Trinseo Second 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
- Matthew Blair
- Hassan Ahmed
- David Begleiter
- Eric Petrie
- Angel Castillo

Presentation

Operator introduction:
Hello ladies and gentlemen, and welcome to today's Trinseo conference call. We welcome the Trinseo management team, Frank Bozich, President & CEO, David Stasse, Executive Vice President & CFO, and Andy Myers, Director of Investor Relations. Today's conference call will include 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 yesterday. These documents are posted on the Company's Investor Relations website and furnished on a Form 8-K filed with the 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, Felicia, and good morning everyone. At this time, all participants are in a listen-only mode. After our brief remarks, instructions will follow to participate in the question-and-answer session.

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 August 5th, 2022. Now, I would like to turn the call over to Frank Bozich.

Frank A. Bozich

Thanks Andy, and welcome to Trinseo's second quarter earnings call. I'm excited to discuss another strong quarter of earnings performance as well as our improved outlook for the rest of the year. However, I would like to begin by thanking our employees for all their hard work and dedication. The transformation journey we are on requires tremendous effort and we've already taken some big steps thanks to the dedication of our team. All of this was amid some very difficult operating conditions, including significant supply chain challenges where our team did an exemplary job of ensuring customer supply, sometimes when others couldn't, and we have been able to deliver record quarterly profitability. I can't stress enough how proud I am of our team and how much I look forward to continuing our transformation together.

Now, I want to provide an update and overview on where we stand on our transformation to a specialty material and sustainable solutions provider given the many actions we have already taken this year.

In May we finalized the acquisition of Arkema's PMMA business and I'm happy to say the business is performing well despite some industry-wide headwinds such as production constraints for automotive customers and limited MMA supply. The strong EBITDA margins that made the business an attractive target are already positively impacting our overall results and we look forward to even better results from that business moving forward.

We originally anticipated $50 million of cost synergies in the business with $10 million being realized in the first year. We are on schedule to achieve the first year of cost synergies and we have identified a larger pipeline of synergy opportunities than what was originally communicated. We are going through the process of prioritizing these opportunities across three dimensions – magnitude, ease of execution, and speed to deliver – and I look forward to updating you on our progress in future calls. Fully integrating this business remains a high priority, including the migration to our new ERP system and the elimination of TSA's which we estimate to occur in mid-2022. As previously mentioned, the resulting IT and business process harmonization from the ERP deployment is expected to result in at least an incremental $25 million of cost savings in the legacy Trinseo business.

The acquisition of this PMMA business has enabled us to increase our product offerings in our differentiated Engineered Materials segment. Our recent announcement of the agreement to acquire Aristech Surfaces will allow us to broaden our product portfolio by offering continuous cast acrylic sheets into attractive end markets including end uses for wellness, leisure and architectural markets. The key applications are in hot tubs, swim spas, bathtubs, counter tops and recreational vehicles. Aristech, which has EBITDA margins in the mid-20s and cash flow conversion of over 80%, represents a business that aligns with our strategy of seeking out markets that support higher margins, higher growth and less cyclicality.

With this transaction we identified $10 million of cost synergies which are expected to be fully realized by the third year, and we anticipate $50 million in value from a tax basis step-up. In addition to these benefits, Aristech will accelerate our growth in Asia where significant product applications like hot tubs and swim spas occur. We estimate that Asian production in these applications will enjoy an average growth rate of 13% from 2020 to 2025. We believe there are also meaningful revenue synergy upsides that are achievable through the combined positions of our Engineered Materials business and Aristech. We expect the deal to close by the end of this year and the $445 million purchase price will be funded with a mix of existing credit facilities and cash on hand. I'm looking forward to adding Aristech and its 260 employees to the Trinseo family.

Ultimately our new portfolio will result in increased exposure to markets with an improved ability to generate cash with higher, more stable margins and greater opportunities for growth. I believe we are well on our way to transforming to a specialty materials company.

The other component of our transformation goal is to improve our offerings in sustainable solutions. To that end, I'm proud to say that in May we announced that our Polystyrene business now supplies recycled polystyrene for food contact applications; specifically, Yoplait yogurt containers that are now available in France. This kind of product supports our 2030 sustainability goal of increasing our share of sustainably advantaged products to 40%.

Goals like these are used as the guideposts for many of our decisions and a list of these goals can be found in our eleventh sustainability report which was released in July. The report outlines our progress on our numerous sustainability initiatives such as our reduction of Greenhouse Gases by 21% since 2017. And, for the first time, the report includes a SASB reporting framework in addition to GRI. Sustainability remains a foundational component of our Company and I look forward to sharing more exciting updates in the future.

Moving to the second quarter performance, we delivered record net income and Adjusted EBITDA. We observed solid demand for many of our products in applications such as appliances, packaging, textile, footwear and building and construction. In fact, our CASE products in Latex Binders have grown 23% on a year-to-date basis. This solid, consistent demand over the last few quarters has combined with raw material and logistical constraints to create tight supply conditions which has led to very strong margins in styrene, polystyrene, ABS and polycarbonate.

While we are seeing styrene margins normalizing already in the third quarter with supply improving, we anticipate a strong operating environment in derivative products well into 2022. As I previously mentioned, I'm extremely proud of our team and we've been able to navigate external challenges to continue to provide quality products to our customers with minimal interruption.

Our second quarter cash used in operations was $21 million which, combined with $20 million of capital spending, led to a Free Cash Flow of negative $41 million. This figure includes an increase in working capital of $180 million during the quarter. This significant working capital cash use was primarily caused by steep increases in raw material costs brought on by the same strong demand and tight supply conditions that I described earlier.

For example, the cost of benzene in Europe, one of our largest raw materials, almost doubled to levels never seen in our company's history, and we observed meaningful increases in other raw materials, such as butadiene. As raw material prices normalize and decline, we expect a significant benefit to working capital and increased cash generation in the second half of the year, and we're already observing this in our July cash results.

Now, looking at our earnings outlook for the year, we expect net income from continuing operations of $344 to $380 million and Adjusted EBITDA of $750 to $800 million. These estimates include eight months of the PMMA business but do not include Synthetic Rubber, which has been moved to discontinued operations, or any impact from the pending Aristech acquisition. In comparison to our prior guidance, this estimate includes approximately $80 million improvement in our legacy businesses including better than expected results from the second quarter performance, plus continued strong market conditions in the second half of the year. I'd like to point out that about half of the $80 million in improved guidance is from our more specialized products offering and as a result we expect these to be sustainable. It also assumes no contribution from Feedstocks in the second half of the year as European styrene margins normalize due to a more balanced supply / demand environment.

For the full year we expect to generate cash from operations of between $425 million and $475 million and Free Cash Flow of between $275 million and $325 million. This implies capital spending of $150 million which is an increase from our last call mostly due to the addition of the PMMA business and the SAP S4 upgrade project. It also assumes that we'll recoup about half of the working capital cash used from the first half of the year.

Putting all of this together, we expect to finish the year with a net leverage ratio in the low 2's, pro forma for the PMMA business and the announced Aristech acquisition, and the Synthetic Rubber divestiture.

In summary, we are expecting 2021 to be a year during which we deliver record profitability while taking significant steps to continue our transformation. With these steps, on a go-forward basis, we estimate that the non-commodity portion of our portfolio will contribute about three-fourths of the annual Adjusted EBITDA. This includes the Base Plastics, Latex Binders and Engineered Materials segments. We have taken these steps while providing exceptional customer services and all with a foundation of safety, sustainability and a solid balance sheet. I'm pleased with the progress we have already made in our transformation and I know with the help of our dedicated and engaged employees, we will achieve much more.

With that, Felicia, you can open the line for questions.

Questions and Answers

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

Q – Frank Mitsch
Hey, good morning and congrats on a record quarter. I just want to parse through the guidance for '21 a bit better. I believe your previous guidance at the midpoint was like $650 million and so you're saying that $80 million is improvement in the legacy business so that on an apples-to-apples basis that would get you to $730 million for this year. And then the delta between the $730 million and the 775 million at the midpoint of your new guidance is strictly the addition of PMMA and the reduction of synthetic rubber. Is that the way that we should be thinking about this?

A – Frank A. Bozich
Exactly, Frank. I'd just repeat what you said, but that's exactly right.

Q – Frank Mitsch
So okay. All right. Fantastic. I just wanted to make sure of that. So that's a very nice step up in the legacy business. And Frank, in the guide on Free Cash Flow, you're at a 15% free cash flow yield relative to your market cap. So what we going to do with the money?

A – Frank A. Bozich
Well, we're going to continue the transformation. I would expect that at some juncture in the near future, we'll meet with the board to reassess our dividend and to normalize that consistent with our peer group. And so again, our first priority is to continue this journey to upgrade the portfolio, make us higher margin and less cyclical and increase the free cash flow generation of the business. So we're going to continue doing that. We're very positive of about the results we've had so far.

Q – Frank Mitsch
Is there any room in the mix for buybacks?

Q – Frank A. Bozich
That wouldn't be a top priority. Transformation would be number one. We continue doing that. Servicing debt would be second priority and reestablishing the dividend would be another priority that I would put ahead of that.

Q – Frank Mitsch
Terrific. Thanks so much.

A – David Stasse
Frank, this is Dave. I'd just one thing on -- just to give some confidence on the guide, we've obviously had a big working capital outflow in the first half of the year. In fact, on a year-to-date basis, our working capital outflow is about $300 million. We've already seen that reverse itself in July. Our free cash flow in the month of July was about $75 million positive as benzene and styrene have started coming down. So we do have a lot of confidence in the free cash flow guide of about $300 million for the year, which obviously incorporates getting back some of that working capital in the back half of '21.

Q – Frank Mitsch
Gotcha. Looking forward to the execution. Thanks so much.

Operator
Your next question comes from the line of Matthew Blair of TPH.

Q – Matthew Blair
Hey, good morning. Thanks for taking my question here. So styrene has obviously come down quite a bit in Q3. Could you talk about how things are trending so far this quarter on polystyrene.

A – Frank A. Bozich
Polystyrene is actually looking very good. In fact, if I go back to the discussion we just had with Frank on the $80 million improvement in our outlook, $25 million of that improvement is from polystyrene and I want to remind you that a big portion of our polystyrene business goes into higher performance, our high impact polystyrene that goes into appliances and consumer goods. So it's a more specialized product than what you would consider more commodity polystyrene and single use plastics. So polystyrene, the outlook looks is very good and the applications we sell into are seeing very good demand.

Q – Matthew Blair
Sounds good. And then could you share any trends in ABS? It looks like China op rates remain quite high around 92%. What's the impact of the auto chip shortage in this business and what are some general trends you're seeing?

A – Frank A. Bozich
Well, yes, ABS has seen very strong demand and I think one of the things that we're seeing is that there's been a raw material tightness feeding ABS. So one of the raw materials acrylonitrile that feeds ABS has been short and tight all year. That's created a market environment that has been robust and value added for us. But I would say that in general, we see very strong demand and I remind you our ABS is a higher quality ABS. It's a mass ABS product that is a small percentage of the ABS produced in the world.

Q – Matthew Blair
Great. Thank you.

Operator
Next question comes from the line of Hassan Ahmed of Alembic Global.

Q – Hassan Ahmed
Good morning, Frank. A nice bump up in Engineered Materials EBITDA margins and obviously I understand that the PMMA business is now included in the segment. Just want to get a sense of how you're thinking about sort of run rate EBITDA margins going forward. I mean, you guys reported 15% this quarter, but obviously synergies need to be realized. And then obviously, you guys pointed out certain raw material headwinds in the quarter despite sort of a bump up in volume. So just want to get a sense of how to think about run-rate EBITDA margins for this segment.

A – Frank A. Bozich
So we would expect the EBITDA margins to be above north of 20% EBITDA margin going forward. But remember, when we're doing some purchase price accounting to reflect the asset value of the acquired assets that's stepping up depreciation in the acquired assets, so at the gross margin level. So in general, we would still see 20% going forward and the headwinds that we saw that was really a timing impact with passing price increases in Q2 in the consumer product side of our rigid compounds business and we're well on track in Q3 to recover that.

Q – Hassan Ahmed
Understood. And maybe this is a question for David and the IR team. But just trying to get a sense of the full year guidance you guys have given relative to consensus estimates. My feeling basically is that while the consensus may have baked in the inclusion of PMMA, it I don't think has excluded synthetic rubber. So I mean, since you guys talk to all the analysts, I'd love to hear your views about that.

A – David Stasse
I think you're exactly right. As they're reading the flash reports that came out last night, they had the same reaction. I think almost all of the consensus numbers had Synthetic Rubber in there and they had it in their kind of order of magnitude $50 million EBITDA for the year. Now obviously that we would move that to discontinue op, so we're not including that in our guidance anymore. So I think you're actually right. I think that was something that was -- look, there's a lot of moving pieces, but I think that was something that might have been missed.

Q – Hassan Ahmed
Perfect. Thanks so much for your help.

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

Q – David Begleiter
Good morning Frank and Dave. Frank, just on the upside to PMMA synergies, can you give a little bit of color as to what areas it might be coming from and the timing of those synergies?

A – Frank A. Bozich
So the $10 million that we're on track to deliver in Q1 -- in year one are really coming from organizational and procurement or supply chain efficiencies that we have between the businesses. As we move forward, we have some OpEx as well as the elimination of the TSAs that we got supporting the business when we carved it out of (inaudible). And then in year three, we'll begin to get significant savings -- a significant group of savings from the harmonization of our ERP systems and the efficiency from that.

I think the other thing that is really exciting to us and this is sort of an upside to the synergies, if you will, that we hadn't fully baked into the $50 million is how the opportunity for chemically recycling our own PMMA scrap is. And so in the sheet operations, there's actually several percentages of production lost in scrap and we can recycle that chemically just like we've demonstrated we can do with

polystyrene, and that represents a really nice savings and also gives us an opportunity to put that back into our product mix and sell a circular PMMA resin. So we're excited about that. We're looking at what the technology solution and the capital associated with that would be, but it's not significant capital I would tell you and at least our preliminary view is it will give us a very fast payback.

Q – David Begleiter
Very good. And just on styrene and feedstocks. You gave us a back half guidance of basically breakeven. Is that a good run rate for next year as well? Breakeven? And what's your view on new demand / new supply coming out of China over the next maybe 12 to 24 months?

A – Frank A. Bozich
Yes, David, I think just like we've talked about in the past, our view is that over the course of time, feedstocks in Europe will normalize to a breakeven level where supply conditions or supply shocks or -- will could cause things to spike up or timing could cause a quarter to be lower. But over time, we think that we'll end up at a breakeven level. Now AmSty is different obviously because they have a better cost position in North America, but that's our view going forward. So we see little downside and potential upside in certain market conditions from styrene monomer.

A – David Stasse
Dave, as it relates to new supply and I think our view is pretty consistent with the last time, I would say we see mid to high single digit additions both this year and next year for global supply and then falling off considerably after that for '23 and beyond.

Q – David Begleiter
Very good. Thank you guys.

Operator
Your next question comes from the line of Eric Petrie of Citi.

Q – Eric Petrie
Hey, good morning Frank. How much did your volumes grow in PC and blends and then how much do you believe the non-backward integrated PC producers in China are offline due to the bid shortage?

A – Frank A. Bozich
Well, Andy is looking for the figure on the growth in PC demand. But what I would tell you is I want to make a couple points about polycarbonate for us. Polycarbonate, the merchant polycarbonate business in Trinseo is very small and polycarbonate is mainly a feedstock that goes into our rigid blends in engineered materials and that product line has been growing steadily over the past several years in consumer electronics applications and we've been cannibalizing our lower margin merchant business to support that growth. So ultimately, we will consume the stud volume internally in our blending. That's our goal and we won't really have much market exposure to merchant polycarbonate. The other thing I would point out is that the polycarbonate that's being capacity that's coming on in China is not of the same quality as the material in Germany that at our Stade plant and so it's not

relevant -- in our view, it's not relevant to compare that with the quality of that material to what we produce because it's highly specialized. So, Dave has the answer on the volume growth.

A – David Stasse
Yes. So I mean, our volume growth -- I mean, well, it is a easy comp quite honestly compared to the second half of last -- excuse me, compared to the first half of last year, but our PC compounds and blends volume on a Q2 year-to-date basis is up about 30 %.

Q – Eric Petrie
Helpful. And then secondly, on feedstocks, it looks like EBITDA declined sequentially to $40 million down 7%. Why was that given Europe styrene margins were higher and you had favorable timings?

A – Frank A. Bozich
So we had interruptions at our Boehlen plant and were in the spot market when Boehlen was shut down for some unplanned maintenance.

Q – Eric Petrie
Great. Thank you.

Operator
And your next question comes from the line of Angel Castillo of Morgan Stanley.

Q – Angel Castillo
Hey, good morning gentlemen. Thanks for taking my question. Just on PMMA, I was wondering if you could give us a sense for how that business is doing year-over-year if you kind of exclude some of the step-up D&A or other kind of merger related adjustments. How that's kind of doing from a margin perspective, volume and price as well?

A – David Stasse
Yes. This is Dave. I'll address that. I would say on an EBITDA and a margin basis, it's doing pretty similar to year-over-year basis. You remember when we made that announcement, we talked about dynamic for the PMMA business in 2020 where obviously the COVID had a significant impact on our automotive volumes, but they largely replaced that with barrier protective sheet going in the retail and other things. So their EBITDA in 2020 kind of order of magnitude was about $140 million. I would say that's consistent with what I would expect this year.

We obviously have a pro-rated portion reflected in our guidance only the eight months of the year that we expect to own it, but kind of on a pro-rated basis, it aligns with that $140 million, EBITDA number. So look, we think that's a very good result particularly given some of the constraints that the business has had in the first half of this year on getting MMA. MMA has been quite tight and under supplied in North America in the first half of the year. Fortunately, we're seeing that ease as we go into the second half of the year, but yes, that was a kind of a first half headwind.

Q – Angel Castillo
That's very helpful. Thank you. And then just maybe, I guess, compiles a lot of discussion around both ABS and polycarbonate. Just curious how you're thinking about base plastics as we go into 2022 from kind of an EBITDA perspective and kind of the cadence of earnings from '21 to '22.

A – David Stasse
Look, I think we see nothing is visible to us now that would indicate any change in kind of the run rate of the business --the second half run rate of the business. The demand pipeline continues to look very strong. We have all positive indications from our customers really across all markets. In automotive, automotive inventories as I'm sure you know are at the lowest they've been since the financial crisis. Our sales into automotive have declined in the second quarter because of the production issues that the auto manufacturers have had. So I don't think we see anything standing here today that would give us any indication that 2022 would be materially different than '21 in base plastics.

Q – Angel Castillo
Very helpful. Thank you.

Operator
And there are no further questions at this time.

A – Frank A. Bozich
Thank you.