Trinseo First Quarter 2021 Earnings Call

Company Participants

- Andy Myers, Director of Investor Relations
- Frank A. Bozich, President and Chief Executive Officer
- David Stasse, Executive Vice President and Chief Financial Officer

Other Participants

- Frank Mitsch
- Laurence Alexander
- Angel Castillo
- Hassan Ahmed
- David Begleiter
- Matthew Blair

Presentation

Operator introduction:
Good morning, ladies and gentlemen, and welcome to the Trinseo First Quarter 2022 Financial Results Conference Call. We welcome the Trinseo management team, Frank Bozich, President and CEO; David Stasse, Executive Vice President and CFO; and Andy Myers, Director of Investor Relations. Today's conference call will include brief remarks by the management team followed by a question-and-answer session. The Company distributed its press release along with its presentation slides at close of market Wednesday, May 4th. These documents are posted on the Company's Investor Relations website and furnished on the Form 8-K filed with Securities and Exchange Commission.

If anyone should require operator assistance during the call, please press *, then zero, on your telephone. I will now hand the call over to Andy Myers.

Andy Myers
Thank you, Sara, and good morning, everyone. (Operator Instructions) Our disclosure rules and cautionary note on forward-looking statements are noted on Slide 2.

During this presentation, we may make certain forward-looking statements, including issuing guidance and describing our future expectations. We must caution you that actual results could differ materially from what is discussed, described or implied in these statements. Factors that could cause actual results to differ include, but are not limited to, risk factors set forth in Item 1A of our annual report on Form 10-K or in our other filings made with the Securities and Exchange Commission. The Company undertakes no obligation to update or revise its forward-looking statements.

Today's presentation includes certain non-GAAP measurements. A reconciliation of these measurements to corresponding GAAP measures is provided in our earnings release and in the appendix of our investor presentation.

A replay of the conference call and transcript will be archived on the Company's Investor Relations website shortly following the conference call. The replay will be available until May 5, 2023. Now I'd like to turn the call over to Frank Bozich.

Frank A. Bozich

Thanks Andy, and welcome to our first quarter earnings call. We had a very good start to the year with continued solid earnings in the first quarter. Q1 results reflect the continued progress we have made in reshaping our portfolio as it was one of the highest quarterly Adjusted earnings results in the company's history. I am particularly pleased with this as we are operating in a challenging macro-environment, which now includes uncertainty and volatility from the conflict in eastern Europe. Our thoughts are with the people of Ukraine and I want to thank our employees who have shown great generosity through their donations to benefit those who have had their safety and well-being compromised.

The conflict has had no direct impact to our operations as all of our plants in the region are in Western Europe with no regular direct suppliers in Ukraine, Russia or Belarus. However, we have observed indirect impacts in the region including automotive production issues as well as higher and more volatile prices of natural gas and other inputs. We've taken proactive steps to mitigate some of these effects including creating new mechanisms for customer pricing to more accurately pass-through input costs. These actions have helped, but given the volatile environment, we're still subject to significant day-to-day swings in prices. I'm confident that our teams will continue to find ways to securely source raw materials and keep our operations running to provide customers with our quality products in a timely manner.

While we contend with external challenges, our strategic focus continues to be on the transformation of Trinseo to a specialty material and sustainable solutions provider. As you know, we've already taken several meaningful steps in this process including the acquisitions of our PMMA business, Aristech Surfaces and the recycled materials business, Heathland. These new businesses have greatly expanded the opportunity landscape for organic growth by providing us with access to new markets, new products, and new top line synergies due to our unique product portfolio. To realize these growth opportunities, we are focusing on three distinct dimensions of growth which will impact our core business by Strengthening the Core, Extending the Core and Expanding the Core. Internally, we have begun to refer to these distinct efforts as our SEE strategy – S.E.E. for short.

I would like to elaborate on these three growth dimensions to provide some color on them and to highlight some of the progress we have made. First, our Strengthen the Core efforts focus on improving our position in the markets in which we currently operate by reducing our cost position in our core chemistries, driving business excellence programs, and delivering on cost synergies from our recent acquisitions. More importantly, our efforts to strengthen the core include our efforts to leverage our new capabilities to grow our total addressable market, or TAM. A good example of growing our total addressable market is through material replacement, such as replacing painted metal exterior trim parts with color-matched PMMA products. This application creates value for our customers by reducing emissions, weight and cost.

Material replacement is a significant opportunity for us because we can offer customers a quality product that not only costs less to use but is more environmentally friendly by virtue of eliminating process steps or alternative materials that have higher CO2 footprints. For example, because we have both PMMA and ABS in our portfolio, we're able to offer multiple end-markets a PMMA laminate sheet in any color that's reinforced by ABS rather than the more conventionally used fiberglass. This co-laminate product, which had Q1 sales volume growth of more than 20% versus prior year, provides customers with a solution that's both lower cost and more sustainable. In total, we believe we can expand our total addressable market in Auto, Building and Construction, and Consumer Goods by over $3 billion.

The second area of growth focuses on those opportunities to Extend the Core by moving the core business into new higher value-added applications via M&A. We will also extend the core through the implementation of our sustainability roadmap which has three building blocks. These efforts focus on decarbonizing our operations, developing an advantaged product offering based on recycled materials, and lastly, developing a sustainable feedstock business. This involves positioning Trinseo as a leader in waste polymer collection and recycling and upgrading it with our innovative technologies which will allow us to offer more sustainable solutions. That was the main rationale behind the recent acquisition of our plastics waste collector and recycler Heathland earlier this year. We view security of supply of sustainable feedstocks as vital to our long-term success in sustainability. While Heathland has been our first major step into recycling feedstocks, we will look to expand the sustainable business unit organically and inorganically.

In addition to strengthening and extending our position in our core markets, we look to create additional opportunities to grow further by Expanding the Core through the addition of complementary technologies. This will be accomplished through targeted M&A of specialty businesses with attractive adjacent chemistries that broaden our offering into applications in Mobility, Building and Construction, Medical and Consumer Goods. The potential divestiture of the Styrenics business, which continues to progress, would provide us with capital that will aid in this effort. But setting aside the potential proceeds from the sale, we are well positioned to grow thanks to our strong balance sheet and a portfolio that is very cash generative with relatively low capital intensity.

To effectively guide these S.E.E. efforts, we have recently added three new executive leadership positions: Chief Sustainability Officer, Chief Commercial Officer and Chief Technology Officer. These positions will report to me and be a part of our Executive Leadership Team. Francesca Reverberi was appointed Chief Sustainability Officer last October. Her primary responsibility is to keep us on track to achieve our 2030 Sustainability Goals as well as expand our product portfolio of sustainable materials, such as the recently launched Magnum Bio ABS Resin for automotive applications which contains up to 80% bio-attributed content. She will also take the lead in defining the investments and partnerships required to decarbonize our assets. In fact, her team's efforts have already defined an opportunity to decrease our already market leading Scope 1 & 2 emissions by over 70% by 2035, which is significantly ahead of our previously stated goal of a 35% reduction. I am also thrilled to point out that our Q1 sales volume and variable margin of recycled-containing solutions grew 39% and 31% respectively over the prior year. To give you a sense of scale for our sales of these solutions, they represent about $30 million in annual variable margin.

The role of Chief Commercial Officer was recently filled by Andre Lanning, who was previously responsible for our Strategy and Corporate Development efforts. In his new role, Andre will ensure that we have the right commercial processes and tools in place to better serve our customers. He will also have oversight over all our organic growth opportunities and will provide the dedicated focus to resource and drive these market expanding efforts which focus on material replacement. To give you a sense of scale for our materials replacement activities, these represent about $100 million in annual variable margin.

The role of Chief Technology Officer, which we expect to fill soon, will be responsible for creating a framework for our technology and innovation capabilities that allow us to provide solutions and products that differentiate Trinseo and expand our total addressable market.

Before I turn the call over to Dave, I'd like to comment on our recent press release concerning the request for information related to styrene monomer purchasing activity that we received from the European Commission in 2018. As a result of further developments on this matter, we have recorded a reserve of $36 million in the first quarter. We continue to cooperate fully and look forward to the resolution of this matter. Lastly, we do not expect this to impact the sales process of our Styrenics business.

Now I would like to hand the call over to Dave who will comment on our first quarter earnings.

David Stasse

Thank you, Frank. First quarter Adjusted EBITDA of $178 million was similar to the prior year but with an improvement in the quality of earnings as the specialty segments of our portfolio made up a larger share of our profitability. Last year's outsized contribution from Feedstocks was replaced primarily by the incremental earnings from our acquired businesses in Engineered Materials. The benefit from the large favorable net timing variance in the first quarter of this year was mostly offset by about $20 million of headwinds including lost sales from industry supply chain issues and lower margin from volatile input costs. While we made progress in pricing to more effectively react to rapidly increasing input costs, the high level of volatility and the lag effect of pricing still led to some earnings headwinds, mostly in Engineered Materials.

The Engineered Materials segment also experienced a reduced benefit from ammonium sulfate sales during the quarter. Ammonium sulfate is a byproduct in the C3 MMA production process that we utilize in Europe. We produce about 180 kilotons of ammonium sulfate per year and sell it into the fertilizer market in Europe. As most of you are probably already aware, nitrogen fertilizers in general have experienced a significant increase in price during the quarter because of the conflict in Ukraine. This historic price increase pushed demand out of the first quarter and into later quarters of 2022. We are already seeing demand return in Q2 as commodity grain prices are stimulating increased plantings in Europe.

We had a cash use in operations of $5 million during the first quarter leading to negative Free Cash Flow of $30 million, which included a use of working capital of $103 million. We typically have a working capital use in the first quarter following seasonally lower December sales volume, but this year's draw was exacerbated by a steep rise in raw material prices and an inventory build ahead of planned turnarounds in the second quarter. We should generate

higher cash in the coming quarters as we don't expect a continuation of the rapid rise in raw materials and as we run off inventories after mid-year turnarounds. We'll continue to use cash to grow the company and return cash to shareholders including via our share re-purchase program which, as of the end of March, still had $100 million of authorization remaining after another $50 million of re-purchases during the first quarter.

Now I'll turn the call back over to Frank to comment on our updated guidance and expectations.

Frank A. Bozich
Thanks Dave. Looking ahead to the second quarter we expect earnings to be sequentially similar as higher styrene profitability, higher margins in Engineered Materials, and stronger volume in Latex Binders are offset by more normalized margins in polystyrene, ABS and polycarbonate products.

We still expect 2022 to be another year of solid earnings, and we expect full year Net Income of $174 to $211 million and Adjusted EBITDA of $625 to $675 million. This outlook assumes a continuation of the Q1 demand levels through the end of the year, including impacts from the Ukraine conflict, inflationary pressure and more modest auto production growth. Our previous outlook reflected an easing of these conditions following the first quarter and did not consider a military conflict in Europe or ongoing COVID lockdowns in China. This also includes an anticipated $35 million impact in the second quarter from the current styrene production outages at our Ternuezen site and AmSty's St. James site. In addition, we expect no meaningful net timing impact over the remainder of the year.

We expect to generate Cash from Operations of approximately $355 million and Free Cash Flow of approximately $175 million which we'll use to continue to provide value to shareholders by both growing the business in specialty and sustainable areas and providing cash returns.

Certainly, there's no shortage of uncertainty in the world right now but we're well positioned to navigate in this environment with our strong balance sheet, continued progress on our transformation journey and skilled teams to provide our customers with our quality products and solutions.

Thank you and we're happy to take any questions.

Questions and Answers

Operator
Our first question comes from the line of Frank Mitsch with Fermium Research.

Q – Frank Mitsch
Good morning and thank you for the additional color. I was wondering in your comments as well as in the release, you're saying that the Styrenics divestiture process that you're running continues to progress. So I was wondering if you might be able to provide any more color on perhaps the timing or the interest level that you're seeing there. And there has been some concerns that with the energy situation in Europe that might have made things a bit more problematic. Any color there would be very helpful.

A – Frank A. Bozich
Yeah Frank, as we've said previously, we expect to see our process play out by mid-year and it continues to progress as we expected. So we haven't seen any negative impacts in our process related to the energy price increases in Europe.

Q – Frank Mitsch
Fantastic. Very helpful. And we saw the styrene margins come in better than anticipated and I was wondering what your outlook is there.

A – Frank A. Bozich
We think styrene margins are significantly elevated right now because of a number of outages in the industry as well as the arbitrage window being unavailable because of logistics challenges. So we see that fly-up margin, or the higher than normal margins in styrene, to continue through Q2 but then normalize in the second half of the year to basically zero EBITDA contribution level in Europe. AmSty will revert back to its normalized earnings level because of their advantaged cost positions.

Q – Frank Mitsch
Very helpful. Thanks so much.

Operator
Your next question comes from the line of David Begleiter with Deutsche Bank.

Q – David Begleiter
Good morning Frank and Dave. Could you just bridge the EBITDA reduction guidance? I know a big chunk of that is related to the outages at Terneuzen and St. James. Can you bridge the remainder of that, I think, $75 million decrease at the midpoint of the current and prior EBITDA guidance?

A – Frank A. Bozich
So I think the simple answer is we think the rest of the year will continue at the environment similar to what we experienced in Q1 with the elimination of the timing benefit and the fly-up margin that we're currently seeing in styrene margins ending and not recurring in the second half of the year. So that's how we get to the full year. To the extent that there is an improvement in the conditions that we see versus Q1, there would be some upside.

A – David Stasse
Dave, to add on to if you don't mind, to be clear on the $75 million reduction, you correctly highlighted the $35 million that we expect the impact of the outages to be in the quarter and that's across both Americas Styrenics and our own Feedstock segment. That is not a component of the $75 million because our prior guidance didn't assume those fly up margins to begin with. So, the real composition, the change in guidance, is entirely due to a change in our assumptions on the business conditions through the rest of the year from what we gave in the

first quarter. And to break that down a little more finely, I mean there's really three components. There's automotive demand which is across Base Plastics and Engineered Materials. There is lower margin in polycarbonate that we highlighted and the other bucket is really a lot of smaller things but really attributable to the same things that we've been talking about - supply chain challenges and COVID related shutdown issues in China. Those are largely the three buckets. But I just want to make sure you understand that the $35 million is not part of that bridge.

Q – David Begleiter
Very helpful, Dave. Thank you for that. And just on ammonium sulfate, can you quantify the shift of earnings from Q1 to the back half of the year and what's normalized earnings in that line of business for you guys?

A – David Stasse
Well, the way we account for that, Dave, it is a byproduct of producing MMA. So the way we account for it, we don't book revenue and margin that you would see. It's booked as a credit to the manufacturing costs, okay? So it lowers cost of goods sold I guess you would say. I probably wouldn't consider that, Dave, to be a profit. I mean it obviously is profitable. But the way we think about it is that they're a natural hedge that exists in that business against a portion of our natural gas purchases. And the reason I say that is what drives the price of ammonium sulfate is the price of ammonia and what drives the price of ammonia is natural gas. So, the sales of that byproduct, the dollar amount of those sales is really driven by the price of natural gas and, like I said, the income, if you will, that we recognize from the sales really serve as a natural offset of part of our natural gas purchases. Does that make sense?

Q – David Begleiter
It does. Appreciate that detail. Thank you.

Operator
Your next question comes from the line of Hassan Ahmed with Alembic Global Advisors.

Q – Hassan Ahmed
Good morning, Frank and Dave. A question around EM segment margins. They jumped up nicely sequentially from 9.4% to 11.9%. The question is that, I mean, obviously 2022 is certainly not a normal year with all the cross currents we are seeing, be it logistical, be it sort of auto end market demand and the like. Twofold question, one is where would these margins sit through the course of 2022 and where do you see them going in a more normalized environment?

A – Frank A. Bozich
Thanks for the question. Let me first point out that, as Dave mentioned, we did have some headwinds in Q1 that we highlighted in the earnings release and in fact we said there were approximately $20 million of non-recurring headwinds in the first quarter. I would say slightly less than half of that accrued to EM. So you could expect that in Q1, we would have had low $40 million adjusted EBITDA contribution from EM minus those non-recurring items, and it puts us into the mid-teen range. Now when we gave some feedback on where we envision EM being in the low $20 million or over $50 million quarterly EBITDA contribution that contemplates a normalization of auto builds to a level that we were anticipating historically.

But it also contemplates that the supply chain issues in the extreme freight inflation coming out of China normalizes. Those two factors are depressing, let's say, demand for EM materials. So I think in the near term, we expect that those one-time issues go away and in the medium term, as we continue growing these growth programs as well as we see markets in China and in automotive normalizing we would get into the low 50s.

Q – Hassan Ahmed
Very helpful, Frank. As a follow-up, in the press release you guys put out there was a line stating that the synergy pipeline is greater than anticipated. I'd love some sort of further color around that.

A – Frank A. Bozich
So on the cost synergies, we are clearly on track to deliver the year one savings of $10 million. We're clearly above that. The full synergies between Aristech Surfaces as well as the PMMA acquisition were in total cost saving synergies were $60 million over the three-year period, or the first three years. We're well on track to achieve those and we see a bigger pipeline than that $60 million in aggregate. Where we are significantly higher, is on the growth side and as I mentioned in the market expansion opportunities that we have that we previously didn't have, we can expand our total addressable market by over $3 billion. And it's a very significant expansion opportunity and as I said in the script, it was those markets with our material replacement activities today that are ongoing, represent $100 million in annual variable margin. So they're ongoing, they're significant already and they're growing much faster than the market because of the value proposition that we offer. So that's the color I would give you.

Q – Hassan Ahmed
Very helpful, Frank. Thank you so much

Operator
Your next question comes from the line of Laurence Alexander with Jefferies

Q – Laurence Alexander
Good morning. A question about sort of your customer activity. I mean to what extent, given the range of end-markets to exposure, to what extent are any customer or value chains not living hand to mouth that is selling everything they produce? Are you seeing any signs of customers going to get some slack and build inventory?

A – Frank A. Bozich
I would say generally the answer is no. We aren't really seeing inventories being built in any of the major markets we participate in.

Q – Laurence Alexander
And can you give a feel for kind of the level of incentives and kind of the capital intensity of expanding capacity in your downstream businesses given how strong demand is and the size of the opportunity in the new product replacement areas?

A – Frank A. Bozich
Yes. So in the product replacement technologies, it's a mixed bag and I would say there's probably five distinct opportunities that we have. In many of these, we have the ability to grow organically with very little capital investment, so single digit to low double-digit million capital investments to affect the growth in those areas. So they are not capital intensive and we have the ability to grow them significantly.

Q – Laurence Alexander
Okay. Thank you.

A – Frank A. Bozich
I guess the one thing that we've pointed out previously is we'll make an expansion of our PMMA business into Asia and that capital is in the mid double-digit million capital size. Now I do want to spend a second on the opportunities that I highlighted to reduce the carbon footprint of our business because we see not only does it improve our environmental footprint but it creates an OpEx savings and reduces our energy dependence. And the 70% reduction in Scope One and Two emissions that I referenced in the script is associated with approximately $100 million of capital investment over the rest of this decade.

Operator
Our next question comes from the line of Angel Castillo with Morgan Stanley.

Q – Angel Castillo
Hi, thanks for taking my question. Just a quick one on the normalization around margins for ABS polystyrene and polycarbonate. I was wondering if you could give us sort of a more color as to what you're seeing across, I know that auto is a big end market within ABS and PC but across other end markets, what are you seeing and specifically as we think about the second half and the margin normalization of these products? Where do they go in the second half and where do they go, kind of as we think about 2023 in a more kind of steady state environment?

A – Frank A. Bozich
I'll give you some background and so, as you know, PC and ABS, the biggest consuming region in the world is China. With some of the rolling lockdowns, the demand in Asia has been reduced and at the same time we've seen low double-digit capacity expansions to the global supply our current PC and ABS in Asia. And so that puts some margin pressure and made the supply demand balance, it's gotten a bit long and we anticipate that staying through the remainder of the year and that's what driving the normalization of the margins that we anticipate.

Q – Angel Castillo
Got it, that's very helpful. And I guess as you think about, I think the guidance for now implies I think I got $150 million type EBITDA in the back half kind of exit rate. So roughly $600 million on an annualized basis, is that the level you would kind of anticipate as we move forward or it sounds like it's fairly de-risked so as autos and other end markets recover, you would anticipate further I guess improvement in that, but just as we think about other products normalizing like

ABS, PC, would you anticipate some kind of offset and therefore that $600 million is roughly kind of a good level as we think beyond 2022 or how would you think about it?

A – David Stasse

Yeah Angel, the answer is yes. This is Dave. The answer is yes. There is an offset. And the offset, it is going to be improvement in Engineered Materials for the reasons that we just talked about. So to be clear and just to add on to what Frank said, I mean I think the direct question was, is there still some over-earning that exists in Base Plastics and Polystyrene in Q1. I mean clearly we highlighted the Q4 was there was some over-earning and that over-earning, there probably was some over-earning that existed in the first quarter also. So you're right, we do expect the normal kind of a normalization of margins and in both Polystyrene and Base Plastics as we go to the back half of the year. To put a number on that, on a quarterly basis, I would say the two of those combined, it's probably over-earned by $20 million to $25 million in the first quarter. So that's the magnitude, I would say, of the normalization. So you're right also what the guidance implies is order of magnitude $150 million a quarter in the back half of the year. What will offset that decline is clearly an improvement in Engineered Materials. And the other thing is a realization of synergies. I'm talking about the cost synergies here as Frank said, we're well ahead of what we said was the target for the first year and looking ahead to the second year. So I think those two things combined are what offsets the decline, Angel.

Q – Angel Castillo

Very helpful. Thank you.

Operator

Your next question comes from the line of Matthew Blair from Tudor, Pickering, Holt and Company.

Q – Matthew Blair

Hey, good morning everyone. So I think back in December you announced the $200 million buyback program over the next 18 months. Q1 buybacks were quite strong over $50 million. How should we think about the cadence of buybacks in Q2 and beyond and is there potential for you to re-up this program – finish it early and re-up at higher levels?

A – David Stasse

Yeah, hi Matthew, it's Dave again. Yeah, is there a potential? I mean, absolutely. As I said, we have another $100 million left under the authorization. We see a lot of value in buying back our stock at these levels. I would expect Q2 to be a similar number to Q1 and when the program exhaust ourselves we'll talk to our Board in light of our balance sheet position and what other cash needs we have and have a discussion about putting in place a new authorization. But I can't really comment beyond that other than the say that we clearly see a lot of value in buying back stock at our current multiple and our cash flow yield and Q2 expect a similar number to Q1 and Q4.

Q – Matthew Blair

I'll leave it there. Thank you.