Trinseo Third 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
- Eric Petrie
- David Begleiter
- Duffy Fischer

Presentation

Operator introduction:
Good morning, ladies and gentlemen, and welcome to the Trinseo Third Quarter 2021 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 last Friday, November 5th. 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, Tammy, 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 November 8th, 2022. Now I'd like to turn the call over to Frank Bozich.

Frank A. Bozich

Thanks Andy, and welcome to Trinseo's Third Quarter earnings call. This morning we would like to cover three topics before turning to Q&A. First, I will outline our progress in our journey to transform our portfolio and then I will provide a deeper insight into our Engineered Materials segment, including some expectations for this business going forward. Dave will then cover the Q3 earnings and outlook for the remainder of the year.

As you are aware, the goal of our portfolio transformation is for Trinseo to become a specialty materials and sustainable solutions provider with a focus on four end-markets: building and construction, consumer goods, mobility, and medical. We expect that this will result in financial performance that demonstrates higher growth rates, lower volatility, higher margins and higher free cash flow. An additional benefit of this journey is that Trinseo will improve upon our already favorable environmental and energy profile.

We have already made significant progress on this journey with the additions of the PMMA business and Aristech Surfaces, along with the announced divestiture of Synthetic Rubber. In late October, we received the final regulatory approval for the completion of the sale of Synthetic Rubber to Synthos. This puts us on track to complete this transaction before the end of 2021, which is at least a quarter faster than we originally anticipated.

The next step in our journey to transform Trinseo will be the separation of our styrenics businesses, which will include our Feedstocks and Polystyrene segments as well as our 50% stake in Americas Styrenics. It is our intention to launch a process to divest these assets in the first quarter of 2022.

By 2025, we envision Trinseo being a company with EBITDA margin of at least 20%, Free Cash Flow conversion above 80% and with a robust portfolio of sustainability-focused solutions for our customers.

Not only do we expect the financial metrics and strategic options for Trinseo to be significantly improved through the transformation of our portfolio, but we also anticipate the additional advantage of reduced carbon and energy intensity of the remaining portfolio. We are convinced that the carbon and energy intensity of a company are critical factors that will drive the future regulatory impact and EH&S capital spending for the business over time. To put it another way, companies with low carbon and energy intensity will be advantaged in their ability to allocate capital toward growth and shareholder value because they will be less burdened by regulations and the capital spending needed to address the inevitable energy transition.

We believe that a key performance metric for companies is profitability in relation to their CO_2 intensity. Businesses that have low CO_2 intensity and high profit margins can fund compliance while growing and returning capital to their shareholders. Conversely, businesses with high CO_2 intensity and low profit margins will face steeper capital needs to meet future regulatory requirements and efficiency programs and will have more difficulty funding those needs.

Scope 1, 2 and 3 CO2 footprint reduction is a key part of Trinseo's sustainability strategy. Like the rest of the industry, we will address Scope 3 through the careful selection of sustainability-focused partners and suppliers as well as through recycling activities. Slide four of our investor deck shows how the portfolio transformation of Trinseo reduces Scope 1 & 2 CO2 emissions of the company while also improving the profitability – this data represents the 2018 to 2020 average. In fact, among the chemical companies shown on this chart, Trinseo would have had the second lowest CO2 intensity after excluding Synthetic Rubber. Plus, you can see that our Engineered Materials business has a very good position with a relatively low Scope 1 & 2 CO2 intensity and a relatively high EBITDA margin. For this reason, we are convinced Engineered Materials will continue to offer very high Free Cash Flow and growth opportunities for Trinseo.

I would also like to point out that our investor deck shows some of the other key sustainability metrics we are monitoring such as water usage, VOC emissions and waste intensity. Similar to carbon intensity, Trinseo's operations have low intensity in water usage, emissions and waste, which is beneficial not just for the environment, but also, to my earlier point, because superior environmental performance allows more cash to be channeled toward growth and returns to shareholders instead of toward compliance capital.

We're encouraged that our positive sustainability story and efforts are being recognized by ESG raters, including MSCI who awarded us a 2021 rating of "AA" which is a very strong rating and the highest in our sector. I look forward to continuing our momentum in sustainability as a vital part of our company strategy.

I would now like to spend a few minutes providing deeper insight into our Engineered Materials segment. This segment is comprised of PMMA resins and sheets, thermoplastic elastomers or TPEs, and rigid compounds that serve end use applications primarily in the mobility, building and construction, consumer goods, and medical markets. Based on the estimated Q4, 2021 annualized figures, the business is generating about $210 million of Adjusted EBITDA on sales of just over $1 billion.

We are very excited about the success this business has had growing its sustainable product offerings into various end markets. In 2021, we anticipate that the percentage of post-consumer recycled containing materials sold to consumer electronics applications will be more than 30% of the total sales volume to that market. To achieve this, the team has been able to grow these products 5-fold over the last 3 years.

We are also very excited about our ability to increase the profitability of this business by capturing market growth as well as realizing synergies. We have a robust pipeline of growth opportunities for this business as well as organic investments through 2025. In addition, about two-thirds of the cost synergies we have announced related to the recent acquisitions are expected to accrue directly to Engineered Materials. This will result in a business we expect will generate over $300 million in Adjusted EBITDA by 2025 while producing a cash conversion of about 85% over the next 4 years.

Engineered Materials' competitive strength is its ability to create customer capabilities across our target markets in three ways, which we describe as innovation pillars. These pillars are process innovation, sustainable solutions and material substitution. Here are some examples of product offerings which result in value creating customer capabilities:

- Our PC EMERGE ™ compounds with 30% post-consumer recycled materials content allows consumer electronics customers to provide a circular consumer offering.
- Our InDURO continuous cast PMMA laminated with ABS provides high performance, durability & UV resistance for the Recreational Vehicle and marine markets.
- Our PMMA SOLARKOTE™ capstock resin over styrenic or vinyl substrates in building and construction replaces more costly, higher maintenance materials with a lower cost of ownership to the end consumer.

Ultimately, these and other value-added capabilities that we provide to our customers allow for higher growth rates and margins. Because our ability to value price them is not dependent on cost structure and commodity cycles, the segment results are expected to be much less volatile in comparison to our other segments. Also, the growth rate of this business can be higher than the underlying market growth because we can replace other materials through the capabilities we offer.

Now, I would like to turn the call over to Dave who will walk you through our Q3 performance and full year outlook.

David Stasse

Thanks, Frank. During the third quarter we delivered solid financial performance despite the energy and supply chain issues that by now you are all familiar with. Demand for our products has been very strong, and we've seen very good margins due to tight supply and commercial excellence initiatives we've been implementing over the last two years.

These results were made possible by our employees, whose dedication and problem-solving allowed us to mitigate the negative impact from a challenging industry environment. Frank and I are grateful for their hard work and they continue to be one of our greatest strengths as a company.

During the third quarter we generated cash from operations of $208 million which, combined with $36 million of capital spending, led to Free Cash Flow of $173 million. The strong quarter of cash generation can be attributed to solid earnings as well as a small working capital release of about $30 million.

Looking to the fourth quarter, we expect sequentially similar earnings. Higher styrene margins, a full quarter of AmSty production and commercial actions are expected to offset increasing headwinds from chip shortages, China energy rationing and higher utility costs. It's important to note that we view these headwinds as transitory and not reflective of underlying market demand, which we view as robust in all segments and geographies.

We expect to end the year with record earnings with full-year net income from continuing operations of $336 to $376 million and we are reaffirming our prior full-year Adjusted EBITDA guidance of $750 to $800 million.

We expect full-year cash from operations between $420 and $445 million and Free Cash Flow of $300 to $325 million. This anticipated strong cash generation is particularly notable given an assumed $200 million use of working capital caused by feedstock price increases over the course of the year.

Putting together our earnings and cash guidance, we expect to finish the year with a net leverage ratio in the low 2's, pro forma for the acquired PMMA and Aristech Surfaces businesses, which puts us more than one year ahead of the de-leveraging schedule that we laid out in December of last year when we announced the PMMA acquisition.

The takeaway is that we close out 2021 in excellent financial position to continue funding our transformation strategy and returning capital to shareholders.

I'll now turn the call back over to Frank.

Frank A. Bozich
Thanks Dave. In closing, I would like to leave you with a few summary points on our recent performance and portfolio transformation. With the planned separation of our styrenics assets, which we expect will begin in 2022, we will have transformed our portfolio to what should result in a much less cyclical, higher margin, and higher free cash flow business. The portfolio should also have an even more advantaged carbon and energy footprint and be better positioned to continue growing and returning value to shareholders through the anticipated energy transition in the chemical industry.

We believe Trinseo represents an excellent value to investors with a robust pipeline of profit improvement opportunities, free cash flow conversion of approximately 80% and net debt in the low 2X range.

Thanks and we're happy to open the line for questions.

Questions and Answers

Operator
Thank you. Your first question is from the line of Frank Mitsch with Fermium Research.

Q – Frank Mitsch
Hi, good morning. Frank, on the news on the potential sale of Styrenics, I just want to dig into that a little bit. I assume you've had some conversations with the investment bankers on this. And, what are you hearing with respect to the M&A environment for commodities, and the interest that this property may be able to generate from either strategic or private equity. Any more color on the market would be great.

A – Frank A. Bozich
Yeah. Thanks, Frank. We think that we'll have a very good process. We think that there's really three categories of buyers who will have interest. Obviously, there is strategic and those who are in the same value chain that we anticipate will be interested. We also think there are regional players who will want exposure to North America and European styrenics markets.

And then lastly, we believe that there is a good number of financial sponsors who are looking for to do a roll-up, if you will, and aggregate assets that offer a high cash-on-cash return. So, we expect to have a good process, robust number of participants in those categories.

Q – Frank Mitsch

Got it. And then just a quick question on the guide for the fourth quarter. You call out higher styrene margins here in the fourth quarter. And we just saw a very significant increase in Europe for the month of November, I think it was up EUR232 per tonne. What's the scope here for potential upside in terms of the margins on styrene and polystyrene, impacting your fourth quarter. How do you think about it? What's baked in?

A – Frank A. Bozich

Yeah, it's a great question and I would say, look, there's a mixed bag of factors that are impacting the business going forward. If you think about it, energy price quarter-over-quarter is going to be up $30 million approximately and the chip shortage should give us about $10 million to $15 million of headwind across the portfolio. Now, offsetting that, we're going to see the traction in the pricing actions we've taken in Engineered Materials, as well as Base Plastics. And then, as you point out the uplift in some of the styrene margins. So, those are the pluses and minus -- the gives and goes that are going to lead to how we've guided for the Q4 and full year.

Q – Frank Mitsch

Got it. Very helpful. Thanks.

Operator

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

Q – Laurence Alexander

Good morning. Can you give us a sense of your thoughts about what the new Trinseo balance sheet should look like or how you be thinking about capital allocation or future bolt-on M&A or willingness to do further large M&As, just to give a sense for what happens once the divestitures out of the way?

A – Frank A. Bozich

Yeah. Thanks, Laurence. Look, I think our priority clearly in the near-term is to get through the integration and realize the synergies and execute against the growth programs that we've identified from what we've already bought. And also complete the separation of Styrenics. Now, going forward, frankly, we'd see a balanced approach to looking at future M&A, and frankly, we want to continue the portfolio transformation.

But as long as we trade at a 15%-plus free cash flow yield, we believe that our own shares represent a compelling investment opportunity that will have to be part of our calculus and how we think about capital allocation. So that's how we would think about it at this point. And, so

again, on balance, looking at additional investments and sustainability and growth opportunities both organic and inorganic along with our own shares as long as we trade where we do before rating upward.

Q – Laurence Alexander
And given the discussion, both in your prepared remarks but also you have it in your appendix slides around the environmental footprint of the portfolio. What is the degree of demand pull that you're seeing or signaling that you're seeing from your customers? That is either translating into better returns or more order stability, or what's the kind of real-world kind of flow-through of these metrics?

A – Frank A. Bozich
Yes.

Q – Laurence Alexander
Or is it that you're seeing it more as a kind of regulatory or disclosure issue rather than a customer issue?

A – Frank A. Bozich
Yes. Thanks. No, it's great question. And actually, it's a change that we've seen during the course of '21 that's marked. And what's happening is, the discussions that we've had prior to this year with our customers, and I would say, this is broad-based but in particular in consumer products as well as automotive, has been really been a value-based discussion and something of a more technical discussion.

The two topics that have really emerged during the course of 2021 and are now really significant factors with those clients are security of supply and supply chain integrity, as well as the sustainability of your offering because they're under it. And what we're being told is, they're being up-pressured significantly to reduce the carbon footprint of their product and they're translating this into their vendor selection and material selection criteria. So, it's a very important customer-related factor and it's growing in importance, I would argue.

Q – Laurence Alexander
Okay, great. Thank you.

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

Q – Hassan Ahmed
Good morning, Frank and Dave. A bit of a philosophical question about the portfolio transformation strategy and the like. I mean, obviously, I understand, the transformation and the philosophy behind that. I mean, you're obviously creating a less volatile sort of earnings profile, you're improving the margin profile while obviously enhancing the free cash flow conversion. But obviously inherent in all of that is that you get a multiple re-rating, right? And I mean, if one looks at the last couple of years, the multiple compression within the chemical space has been quite extreme.

And I understand the fact that everyone seems to be sort of painting the entire sector with one broad brush, and not delineating between call it the margin stability side of it, commodities from specialties, and even the carbon footprint that you talked about. So, long-winded way of asking you, you carry out this sort of portfolio transformation, you're a year out, you're two years out and you're still not getting the multiple that you desire. How would you think about things in that environment? I mean, would you sort of a couple of years out consider a sale, would you just buy back the company and say, look, maybe there's no place in the public domain for a company despite all of these efforts?

A – Frank A. Bozich

Yeah. No. Thanks for the question. And, I think the answer is really simple and it's twofold. One, we asked ourselves several years ago, where is a company like Trinseo best able to compete and grow in the future? Is it in a specialty business or is it in more of a cyclical commodity business? And it's very clear to us that a company of Trinseo's size, a mid-cap or small-cap company, is much better able to grow and return value to shareholders as a specialty company than we are in a global commodity market when you don't have access to the cracker or advantage feedstocks. So that's number one.

So, okay, as we go forward with that transformation, one of the key outcomes is, we're going to generate significant free cash flow. So this is one of the things we're most excited about this portfolio. So, the growth opportunities that we'll have relative to organic and inorganic opportunities are going to be significant. And then the other thing is if we're in an environment where that free cash flow yield isn't re-rated up, Trinseo's own shares represent a compelling investment opportunity that we'll have to figure in the mix of our capital allocation and we'll have to consider. So again, we think that our strategic options are vastly improved with the transformation we've made going forward.

Q – Hassan Ahmed

All makes a lot of sense. And as a follow-up, again, in light of my question, the answer that you gave, and the like, again wanted to revisit the whole sort of capital allocation side a bit. In the near to medium term, right, one, two, three years out, what is the right way to think about buybacks? And I know that is probably a moving target but how do you sort of look in that moving target with regards to buybacks?

A – Frank A. Bozich

Yeah. Look, I think, it's exactly what I said before. As long as we look at external opportunities and organic investments, we'll have to weigh that against the opportunity to buy our own shares. And when we do that calculus, if on a synergy-adjusted basis and strategically, our own shares represent a compelling opportunity we'll have to consider that. So, you know, I can't give you a definitive answer other than we think Trinseo represents a really compelling investment opportunity not only for the market but for ourselves and with the free cash flow we'll be generating.

Q – Hassan Ahmed
Very helpful, Frank. 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. Frank, any thoughts on keeping polystyrene as it does have some performance attributes similar to Engineered Materials?

A – Frank A. Bozich
David, I think the simple answer is, we did evaluate a number of options on what we would retain. And frankly, we see that activity where polystyrene fits with the styrene monomers and gives that the opportunity to divest it, some critical mass.

And then I would say that the market overlap with the rest of the portfolio provides less market traction and market synergy than the portfolio that we're building in Engineered Materials, Base Plastics and then also with Latex. So, at the end of the day, we looked at various options and we came out in favor of it had to be included. The other thing I would point out is, we would expect that the recycled polystyrene should be included also and are in what would be divested with polystyrene. Because at the end of the day, the biggest source of feed for that recycling activity is going to be single-used plastics or plastic packaging that contains polystyrene. So, we see those as being included in that scope.

Q – David Begleiter
Understood. I guess on the M&A question, there are at least two large assets now in this Engineered Materials space, and given the scarcity of these assets, I know the timing may not match up perfectly with what you're trying to accomplish. But given the scarcity of these assets and the premium versus payoff for growth versus share buybacks, want it to be a little more aggressive perhaps right now given again uniqueness of these assets for sale.

A – Frank A. Bozich
Yeah, David, like I said before we've done a lot this year. We have a lot to do with the separation of the Styrenics assets as well as completing the integration of what we've already acquired and that's going to be our near-term priority.

Q – David Begleiter
Got it. Thank you very much.

Operator
Your next question comes from the line of Duffy Fischer with Barclays.

Q – Duffy Fischer
Yeah, good morning. Just on the upcoming separation in styrene, polystyrene, I guess the first question is how clean is that going to be for you guy plant site-wise, as intercompany supply-wise stranded cost, that type of stuff?

A – David Stasse
Yeah, Duffy, hi, it's David. Well, I think there's two pieces. I mean the Americas Styrenics piece obviously is quite clean since that's a joint venture and separate company.

Now within Trinseo, I mean look, there will be a carve-out. I would expect our downstream businesses to have supply agreements with the carve-out businesses as it relates to styrene. And some of the sites, not all of the sites, are kind of co-located with other businesses, with other Trinseo businesses. So there is a fair amount of separation work to do. We've already started that. I think that's the good news. That's why we're kicking off our process in the first quarter. We started working on not only the financials, but also the carving out of the operations, supply agreements, and all those sorts of things. So it is a fair amount of work that does have some lead time. But I think, it's a manageable process that allows us to kick things off in the first quarter.

Q – Duffy Fischer
Okay, and then roughly how many employees would you expect to go with that carve-out? And then do you have an early view of how much stranded cost will be left that you'll have to work down over time?

A – David Stasse
Yeah, we're working through those. In terms of specific FTEs or the employees, I can't give you a number right now. And also, the stranded costs that's something we're working on to understand what that would be.

Q – Duffy Fischer
Okay. All right. Thank you, guys.

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

Q – Eric Petrie
Hi. Good morning Frank. On the PMMA footprint investment in Asia, how much would the plant cost and is the margins in line with that 25% target that you've put out for 2025?

A – Frank A. Bozich
So, we're in the process of doing some preliminary engineering and site selection work. We have seen an estimate -- preliminary estimates that would put the greenfield investment at somewhere around $40 million. Now, if we're able to put the investment on a site where we have some infrastructure, it could affect that but that's order of magnitude what we're thinking. And yes, for us the investment in Asia Pacific for the scale that we're thinking. And let me remind you, its focus will be on formulated PMMA resins that goes into more of the specialty

applications that serves our global customers. So I think global OEMs and being able to supply them in all regions with the same specification materials. We think that we'll achieve that margin.

Q – Eric Petrie

Helpful. And then, secondly, just on the Engineered Materials business from a recyclability point of view, of that 30% sales volume, is most of that in PMMA or could you take a step back for us in terms of how you see that going forward, in terms of buckets between PMMA, rigid compounds and TPE?

A – Frank A. Bozich

Yeah. So, the 30% that I referenced is specific mainly to PC/ABS compounds that goes into consumer electronics. And that's where our group has had some traction over the last several years building that offering. Now, I would expect that we would see similar growth traction on the circular PMMA offering as we have more time under our belt as the owner of the asset going forward and we're seeing a similar interest from the customer base in those end markets too.

Q – Eric Petrie

Thank you.

Operator

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

Q – Angel Castillo

Hi. Thanks for taking my question and good morning. Just wanted to get a little bit more color on the Engineered Materials business. If you could give us a little bit more color to what, I guess, what pressured that in the third quarter? And the implied guidance for the fourth quarter is based on the $210 million EBITDA that you gave. Could you kind of bridge similar to what you gave in terms of the puts and takes for the full company? What kind of the puts and takes that get you from the third quarter EBITDA to that implied kind of low-50 million of EBITDA for the fourth quarter?

A – David Stasse

Yeah. Good morning, Angel. This is Dave. I can address that. I think, probably for starters, given the automotive exposure that we do have in the PMMA business, I'd expect the third quarter to always be the lowest level of EBITDA and that's just due to automotive production seasonality. So, not only for this year but going forward, I would always expect that seasonally speaking.

Now auto demand was incrementally lower than what we would expect just due to seasonality, due to the supply challenges that I think everybody is aware of with the OEMs. Now, compounding this in the third quarter, we had an extremely rapid pace of feedstock increases, specifically MMA increases in the third quarter and our price increases just weren't able to keep

up with that. So, transitioning to Q4 you're right, we do expect EBITDA to be about $20 million higher for Engineered Materials and that's really attributable to three things. The first is pricing actions that we've taken that have gone into place on October 1st. The second is, we're seeing higher MMA margins on the merchant volume that we do have on our MMA production in Europe. And then the third thing is, we do have an incremental two months results of Aristech, so we're reporting a full quarter of Aristech results in the fourth quarter, whereas we only had one month in Q3.

Q – Angel Castillo

Okay, that's helpful. And then in terms of CapEx, that was reduced for the full year. What was, I guess, the driver for that and how should we think about it for 2022 and beyond? It sounds like some of that maybe investment in plants in Asia might be part of that, but how should we think about timing of that?

A – David Stasse

Yeah, so we lowered our CapEx from $150 million to $120 million. I would say $20 million to $25 million of that is purely going to be a rollover. So, our other vendors are having supply chain issues as well. So, getting things that we've ordered is taking longer really across the board. So, I would expect that spend to still occur, but it will just roll over into next year into 2022.

Angel, the other thing, I think I mentioned this in the last call, 2022 will be the peak year of spending as it relates to our SAP implementation, so I think clearly, we do see '22 as being a higher year for capital than 2021.

Operator

There are no further questions at this time. This concludes today's conference call. We thank you for your participation. You may now disconnect your lines.