Trinseo Third Quarter 2022 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
- David Begleiter
- Mike Leithead
- Hassan Ahmed
- Angel Castillo
- Eric Petrie

Presentation

Operator introduction:
Good morning, ladies and gentlemen, and welcome to the Trinseo Third 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, November 2. 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, Regina, 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 Nov. 3, 2023. Now I would like to turn the call over to Frank Bozich.

Frank A. Bozich

Thanks Andy, and good morning, everyone. As we highlighted in our last quarterly call, the combination of economic uncertainty, high energy prices and falling raw material prices triggered significant customer destocking throughout the third quarter. In addition, record energy prices in Europe resulted in reduced demand and lower margins due to the inability to fully recover input costs. We estimate that the sequential impact of higher gas costs on margins was about $50 million. Asian demand remained consistent with Q2 levels and there was no significant demand improvement as COVID restrictions continued. North American demand was steady in Auto, but demand for building and construction applications and consumer discretionary items fell during the quarter as a result of rising interest rates and inflation.

Against this economic backdrop, our volumes and margins in Europe showed considerable weakness during the quarter. Additionally, elevated energy costs placed the entire industry's more energy intensive products on the high end of the global cost curve and, as a result, created opportunities for regional arbitrage. For our more globally traded products like styrene and polycarbonate, the adverse impact on margins was significant, with the oversupply leading to negative margins.

In response to these market conditions, we have announced several potential actions that we are considering to optimize our assets and improve our cost position with the largest area of focus on the more energy intensive products in our portfolio, namely styrene and polycarbonate. We have begun dialogue with the Works Council of Trinseo Deutschland regarding the potential closure of our styrene plant in Boehlen, Germany. The plant has been offline since August, first for planned maintenance and then idled in response to poor economic conditions. The Boehlen facility contributed approximately negative $30 million to EBITDA during the 12 months ending June 2022. We have also temporarily idled our styrene production in Terneuzen, in the Netherlands. The styrene needs for our downstream businesses beyond our production are expected to be met via external purchases.

In polycarbonate, we're evaluating steps to optimize our production and supply chain for our downstream PC compounds. As a reminder, we consume about half of our PC production in our higher margin downstream compounding business but the remaining 50% is sold into the more cyclical merchant PC market. Part of our evaluation relates to potentially closing one of the production lines at our Stade plant and we have initiated discussions with the works council

there. This potential production line closure would lower costs and greatly reduce exposure to the merchant polycarbonate market.

In addition to these potential steps regarding our styrene and polycarbonate assets, we are reviewing ways to optimize our asset footprint in other segments such as restructuring our PMMA sheet business in North America as well as reducing styrene butadiene Latex capacity at our Hamina, Finland plant. Together, all these initiatives, if approved, would lead to an improvement in annual profitability of about $60 million, under current market conditions.

I am confident that in the medium to long term we have a very competitive asset footprint. We are working on some very exciting energy efficiency initiatives that will both reduce our carbon intensity and decrease our utility costs, for example, heat recovery through mechanical vapor recompression. The financial benefits of these can be significant, and we estimate an annual savings of approximately $60 million for the initial set of projects, assuming a natural gas price of $100 per megawatt hour.

However, like the rest of the industry, in the short term we are faced with the combination of historically high energy costs and low demand, particularly in Europe. Therefore, we're actively evaluating steps to improve our operating cost position and operating flexibility, and we've also enacted cost controls such as limiting discretionary spending and reducing capital spending.

The current challenges we face as an industry reinforce the importance of continuing to transform our portfolio into a specialty solutions provider that, as a consequence, has lower carbon intensity. We remain focused on the overarching priority of our transformation, and I want to be clear that we will continue to prioritize the key investments and initiatives that support this strategy.

It's understandable that a significant amount of our current focus is on the headwinds we're facing from the macro-environment, but I'm encouraged by the progress we're making on our transformation. Volumes of sustainable products, meaning products that contain recycled materials, grew 70% in the third quarter versus prior year, with a Q3 year-to-date increase of 65%. Margins for these products have been some of the most resilient in our portfolio, which is evidence of how highly they're valued by our customers. To expand our sustainable product offerings, we're creating and cultivating beneficial relationships to widen our range of sustainable products including our recent announcement of a collaboration with Japan Steel Works to further develop recycled MMA which will feed into circular PMMA solutions.

We are also growing in material substitution applications that help our customers achieve their sustainability and cost reduction goals, such as replacing fiberglass with the co-lamination of PMMA and ABS for mobility and wellness applications. Co-laminated product volumes have grown 20% this year through Q3 and this is one of several material substitution offerings with significant, additional growth potential.

There are additional growth opportunities through expanding our existing products into adjacent applications. For example, our PMMA capstock technology has been adopted for PVC decking and railings as it provides high durability and weatherability as well as the environmental benefit of lower VOC emissions by eliminating the painting for the consumers. We recently began

supplying this technology into siding applications and with the expansion of capstock into siding, which has a total addressable market of approximately $200 million, we can deliver these benefits to a wider range of customers.

We remain committed to developing our product portfolio as part of our transformation with organic and inorganic growth. This will place us in an advantageous position when market conditions inevitably improve. Our recently appointed CTO, Han Hendricks, will lead this effort to expand our technology offerings into higher value applications.

Now I'll turn the call over to Dave to walk through some additional financial points.

David Stasse
Thanks Frank. I'd like to give a little more detail on our cash generation, liquidity profile, and our near-term thoughts on capital allocation.

Despite the low level of earnings in the quarter, we still generated $98 million of Cash from Operations and $59 million of Free Cash Flow. This included a $166 million release of working capital driven by the steep decline in raw material prices and inventory reduction initiatives. We expect another working capital release in the fourth quarter, which is seasonally a strong cash generating quarter.

Our liquidity position continues to be very strong, and we're well positioned to withstand a prolonged industry downturn, if that becomes an eventuality. We ended the quarter with $243 million of cash and have access to over $500 million through undrawn, committed credit facilities.

From a capital allocation perspective, we have a number of very attractive organic growth and sustainability projects that we'll continue to fund through this down cycle. However, share buybacks will be deprioritized until we have better clarity into future economic conditions.

For 2023, we expect our free cash flow breakeven level of EBITDA to be about $350 million dollars. To be clear, we're not giving guidance for 2023 at this point, but I wanted to give you this information to instill confidence in our balance sheet and liquidity position in the context of the current economic environment.

Now I'll turn the call back over to Frank to cover our fourth quarter outlook.

Frank Bozich
Thanks Dave. Looking at Q4, we anticipate similar market conditions to Q3. Europe continues to face considerable challenges, with decreased demand and high utility costs significantly impacting near-term performance. However, North America and Asia are generally seeing steady demand in most markets and some improved demand in Asia for polystyrene and ABS products, hopefully signaling the end of destocking.

For the full year we expect a net loss of $126 million to $91 million and Adjusted EBITDA of $325 million to $375 million. Further cash generation is anticipated in Q4, leading to expected

full-year cash from operations of approximately $150 million and, including an estimated capex spend of $150 million, free cash flow of about breakeven.

At the midpoint, our full-year guidance range implies fourth quarter Adjusted EBITDA of $45 million, which is an $82 million improvement over Q3 due to a number of factors. First, we do not expect a recurrence of the $24 million negative net timing impact or the $23 million of one-time charges from the third quarter. So those two factors combined should lead to almost $50 million of sequential earnings improvement. Additionally, we expect an improvement of approximately $35 million in Feedstocks from improved variable margin, including the benefit of idling styrene production. We expect further benefits in 2023 from the potential asset footprint actions we announced, which we expect will provide significant incremental improvement from our Q4 performance.

To sum up, we have a solid financial position to operate in the current conditions and to support our transformation strategy, and we'll continue to be prudent with our cash management. We are progressing well in the integration of our PMMA and Aristech Surfaces businesses and we are on track to realize the associated cost synergies as well as exploit the growth opportunities we now have as a result of these acquisitions. In fact, I'm happy to report that as of this morning we have successfully transitioned all the PMMA sites from Arkema's ERP system to our new SAP S/4 Hana ERP system. This is a major step, and it results in a significant reduction in Arkema TSA services. I want to take this opportunity to thank our employees for all their hard work on this accomplishment. The sale of the Styrenics business remains on pause but is still an integral part of our transformation. Finally, we remain focused on investing in organic growth opportunities to build our product portfolio with additional sustainable and differentiated product offerings.

And now, we're happy to take your questions.

Questions and Answers

Operator
(Operator Instructions.) Our first question comes from the line of David Begleiter with Deutsche Bank. Please go ahead.

Q – David Begleiter
Thank you. Good morning, Frank and Dave. Just on destocking, is it continuing into Q4? And is it worse in Q4 than Q3? And do you think it'll be largely done by the end of the year?

A – Frank A. Bozich
So let me back into your question. We do think it'll largely be done by the end of the year. We're still seeing some level of destocking as we get into Q4. And I guess I'd give you a data point, for example, in appliances just by reading the public announcements from customers like Whirlpool, we've seen their decrease in production rate is three times the reduction in, say, retail sales. So, there's clearly a destocking effect. We think it'll largely be over by the end of the year.

Q – David Begleiter

Very good. And just on Terneuzen, what are the options with this site? Obviously, you need some production in Europe but what are your options to improve the results there?

A – Frank A. Bozich
Thanks for the question. So, part of the $60 million, or a big part of it that I highlighted in the script, relates to energy efficiency opportunities that we have in Terneuzen. So, we think Terneuzen, in this energy cost environment with the investments that we've planned, will be advantaged compared to the rest of the regional production.

Operator
Our next question comes from the line of Frank Mitsch with Fermium Research. Please go ahead.

Q – Frank Mitsch
Good morning. David, I was wondering if you could kind of break down the components of that breakeven EBITDA, the $350 million that you mentioned. I.e. what are you embedding there in terms of capex, etc.

A – David Stasse
Yes. Hi Frank. To be clear, we're still going through our budget process. So, I'll give you the pieces that we kind of know now. But again, things like CapEx are still going through the budgeting process. What I can tell you about CapEx, Frank, is that it will be less than this year's $150 million.

Interest expense, I think we're budgeting $140 million to $150 million next year. Tax is again still a contingency based on where we end up for an EBITDA forecast. So, I realize there's some pluses and minuses in there, but I think we feel pretty good about that $350 million level to get free cash flow breakeven, Frank.

Q – Frank Mitsch
Understood. And I know that you probably won't offer that as your expectations of trough EBITDA. But -- although if you could, that would be awesome. But Frank mentioned a lot in terms of shutdowns that would save $60 million annually. And I'm wondering what the costs are that are required to spend to effectuate those shutdowns.

A – David Stasse
Yes. So again, to be clear, we're working through the Works Council, so no decision has been made there, Frank. But in the event that we do take all those actions, the cash cost to us next year would be under $20 million -- it'll be between $15 million and $20 million. Beyond then, there could be some decommissioning. This would be in 2024 and beyond. Decommissioning costs, I guess we have to net against that with what we could get for selling scrap. But I think the immediate concern is 2023 and it's less than $20 million. And it's embedded in the $350 million number I gave you a couple minutes ago.

Operator

Your next question will come from the line of Michael Leithead with Barclays. Please go ahead.

Q – Mike Leithead
Great. Thanks. Good morning, guys. First question, Dave, I appreciate kind of in your comments around you prioritizing share buybacks near term. Would you expect to build cash on the balance sheet? Or is there a way to maybe buy back some of the floating rate debt you have out there today?

A – David Stasse
Well, I think all I'll comment on, Mike, is the near term. And in the near term we'll focus on preserving liquidity and protecting the balance sheet. And I think in the near term, certainly in the fourth quarter, there would be no buybacks of either stock or bonds. We're well aware of where the bonds are trading. We've gotten a lot of inbounds on that question. But in the immediate term, I'm just going to speak for Q4, we'll have to see what happens as we start the new year. But in Q4 there will be no repurchases of either.

Q – Mike Leithead
Fair enough and then second, maybe bigger picture question. On the two big acquisitions, Aristech and Arkema's business, you've had both of these for give or take a year or so now. Can you maybe just help provide us, and obviously the macro is a bit different, but just mile markers about where profitability stands? Synergies? Just kind of how the integration has gone relative to maybe versus when you picked up these businesses?

A – Frank A. Bozich
Yes. So let me take a crack at that and we'll have Dave supplement if I miss any points. But what we said is we would estimate that the aggregate cost synergies between the two is approximately $60 million that we would accrue by the end of the third-year post acquisition. I would say, we're on track or ahead of schedule to realize those.

There are additional growth synergies. Frankly, we've seen a lot more growth opportunities than we anticipated into mobility, and building and construction, and sanitary markets than we had anticipated. Clearly, the volumes are down significantly in this environment in building and construction, and mobility. And the Asian markets are lower than we expected. But I would say, our expectation is that these businesses in normalized terms will generate $50 million EBITDA contribution to the business [per quarter]. And I don't see any reason when things return largely to normal, and we've realized the synergies that they won't do that.

Operator
Your next question comes from the line of Angel Castillo with Morgan Stanley. Please go ahead.

Q – Angel Castillo
Hi, thanks for taking my question. I was hoping you could give us a little bit more color on 2023. And particularly, as you think about the range that you've laid out for fourth quarter, I think close to $20 million to kind of $70 million, and if we were to kind of analyze that, it would suggest the range that it's still kind of below the $350 million breakeven cash cost level that you kind of noted.

So just as we think about the puts and takes for next year, can you maybe help quantify some of the incremental factors, at least that you're kind of looking at beyond the $60 million of savings that we would have to think about kind of incremental to the fourth quarter levels? Maybe how much destocking would be incremental and then how much normalization you anticipate? If you could just help us kind of bridge that, that would be helpful.

A – Frank A. Bozich
Yes. So, I'm not going to be able to pinpoint exactly the numbers that I would anticipate incrementally, because as Dave said, we're working through the budget. But let me qualitatively give you the really three big moving parts that will put 2023 above the Q4 run rate.

Number one is the normal seasonality of our business. So Q4 normally, is one of the lowest quarters of the year for us from a normal seasonality standpoint.

The second thing is there is a continuation of destocking which we anticipate will be done by the end of the year. It's a challenge to quantify how much destocking there is, but it is significant, and that we believe will largely be over.

And the other thing is the productivity initiatives that -- the full year benefit that we'll see from those as we drive those to completion. So, I think those three buckets move us substantially above the Q4 run rate.

One other thing I do want to make a point of is that we are seeing in Asia significantly better volumes in both polystyrene and ABS in Q4. And so that's giving us a signal that things are going to return to a better situation in 2023.

Q – Angel Castillo
Got it. That's real helpful, and actually a good segue to my next question. I guess around fourth quarter, could you maybe specify a little bit more what kind of the trends you saw in terms of order patterns in September, October and November and what that kind of cadence was? And then as we think about the $20 million to $70 million range, what do you need to see for instance, as you noted with ABS, what do you need to see to get to the higher end of that $70 million versus maybe what's embedded in the $20 million type outcome?

A – David Stasse
Angel, it's Dave. I'll address that. Look, what we're seeing in terms of order patterns is the continuation of the same in Europe. Clearly no restocking, I mean, kind of bouncing off the bottom I guess, I would describe it at the very low levels of demand in Europe that we saw, really starting early in the third quarter.

North America has largely, at least in our portfolio, been flat for this duration. We have not yet seen any destocking of significance in North America. That continues in the fourth quarter. And then as Frank mentioned, Asia is higher. Asia polystyrene and ABS demand is higher in the fourth quarter. So that's a signal to us that the destocking is over. Feedstock prices have clearly come down considerably. So that's how we see it.

So, all of that kind of gets us to the midpoint of the range I think what would get us in the higher range? I mean clearly some better demand than what I just outlined. Our feedstocks assets are idled so I think that number is somewhat de-risked in the guidance.

I think, Angel, I think this is probably a good point in the call to go back to a question that Frank [Mitsch] raised earlier about the trough level of EBITDA. And I'm sure it's on people's minds. I think we would see -- and this is disconnected from my comments earlier on cash. I mean this is just a fact. In the current environment where demand is, where natural gas is, I think we see trough EBITDA for the company between $350 million and $400 million. And again, for the reasons that Frank just pointed out in your earlier questions, Angel, I mean that's a higher number than obviously run rating the third and fourth quarters, for the reasons that Frank gave.

Operator
Thank you. Your next question will come from the line of Hassan Ahmed with Alembic Global Advisors. Please go ahead.

Q – Hassan Ahmed
Good morning, Frank and Dave. It was very helpful in your slides that you broke out volumes by regions. And I was quite intrigued by the sort of steep volume declines in Asia, not surprising with the COVID lockdowns and the like. And relatively flat year-on-year volumes in North America.

Now, I mean, I'm not looking for quantitative guidance, but just qualitatively. Obviously, the Asian lockdowns are not going to last forever, right? And you're already talking about seeing some sort of volume green shoots out in Asia. Now, the flip side of that is you guys pointed out that there was no destocking as yet in North America and people are already talking about sort of weakening housing market and the like. So, as you look at these volume crosscurrents into 2023, what are broadly your expectations here?

A – Frank A. Bozich
We would see that 2023 at this point is largely consistent with what we're seeing in the second part of this year, and with some decline in the North American market to annualize the growing weakness in building construction and housing. So, I guess that's how we go into our planning cycle looking at next year, is sort of a continuation of the underlying demand ex destocking in Europe and Asia, and some weakening in North America, driven by building and construction, and housing.

Q – Hassan Ahmed
Understood. And just as a follow-up. I know you've obviously announced a variety of sort of restructuring sort of efforts and the like. I mean the EM segment margins were at 3% this quarter. I mean I was a bit surprised by that because I would have imagined the business would have been a little more resilient. So now, with the restructurings that you guys are doing, with destocking behind us mostly, how should we think about -- if current sort of market conditions continue through 2023, with destocking behind and the like, where would you sort of peg these EM segment margins to be in an otherwise sort of relatively recessionary environment in '23?

A – Frank A. Bozich
Yes, I would put the margins for that business in the low-teen level for next year.

A – David Stasse
I just want to add one more thing. I think the margins you're quoting there, there was an element of the one-time charges that were in Engineered Materials as well, Hassan. So, I think those numbers are somewhat deflated by that.

Operator
Our next question will come from the line of Eric Petrie with Citi.

Q – Eric Petrie
Hey, good morning, Frank and Dave. What's your view on auto builds into 2023 compared to this year and the impact on Engineered Materials as well as Base Plastics?

A – Frank Bozich
So, into 2023 I don't know exactly what number we've landed on for auto builds. Yes, we'd have to come back to that number. Dave?

A – David Stasse
Yes, I think Eric, just standing here today our assumption is auto outlook is up low-single digits in 2023 versus 2022. And that's what we're kind of building into our plan based on that assumption.

Q – Eric Petrie
Okay. And then secondly just on styrene, how long can you keep those assets idled? Are you planning to do that through the winter and restarting in the second quarter? And then on your energy efficiency project how fast can you move in timing of the implementation of that?

A – Frank A. Bozich
Yes. So, with styrene, the assets, as long as we can see significant availability on the spot market to meet our downstream needs at a cost that's advantaged versus production, we would continue to leave the assets idled. I would say though that we're seeing the conditions improve significantly from where they were in Q3. So, again, it all depends on the availability on the spot market to get advantaged pricing. We would continue to remain idled.

And then the timing to deliver the energy efficiency programs, some of those will be in effect by the end of 2023 and others we'd begin to see the benefit in early 2024.

Operator
Ladies and gentlemen, that will conclude today's call. Thank you all for joining. You may now disconnect.