 21E of the Exchange Act. 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 discuss certain non-GAAP financial measures, which are described in more detail in this morning's earnings 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 as well as the Q&A.

As a result of the spinoff of GCP Applied Technologies, we have already released some preliminary fourth-quarter and full-year 2015 data. Additionally, we held an investor day just two weeks ago, where we reviewed our performance, strategies, growth opportunities, and 2016 outlook. You can access the replay of this investor day and the associated presentations from the investors section of our website.

Because of these previous communications, we will take a streamlined approach to our prepared remarks on this call. We will start with Hudson to review the quarter and provide some updates following the spin and then go to Fred to touch on some of the key topics from our investor day and for some closing remarks. Then we'll open it up for Q&A.

With that, I'll hand the call over to Hudson.

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

Thank you, Tania; and good morning, everyone. Grace's fourth-quarter sales were $759 million, down 6% as reported and up 2% adjusting for currency in Venezuela. Currency in Venezuela reduced sales by $62 million or 8%.

Adjusted EBIT was $171 million, up 2% as reported and up 10% at constant currency. Adjusted EBIT margin was 22.6%, up 170 basis points over last year.

Adjusted EPS for the quarter was $1.40 per diluted share, up 2% from last year and up 12% at constant currency. For the full year, adjusted EBIT was $619 million, down 1% as reported and up 8% at constant currency. Adjusted EPS was $4.78 per diluted share, up 8% from last year and up 20% at constant currency.

Adjusted free cash flow was $437 million. And adjusted EBIT ROIC was 32% compared to 31% a year ago, up 110 basis points, driven by good working capital management.

Now that the spin is complete, we are transitioning our reporting from old Grace to new Grace. This morning's release is for old Grace. Our comments on Q4 and 2015 will refer to old Grace, while our comments on 2016 will refer to new Grace only.

Starting with Q1 results, Grace and GCP will report results separately. Now that GCP is an independent company, we will limit our comments on their results. As you may have noted, GCP has announced a call to review their results next week on February 18.

As part of this transition, we are revising our historical financials to reflect the spinoff. Earlier this week, we filed an 8-K that included the revised financials for Grace for 2013 and 2014 and the nine months ended September 2015. We are finalizing Q4 now, and we'll report those revisions as soon as they are available.

When we begin reporting 2016 results, we will compare 2016 to these revised financial statements for 2015. We know this is a lot to digest, and we're happy to answer questions about the 8-K or revised financial statements this morning.

Let's turn to catalysts technologies on page 7 of our presentation. Q4 last year was a very strong volume and margin quarter for catalysts, with strong specialty catalyst sales and high licensing revenue. This Q4, catalysts sales volumes were up slightly, and licensing revenue was lower.

Adjusted gross margin was down 260 basis points compared to last year's very high level. This Q4, at 43.1%, still very strong gross margin performance. Adjusted EBITDA margin was over 38% for the quarter and almost 36% for the full year.

Let's move to materials technologies on page 8. Materials technologies had a solid quarter, with sales volumes up almost 5% and earnings up 23% at constant currency. Sales volumes grew in North America, Europe, the Middle East, and Latin America; but declined in China and the rest of Asia. Gross margins expanded to 37.5%, up 120 basis points compared with the prior-year quarter. Adjusted EBITDA margin was almost 27% and almost 26% for the full year.

Please turn to page 9 for construction products. Construction products also had a solid quarter, with sales volume up more than 3%. Sales were up 8% North America and double digits in the emerging regions. Gross margin increased 110 basis points to over 38%. The increase was primarily due to higher sales volumes, improved pricing, and favorable product mix.

Let me touch on a few capital allocation items, and then we'll review our outlook. Last week we paid down $500 million of secured debt versus the $750 million we assumed in our investor day materials. We decided to keep $250 million to give us additional flexibility for growth investments or share repurchase. This doesn't change our net debt level but will increase interest expense a bit for 2016.

In the fourth quarter we spent $81 million for share repurchase, and for the full year we spent about $300 million. We have about $200 million remaining on our current share repurchase authorization.

And last, as a reminder, we have announced that our Board has approved a policy of paying a regular quarterly cash dividend at an initial annual rate of $0.68 per share. We expect to declare the first quarterly dividend equal to $0.17 per share in connection with the release of our first-quarter 2016 earnings, with payment expected during the second quarter.

Let's review our 2016 outlook, and then I will turn the call over to Fred. We expect 2016 adjusted EBIT to be in the range of $400 million to $420 million, adjusted EBITDA to be in the range of $500 million to $520 million, and adjusted EPS to be in the range of $3.02 to $3.21 per share. This assumes an average of $1.10 per euro for the year.

Our outlook also assumes slow but continuing global demand growth. Our underlying global GDP assumption is 2.7%. At current exchange rates, the full-year currency headwind will not be significant, but for the first quarter the earnings headwind will be in the low to mid-single-digit millions.

We expect 2016 adjusted free cash flow to be approximately $250 million, including the favorable impact of our low cash tax rate. As you know, we have US federal income tax attributes totaling almost $1.7 billion on a pretax basis that will reduce our US cash taxes by over $600 million through 2021. These tax attributes are worth about $8 per share today.

As we discussed at our investor day, we expect catalysts technologies earnings to be up mid-single digits for the year. We expect Q1 to be flat to last year, with earnings improving sequentially each quarter during the year, driven by increasing sales volumes. We expect specialty catalysts to grow faster than refining catalysts, and we expect ART earnings be flat for the year.

We expect materials technologies earnings to grow mid- to high single digits for the year. We expect Q1 earnings to be flat to last year. Adjusting for the spin, materials technologies earnings were about $24 million last Q1.

For full-year 2016, we expect corporate costs to be about $65 million to $70 million and pension expense to be about $20 million. The 8-K shows higher corporate costs for Grace in 2015, but those amounts are on a discontinued operations basis and do not reflect the restructuring actions and other cost reductions completed in 2015. While earnings will be weighted to the second half, we expect cash flow to be balanced during the year, with roughly half of our adjusted free cash flow in the first half of the year.

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

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

Great, thanks, Hudson. I'd just like to recap on a couple of topics that were touched on investor day that seemed to get a lot of attention and questions. First, we announced that we had shut down 10,000 tons of FCC catalyst capacity at our Curtis Bay plant. It's about 1% to 2% of industry capacity.

For those of you who were not as familiar with the chemical industry, from time to time companies will eliminate capacity when returns do not justify operating that capacity. In our case, this was our least efficient refining catalyst capacity; and by eliminating the associated fixed costs and other operating costs at the plant and shedding our least profitable business, we can shutter this capacity without reducing earnings. We think this is the necessary investment to generate the overall returns we want in our FCC catalyst business.

Importantly, we still have capacity to do selective catalyst trials with those customers that value our catalyst technology. We have a very flexible global manufacturing footprint, including two very efficient plants -- one in Worms, Germany; the other in Lake Charles, Louisiana; and a new plant on the drawing board in the Middle East.

You know, as we have said before, we'll continue to lead with technology investments and process knowledge that brings tremendous value to our refining customers across the globe. Second, we laid out a five-year view of our capital spending that highlighted the high-return growth investment opportunities that we have. At a time of increased uncertainty about the pace of global demand, properly timing these investments are critical.

As we have always done, we'll watch the industry environment and our customers' investment decisions closely and time our capital investments accordingly. Timing changes could reduce capital up to $25 million to $40 million in any given year. The five-year view should be thought of as the high end of the range for each year.

Third, we've demonstrated that we can execute well in a tough global environment by leveraging our product technology, disciplined productivity focus, and flexible portfolio. While slower growth in Asia has reduced expectations for 2016, we are continuing with key product introductions in catalysts and materials to support our growth objectives.

Lastly, cost restructuring actions we took in 2015 and the rigorous approach we have taken to building a lower-cost organization following the spin position us well. We start 2016 with a lean cost structure, and cost productivity will continue to be an earnings growth driver during the year.

One final point I'd like to cover. I'm sure you saw the announcement last week promoting Hudson to Chief Operating Officer. Hudson is now responsible for our catalysts technologies, materials technologies business segments, our global manufacturing and supply chain operations.

This morning we announced that our new CFO will be Tom Blaser. Today is Tom's first day with us, and he'll officially take over the CFO role once we file our 10-K at the end of this month. We're thrilled to have Tom join the team. He's a proven leader with strong specialty chemical industry experience with global companies.

With that, we'll open it up for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brian McGuire, Goldman Sachs.

Brian McGuire - *Goldman Sachs - Analyst*

If I look at slide 7 on the presentation, it looks like the catalyst pricing was down about 1%, but it looks like half of that was due to just lower metal pass-throughs. Just wondering if you could kind of talk about the other down 0.5%, and how much of an impact that trialing or lower licensing income versus a year ago kind of had there? And what was -- if you stripped out all those things, what would kind of core pricing look like?

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

Yes, I mean, core pricing would have been flat, Brian. Flat to, actually, slightly up. I mean, there was some mix on the specialty catalysts between polyethylene and polypropylene, as well as a little bit on trials. But just slightly positive it would have been, stripping those out.

Brian McGuire - *Goldman Sachs - Analyst*

Okay, great. I'm sure you saw, one of your big competitors announced a big price increase for FCC catalysts earlier this week. Just wondering if you plan to kind of match that in the industry -- what kind of reaction you have to that?

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

Well, you know, two weeks ago I talked about my view of the FCC and the value that we -- and the other suppliers of FCC catalysts -- had provided over the past 24 months. I think I was very clear that I felt that the value we provided and the price that we've gotten paid for that -- there's a little bit of a mismatch on that side of it.

So we will continue, as I laid out at investor day, a very disciplined approach to capture that value. About a third of our contracts turn over every year. We've got a process to look at each of those to match, to make sure we're matching: do we have the right catalysts? How are we getting the right value in that account? And we're going to go at it one by one.

Seeing the Albemarle's announcement is just recognition across the industry. Because, again, it's just not us. I think all of us have provided extreme -- a lot of value. I guess, again, I think it's going to be positive for the industry.

Brian McGuire - *Goldman Sachs - Analyst*

Okay. And just one quick one on the management changes, if I could sneak it in. Congratulations to Hudson and to Tom. But just thinking bigger-picture about it, is this -- should we think about it as part of some kind of longer-term succession planning? And Fred, do you have any particular goals in mind for -- does this have any impact to how you see yourself with the Company over the medium-term?

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

Well, I hope not. I hope my Board thinks the same. But no, I think -- you know, I like the role that -- when we created it, Chief Operating Officer role, when we created it for Greg a few years ago. And my focus will continue to be on strategically positioning the Company. And allowing Hudson on the operations side and Tom Blaser to come in with a unique background, both from a private equity standpoint as well as a big company standpoint and with a strategic bent -- my focus is going to be on where we take new Grace in the future. And I think it balances it nicely.

Brian McGuire - *Goldman Sachs - Analyst*

Great. Thanks very much.

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

Thanks, Brian.

Operator

John Roberts, UBS.

John Roberts - *UBS - Analyst*

Thanks and congratulations as well, Hudson.

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

Thank you, John.

John Roberts - *UBS - Analyst*

Could you give us some granularity on how refinery catalysts' price changes are realized? Is it like a commodity business, where when operating rates are high, the industry raises prices broadly? Or is it different than a commodity?

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

It's different, John. Generally there's contracts, 1 to 3 years; so they don't -- 1 to 3 years is the average. Some are a little bit longer. So they really don't -- they swing on that. And it's based on a discussion on the product.

Fortunately, with an FCC catalyst, the value that we deliver is pennies per barrel of oil. So as they try to eke out additional yields and so on, we have a discussion. And that discussion is based on: what do you want to get out? What's the benefit? What's the yields?

And we're able to quantify pretty succinctly what we believe that benefit is. And then we really have the debate around how much of the benefit goes to the customer, and how much stays with us. And that's how the price discovery really works. And that's been consistent.

John Roberts - *UBS - Analyst*

Okay. And then secondly, we're going to start getting materials technology without Darex. Could you give us a little more granularity about which areas are above-average performance in that segment, which are lagging? I just want to get a sense of the range and the importance of mix in the performance of that segment.

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

Yes, mix has been an important piece, John. And if you look over the past 5 to 7 years, the mix has been able to drive up those margins significantly, close to 40%. So as you think about it, the questions that -- and we'll give you more -- and we'll be sharing more detail. It will be on the mix around our biopharma side of it, our neutraceuticals, our new applications, our colloidals going into environmental catalysts or automotive catalysts, versus some of the more commodity ends of it around precipitated silica and so on.

So we'll try to give you more flavor as we go forward for that. But that's our push: moving with the same base assets that we have, shifting that mix to the higher end, and a lot of efforts being deployed on that.

John Roberts - *UBS - Analyst*

Thank you.

Operator

Mike Sison, KeyBanc.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Good morning, Hudson, congrats as well.

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

Thank you, Mike.

Mike Sison - *KeyBanc Capital Markets - Analyst*

In terms of the outlook for catalysts technologies, up mid-single digits in terms of just EBIT this year, you have a couple big projects that need to ramp up. What is sort of the underlying assumption on those projects? When do they get the full run rate, and what are the risks you see in that ramp-up?

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

Yes, I mean, obviously it's the one we've talked about a lot at investor day. It's Takreer coming online in the second quarter. We are very close to that.

We think the performance test will be run here at the end of the month, and then the unit will start operating in production mode going into the second quarter. You know, our assumption in the EBIT growth is really around volume as well as some productivity. As you know, we've been very clear: we did not put any pricing into the outlook for our FCC catalysts. The other side of it is -- the other side around the volume is just coming out of the turnarounds in the first quarter from a couple of our big customers.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay. And I think you mentioned that ART would be flat in 2016 versus 2015. Can you just walk us through kind of what is driving that?

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

Mike, we've seen a trend, and I think the trend in some of the data that's been coming out -- you know, there are some inventory builds in middle distillates, and as well on the heating oil side of it. And we wanted to be cautious on -- because a lot of that ART product goes into that side around the fixed bed and so on. And we want to be cautious on our outlook.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Okay, great. And then last one on specialty catalysts -- you know, margins for polyolefins continue to kind of get hit here sequentially. Can you maybe walk us through why you see growth there? Does that phenomenon of compressing margins for the resins -- is that good for you going forward, or will they want to use your product more than not?

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

Yes, I mean, you're talking about industry margins getting compressed, right?

Mike Sison - *KeyBanc Capital Markets - Analyst*

The industry margins for -- yes, correct.

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

Yes, no -- it is. You know as industry margins get compressed, the end producers are looking at what advantage or what can they deliver that's a little bit different? And where we've seen the positive pick-up on that is around some of our new catalysts. Whether it be the phthalate-free catalysts, which has gotten a lot of attention from some of the big majors -- that's a way to distinguish themselves from a commodity, polypropylene catalysts either coming out of China or somewhere else.

And on the polyethylene side, there's a lot of new single-site developments that are happening, again, to distinguish and create some new properties. So when we put our outlook together, we wanted to be a little bit cautious on the first half, just given some of the Asian slowdown, but then coming back to more of a normal in the second half -- the higher single-digits growth.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Great, thanks guys.

Operator

Laurence Alexander, Jefferies.

Dan Rizzo - *Jefferies LLC - Analyst*

Good morning. This is Dan Rizzo on for Laurence. Now that GCP is separate, is there any -- what are the next big moves strategically? Is there M&A opportunity out there? Are you going to use cash to kind of ramp up buybacks? I'm just wondering what your thoughts are going forward.

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

No, listen, we want to grow this. We think it's focused around -- we know it's focused account catalysts materials, connected by this material science. We've proven that we can grow with very disciplined acquisitions that can be very accretive. So we will continue to be very inquisitive on those.

Hopefully, there will be more activity on those throughout the industry as the industry goes through some of its churn here. So we'll be there on that side of it. We'll continue to invest in some of our own internal investments that have some good returns. And finally, as we have demonstrated, if those aren't available, we'll return that cash to shareholders. And the quickest way is through -- is the share buyback.

Dan Rizzo - *Jefferies LLC - Analyst*

Okay. All right. Thank you.

Operator

Chris Kapsch, BB&T Capital Markets.

Chris Kapsch - *BB&T Capital Markets - Analyst*

I had a follow-up on the prospects for pricing in the FCC catalysts industry. I think it was early 2013 when Grace tried to lead a price increase -- roughly the same magnitude, I believe -- and that resulted in some market share shifts, a lot of trial activity. So I'm just wondering what's different at this juncture.

If anything, the refining industry is probably under a little more pressure now. Conversely, you've brought more innovation to the table to help them with their yields, as you point out. So I'm just wondering what might be different, do you think, that will actually result in net positive pricing? Is it just a function of supply/demand being tighter? Thanks.

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

No, it's dramatically different. Again, not to rehash all of 2013, but if you'll recall, it was coming up the high, high rare earth prices that were included in those catalysts. That was dropping at that point in time. Industry utilization wasn't at the same rate it was today. And, you know, strategically the decision we've taken on the 10,000 tons to eliminate it proactively may prove to be one of the better strategic decisions that we've come to make in the last few years.

So, again, the dynamics are different. They really are different. And so I'm optimistic. But, you know, it's going to go through a very disciplined approach to it. And it's going to be account by account and discussion, price discovery by discussions individually.

Chris Kapsch - *BB&T Capital Markets - Analyst*

Okay, and just one quick one on the pass-through effect. Is this more the -- what's affected the comps here? Is it more a function of moly in the HPC catalysts or lanthanum in the FCC catalysts?

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

It's actually nickel and metals like that in the specialty catalysts business.

Chris Kapsch - *BB&T Capital Markets - Analyst*

Okay, good to know. And then just on the sensitivity to the euro, I think you explicitly put that in the fine print. So just want to understand for sure, though -- your current guidance was based on $1.10. Would that mean to suggest if current FX rates prevail, particularly the euro being stronger now, then -- that you might see a net benefit of $4 million to $5 million in EBIT, all else equal? Is that -- am I doing the math right?

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

That's the math, Chris. But just to give a little detail on it, that $1.3 million is an annualized number. And the way we set our rates, we set them at the beginning of each month. So you can't just take a daily average and run it out that way, but that's the detail.

Chris Kapsch - *BB&T Capital Markets - Analyst*

Okay, thank you.

Operator

(Operator Instructions) Matt Schnabel, Wells Fargo.

Matt Schnabel - *Wells Fargo Securities, LLC - Analyst*

I apologize if this question has already been answered. I had to jump on late. But just on slide 10, on the outlook for new Grace, under the interest expense you have kind of two options. Just wanted to get your thoughts around any additional paydown and maybe timing around that?

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

You may have missed this in the prepared remarks, but we did say earlier that we've paid down $500 million of debt. We did that last week versus the $750 million that we had assumed in the investor day materials. And basically we're keeping that $250 million to give us some additional flexibility around growth investments or share repurchase.

Matt Schnabel - *Wells Fargo Securities, LLC - Analyst*

Okay, thanks.

Operator

Dermot MacNamara, KKR.

Dermot MacNamara - *KKR Credit Advisors - Analyst*

Good morning, just a follow-on on the last question. Do you have any plans to refinance the loans and notes within the existing capital structure, or are you happy where you're at at the moment?

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

We don't have any plans to do a refinancing.

Dermot MacNamara - *KKR Credit Advisors - Analyst*

Okay, thank you. And just one follow-on. Could you just remind me what percentage of sales are exposed to Venezuela?

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

Zero for new Grace.

Dermot MacNamara - *KKR Credit Advisors - Analyst*

Thank you.

Operator

Jason Weinberg, Columbia.

Jason Weinberg - *Columbia Asset Management - Analyst*

Could you just update what -- the change in estimated debt paydown from GCP? If there's any change in the leverage targets from three weeks ago? Thank you.

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

No, we still have our 2 to 3 times leverage target.

Operator

That's all the questioners that we have at this time. So I'd like to turn the call back over to Tania Almond for closing remarks.

Tania Almond - *W. R. Grace & Co. - IR Officer*

Great. Thank you, Andrew, and we just want to thank everyone on the call for joining us today. If you have any follow-up questions, you can reach me at 410-531-4590. Thanks very much and have a great day.

Operator

Ladies and gentlemen, thank you again for your participation in today's conference call. This now concludes the program, and you may all disconnect your telephone lines at this time. Everyone have a great day.
