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Q3 2018 Harsco Corp Earnings Call

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PRESENTATION

Operator

Good morning. My name is Teresa, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation third quarter release conference call. Also, this telephone conference presentation and accompanying webcast made on behalf of Harsco Corporation are subject to copyright by Harsco Corporation, and all rights are reserved. Harsco Corporation will be recording this teleconference. No other recordings or redistributions of this telephone conference by any party are permitted without the expressed written consent of Harsco Corporation. Your participation indicates your agreement. I would now like to turn the call over to Mr. Dave Martin of Harsco Corporation. Mr. Martin, you may begin your call.

David Scott Martin ***Harsco Corporation - Director of IR***

Thank you, Teresa, and welcome to everyone joining us. I'm Dave Martin, Director of Investor Relations for Harsco. With me today is Nick Grasberger, our Chairman and Chief Executive Officer; and Pete Minan, Harsco's Senior Vice President and Chief Financial Officer. This morning, we will discuss our results for the third quarter of 2018 and our outlook for the remainder of the year. We'll then take your questions. Before our presentation, let me highlight a few administrative items. First, a PDF of our quarterly earnings release as well as a slide presentation for this call have been posted to our website. Secondly, this call is being recorded and webcast. A replay will be available on our website later today. Third, we will make statements that are considered forward-looking within the meaning of the federal securities laws. These statements are based on our current knowledge and expectations and are subject to certain risks that may cause actual results to differ from these forward-looking statements.

For a discussion of such risks and uncertainties, see the risk factors section in our most recent 10-K. The company undertakes no obligation to revise or update any forward-looking statements. Fourth, on this call, we may refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to GAAP results is included in our earnings release as well as our slide presentation today. Now I'll turn the call over to Nick to begin his prepared remarks.

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Thank you, Dave. Good morning, everyone, and thank you for joining us. Once again, Harsco delivered a very solid quarter. The financial results marked the 13th consecutive quarter we have either met or exceeded our guidance. The third quarter results were quite a bit better than expected and continued a trend of improving performance that began over two years ago. In fact, our consolidated operating margin of 13% was the highest margin in any quarter in over ten years. I'm also very pleased that each of our three business segments recorded a double-digit profit margin similar to the results in the previous quarter. Return on invested capital, which for many years was stuck in the mid-single digits, is now above 15%, despite recent investments in growth where the payoffs are expected to occur in 2019 and beyond. Our outlook for the fourth quarter has also improved, due mostly to the Rail business. We expect Q4 profit growth in Metals & Minerals and Industrial to exceed 20%, while Rail is facing a very challenging comparison, the Q4 of last year. I'll make just a few comments on these segments and then turn the call over to Pete.

In Metals & Minerals, we look forward to completing our third consecutive year of revenue and earnings growth and expect our momentum to build and generate even higher revenue and profit growth rates in 2019. The investments that we have made in innovation, commercial resources and the Altek acquisition should push top line growth to roughly 10% next year. In addition, we are considering various investments and innovations that could provide significant value to our customers in the processing of their byproducts. With our renewed focus on innovation, we anticipate, over time, that the mix of M&M revenues will become more heavily weighted towards environmental solutions, which will serve to boost both margins and capital returns. Speaking of our environmental solutions platform, let me briefly update you on our latest acquisition, the Altek Group. Our integration is nearly complete, and we believe the potential of the business is even greater than initially realized. It's new technology to process aluminum byproducts has generated tremendous customer interest. We have identified several opportunities in the aluminum industry for both product and service offerings.

Overall, we are very confident that M&M's potential is yet to be fully realized. And we will continue to invest in both the core mill services business as well as in adjacent markets, such as aluminum, to drive growth and maintain our momentum. Without question, the path to transforming M&M into a provider of environmental solutions across a number of industries has become more clear.

Our Industrial segment delivered yet another excellent quarter with profit up about 50% versus Q3 of last year on a like basis. Significantly, our backlog has reached record levels providing positive momentum well into next year. We anticipate that each business within Industrial next year should benefit from supportive markets, new products, operational efficiencies and improved competitive dynamics.

Our Rail delivered its highest quarterly operating profit in many years, due to strong shipments of both equipment and parts. After a few years of difficult market conditions for maintenance of weigh equipment, particularly North America, the outlook for our business is much improved. The backlog is growing substantially, and we are pursuing several attractive opportunities in new markets.

In addition, innovative new products and manufacturing cost reductions should provide a meaningful lift of profit over the next few years. In fact, I expect the profit growth in our Rail business to exceed that within each M&M and Industrial in 2019 and perhaps in 2020 as well. So as we approach the close of 2018, I'm very confident in our strategic direction, our leadership team and our ability to execute our plan. And while we expect our end markets to remain healthy next year, most of our growth will be driven by internal initiatives. To be more specific, we expect 2019 revenue growth to be in the mid-teens with a further expansion in our operating margins. We also plan to invest in our businesses at a rate above that in recent years, not only in the pursuit of organic growth but perhaps in targeted acquisitions as well. Nonetheless, we will continue to evaluate the return of capital to shareholders when appropriate, as we have over the past few weeks through the repurchase of our shares.

So thank you for your support and your interest in our company. And I'll now ask Pete to provide further perspective.

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Thanks, Nick, and good morning, everybody. So let me start with Slide 4. Harsco's adjusted operating income in the third quarter was $58 million, which exceeded our guidance range of $50 million to $55 million for the quarter.

Among our business units, the largest contributor to our better-than-anticipated result in the quarter was, again, Rail. This was the case with our Q2 results as well, and it's very good to see that momentum building in this business. In the third quarter, Rail benefited from better equipment mix in volume in North America, and in addition, we are aided by higher volumes and a more favorable mix of aftermarket sales.

Another driver of our better-than-anticipated results was our Corporate spending, which was lower than we forecasted, partially due to the timing of some expenditures.

Our Industrial and metals segments also performed very well in the quarter, each generating profitability in line with our implied guidance for the quarter.

Overall, we're very pleased with the performance and outlook of each of our businesses. And our optimism looking forward is supported by the fact that our relevant industries continue to operate at far from peak levels. And we believe we are still in the early innings, so to speak, of executing against our growth strategy.

Harsco's revenues compared with the prior year quarter increased 16% to $445 million. This revenue change led to a 47% increase in adjusted operating income and a 100% increase in earnings per share. Each segment realized a meaningful increase in revenues and earnings relative to the third quarter of 2017. And also each segment again achieved double-digit operating margins for the second consecutive quarter.

Our Rail margin of greater than 20% is certainly a highlight.

Our diluted earnings per share was $0.40 compared to our guidance range of $0.34 to $0.40. This result also compares with adjusted earnings per share of $0.20 in the third quarter of 2017 with a portion of the prior year increase, again, attributable to lower interest costs and a lower effective tax rate.

I would like to point out one unusual item in the quarter. We had a small noncash quarterly purchase accounting adjustment from our Altek acquisition related to the earn out, and which is required under Generally Accepted Accounting Principles. You should expect such purchase price adjustments related to the earn out in the future.

Lastly, on this slide, free cash flow in the quarter totaled $20 million. This total was little changed from the third quarter of 2017. Our free cash flow guidance for the full year is unchanged at $90 million to $100 million. So as in prior years, we anticipate strong free cash flow in the fourth quarter, since sizable collections and advances in Rail are expected in Q4 and our other businesses are also expected to generate significant free cash flow.

Now let me discuss our segments, starting with Metals & Minerals on Slide 5.

M&M revenues increased 5% in the third quarter after a negative foreign exchange translation impact of $10 million. Also, exited contracts affected our growth rate. The revenue impacted these exits was approximately $7 million.

Meanwhile, adjusted operating income in the segment increased to $30 million from $28 million in the prior year. The earnings increase is primarily attributable to higher services demand and improved results at our stainless steel link sites as well as our metal additives business. The net change in contracts also positively impacted the quarter compared with the third quarter of 2017. These positives were partially offset by our planned growth investments included in SG&A and also foreign exchange translation impacts.

As expected, the impact of Altek's operating results were not material to the quarter.

In total, metals adjusted operating income margin reached 11.1% in the third quarter.

So now turning to Industrial on Slide 6.

Revenues increased 20% for this segment versus the comparable period in 2017. And operating income rose more than 8%. Now you may recall that the 2017 quarter included a gain on the sale of real estate of approximately $4 million, which if excluded implies an increase of 50% in the current quarter operating income.

Increased demand mainly for air-cooled heat exchangers accounted for the revenue change. Also, each of our 3 operating businesses within Industrial realized higher earnings and improved operating margins relative to the third quarter of last year.

The segment's consolidated operating margin was 14.9% in the third quarter.

We're also very pleased with underlying customer activity and backlog trends in Industrial during the quarter. Segment backlogs reached $193 million at the end of the quarter, which is an increase of 45% quarter-on-quarter and 120% year-on-year. And notably this backlog amount is an all-time record for Industrial and is clearly reflective of the ongoing investments in the U.S. energy industry.

But the strength goes beyond energy markets. Our other 2 businesses in Industrial also showed year-on-year growth in bookings during the quarter.

So now for our Rail segment.

On Slide 7. Back in August, we highlighted that Rail was going to have a very strong Q3 because of expected shipment timing, and this certainly proved to be the case.

Revenues in the third quarter increased 62%, and its operating income increased more than 300% year-on-year to $19 million. These changes translated to a segment margin of 23% in the third quarter, a tremendous result. In fact, the third quarter represented Rail's highest quarterly profits in more than 5 years.

The earnings improvement relative to the prior year is attributed to higher equipment and aftermarket demand as well as a more favorable product mix. North America, Asia and Europe all contributed to the improved result.

SBB revenues totaled $5 million in the quarter, and we continue to make good progress on our two contracts. All 13 of the base vehicles under the first contracts have been handed over to SBB, and meanwhile, our upfront work continues with our customer under the second contract. And as we mentioned in August, we are on track to lock down the design for these utility vehicles prior to year-end.

Underlying business activity for Rail continues to strengthen, here in the U.S. and internationally. In recent months, we announced an important win in Southeast Asia and another with New York subway system. As a result of these wins as well as others, our backlogs are now up strongly year-to-date. Rail backlog at the end of the quarter, excluding the SBB amounts, totaled $175 million, which is 70% higher than it was at year-end.

Now turning to Slide 8 and our final outlook for 2018. Let me just highlight a few items here.

First, our full year adjusted operating income guidance has increased to a range of $185 million to $190 million, and this compares to $175 million to $185 million previously. Likewise, our forecasted adjusted earnings per share is now expected to be between $1.24 and $1.29 per share as compared to a prior range of $1.19 to $1.27.

This outlook changes are being driven primarily by our Rail segment as well as Corporate. In Rail, improved demand and a better mix of both equipment and aftermarket sales support the increased outlook. And net Corporate spending for the year is now expected to be lower than prior year levels.

Our free cash flow guidance is unchanged at $90 million to $100 million. And as we've mentioned throughout the year, raw material and labor cost inflation have not had a material impact on our outlook, and the same is true with foreign exchange rates.

Interest rate volatility has also been very topical in recent months. To-date, we've not seen any related impact within our businesses, and we believe higher financing costs are very manageable for us. Recall that one-half of our outstanding debt at quarter-end is subject to LIBOR-based adjustments. Moreover, we expected any sustained interest rate increase would have a positive impact on our underfunded pension position, which totaled approximately $250 million at year-end.

Now before I turn to the fourth quarter guidance, let me mention two other important items.

First, our net leverage position declined to 1.8x at the end of the quarter. We expect this ratio to fall even further by year-end.

And secondly, as you are aware, we announced the $75 million share repurchase program a few months ago. To-date, under this program, we have repurchased approximately 550,000 shares at an average price of just under $24 per share.

So let me conclude with our fourth quarter guidance on Slide 9.

In Q4, we expect operating income to be between $39 million and $44 million as compared to adjusted operating income of $39 million in the fourth quarter of 2017. Also, diluted earnings per share is projected to increase to be between $0.26 and $0.31 as compared with adjusted earnings per share of $0.20 in the prior year quarter.

Our Metals and Industrial segments are forecasted to show improved profitability versus the fourth quarter of 2017, and the change in corporate costs should also be slightly favorable, while Rail's income is expected to be lower year-on-year. Now you may recall that in the fourth quarter of last year, Rail recognized $42 million of SBB revenue, which makes for a challenging top line comp. Also, the segment's overall profitability in the fourth quarter of last year was very strong due to unusually strong product mix and shipment timing, similar to what we've experienced in the third quarter of this year.

So that concludes our prepared remarks. And at this point, we would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we do have a question from the line of Jeffrey Hammond.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

So I really just want to dig in on, Nick, your comment about mid-teens growth in the '19. One, what's the organic growth rate within that? Does that incorporate any future deals and maybe just give us a little color on how that might spike out between the three segments?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Well, first of all, Jeff, it's almost all organic growth. Within M&M, I indicated that the growth rate, top line could approach 10%. About three points of that would be the Altek acquisition. The rest of it would be organic. Few points from the market and the balance of that being new contracts and new services at existing sites. Within Industrial and Rail, it's all organic. Top line growth in Rail and Industrial should both be double digit. So no additional acquisitions assumed, of course, in that guidance.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. Great. And then just on Rail, the double digits, how much of that is visibility from new contract wins versus just North America Class I Rail, picking up or kind of just underlying international kind of parts and service demand?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Yes. Well, it's certainly a mix. We expect fairly significant growth in the North American equipment market next year. And you know that's been depressed for the past few years. We've announced a few large wins, contractual wins both in the U.S. and outside the U.S. that are in our backlog now, that will begin to ship next year. And then we expect the aftermarket business to continue to be strong. Of course, we have less visibility there, but the outlook remains positive.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then finally, Rail, I think, you mentioned you think profit growth into '19 and '20, in Rail, can be greater than M&M and Industrial? Can you just talk about what informs that view? And where do you ultimately think Rail margins can go over the medium to long term?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Well, I guess, two things informed that view. One is where the business is in its cycle relative to M&M and energy, the Industrial business. It's just coming out of the trough and maintenance of weigh equipment in North America. So clearly, the cycle is going to provide a larger lift on a relative basis to Rail than to the other two. Beyond that, we planted a lot of seeds in markets outside of North America, some of which have already yielded contractual wins and they are in the backlog. Others, we certainly expect to materialize into new contracts in the coming years. So we also have recently launched a few new product categories, new product innovations that we think are quite game changing and the impact that will have on the industry. So that's the combination of each of those. In terms of margins, we've already seen a pretty significant shift in the mix towards aftermarket relative to equipment. So I'm not sure that mix is going to come any richer. So I think the margins that we've seen kind of in the mid-teens would be a reasonable benchmark for margins in Rail over time. The profit growth is driven more by volumes than by mix or price, I would suggest.

Operator

And our next question comes from the line of Rob Brown of Lake Street Capital.

Robert Duncan Brown ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

On the Industrial business, I just wanted to get a little bit into the visibility there. You noted a very nice backlog. How much does that backlog cover for 2019? And how do you feel about 2019 in terms of visibility and kind of the trends in the market?

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Hi Rob, it's Pete. We got good visibility. The backlogs, as I mentioned, are quite significant. And depending on the mix, we've got well in excess of six months of '19 in the backlog. And as I mentioned earlier, the bookings continue to be very, very robust. So we've got great visibility into 2019. And frankly, the indicators are that, that will probably continue in the next quarter or so.

Robert Duncan Brown ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Okay. Good. And then how much of your mix in your heat exchange business, how much is related to new LNG facilities versus through a general energy market?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Yes, the mix is much more skewed towards the upstream segment than it is downstream in LNG. So it's probably 80 to 90% kind of upstream and midstream with a much lower proportion in LNG. With that said, we are increasing share in LNG. And we've want some nice, new business that historically we would not have been even aware of. So we like our trend downstream, but the margins are actually a bit lower in LNG than they're in the upstream. That's roughly the mix.

Robert Duncan Brown ***Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst***

Okay. Good. And then on the M&M business, you talked sort of strategically about environmental solutions. Just maybe at a high level, how is the sort of end customer demand for that product set? And has there been a change in the market there or some color on kind of the environmental solutions piece of that market?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Well, it's driven by changing and tightening environmental regulations, globally. We've seen it in every market in which we operate. And so the core logistics, the services that we provide on the sites will continue to be critical in terms of creating value for the customer. But on a relative basis, the greater value contribution will come from managing their byproducts and their environmental challenges on their sites. And that will clearly grow faster than the core logistics business. There's a lot of innovation, both internal that we are generating as well as I mentioned some external innovation that we're looking at very closely. And that segment of the business, the environmental solutions or Applied Products, clearly, is less capital-intensive and should attract higher margins than it would just express.

Operator

(Operator Instructions) And we have a question from Chris Sakai.

Christopher J. Sakai

Just want to know, as far as the 2018 outlook, is Altek already incorporated in this outlook?

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Yes, Chris. This is Pete. Altek is included. It's going to generate in the neighborhood of $12 million to $13 million of top line. But as I have mentioned before, mostly due to purchase accounting for the first year of operations, it's going to be inconsequential to the operating income line. The big expectations are started in 2019, throughout.

Christopher J. Sakai

Okay. Great. Can you provide any sort of guidance on 2019 and on what sort of impact to expect on the top line?

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Yes, we're looking for significant growth, obviously. This is the first year. We've only had revenue in this business there since the May time frame. So you will get the full year impact plus, as we've talked about previously, we're anticipating some very sizable growth from the AluSalt part of the business, which was the technology we acquired, which is quite attractive and which should generate most of the growth in 2019. So it should be substantial improvement from this year, Chris.

Christopher J. Sakai

Okay. Great. And then as far as future acquisitions goal, is there a specific region? I know you're pretty excited about the environmental sector. Would that be where another acquisition might occur?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Yes, I think, Chris, that's the most likely area in which we'd acquire. It's less of a function of geography than it is technology around processing byproducts, the whole waste-to-value theme that is becoming much more prominent in the basic industries, such as steel and aluminum.

Operator

Our next question comes from the line of Jeffrey Hammond of KeyBanc.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Just a couple of follow ups. One, just again, back on the '19 growth. So it sounds like, Nick, M&M, you still think is in that 10% zip code, so the other two would push into mid-teens?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

That's right.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then you had a pretty heavy investment period in M&M that held back the margins. How should we, I think, you talked about continuing investments but also margin expansion. How should we think about the trajectory of margins in M&M into '19?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Well, I think we've indicated before that we invested about $10 million of incremental expense into M&M in 2018, and that's baked in. That's not onetime, these costs will continue. We will continue to invest probably beyond that $10 million. So there will be some incremental investment in mostly front-end resources in M&M in 2019, but not as much as the $10 million. I think you'll see, in terms of growth investments in M&M next year more in terms of capital investment for new contracts than on expense.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then just on the double-digit growth in Industrial, clearly, we've seen two really good years off the bottom in Air-X. How should we think about a tough compare into that, into '19 and maybe just to comment on how you think IKG and PK trend in the '19?

F. Nicholas Grasberger ***Harsco Corporation - Chairman & CEO***

Well, you are certainly right. The comp for Air-X becomes more difficult. Actually, it has been for several quarters now, but we look at the backlog. And given the lead times on the product in that business, we're pretty confident in our top line outlook for Air-X. PK and IKG have been relatively weaker in the past couple of years, and we think that, for various reasons, that their top line growth will accelerate next year.

Operator

There are no further questions. Now I would like to turn the call back over to Mr. Martin.

David Scott Martin ***Harsco Corporation - Director of IR***

Thank you, everyone, for joining this call. As mentioned earlier, a replay of this call will be available later today through November 14th. And the replay details are included in our earnings release. Also, please contact me with any follow-up questions using the contact details provided at the top of today's release. Again, we appreciate your interest in Harsco, and we look forward to speaking with you in a few months. Have a great day. Thank you.

Operator

This concludes today's conference call. You may now disconnect.