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HSC - Q3 2019 Harsco Corp Earnings Call

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PRESENTATION

Operator

Good morning. My name is Zatania, 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. (Operator Instructions) 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 other party are permitted without the express written consent of Harsco Corporation. Your participation indicates your agreement.

I would now like to introduce Dave Martin of Harsco Corporation. Mr. Martin, you may begin your call.

David Scott Martin - *Harsco Corporation - Vice President of IR*

Thank you, Zatania. Welcome to everyone joining us this morning. I'm Dave Martin, Vice President 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 CFO. This morning, we will discuss our results for the third quarter of 2019 and our outlook for Q4. We'll then take your questions.

Before our presentation, however, let me mention a few items. First, our quarterly earnings release as well as the slide presentation for this call are available on our website. Second, 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 and uncertainties that may cause actual results to differ materially from these forward-looking statements. For a discussion of such risk factors 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.

Lastly, 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 the slide presentation today.

With that being said, I'll turn the call over to Nick.

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

Thank you, Dave, and good morning, everyone. Thanks for joining us. This past quarter was yet another quarter that demonstrated our ability to execute across the organization, while taking meaningful steps to reshape our strategic focus and navigate difficult market conditions. Together, these actions allowed us to deliver growth across our business, even with the challenging market conditions in our Environmental segment.

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Earlier this year, we communicated our vision to be a global leader of environmental solutions, which we believe will create meaningful value for Harsco and all of our stakeholders. This is an important shift for us for a number of reasons. Harsco has always been an environmental solutions company, and it became clear that further investments and focus in this area would allow us to drive higher growth with enhanced margins and reduced cyclicality.

Practically speaking, this also provides some insulation from some of the market dynamics we saw, for example this quarter, in our Environmental segment as its customers manage through some of their own challenges, which I'll touch on in a moment. As we continue to advance our portfolio transformation, we are excited about growing Harsco in a way that reflects our core values, meets the innovation needs of our customers and creates meaningful value for our shareholders.

Turning to the quarter, I could not be more pleased with our first quarter of Clean Earth as part of the Harsco family. Revenues grew 20% and profit doubled compared to the same quarter last year. Our integration of the business is on track to achieve its objectives and prepare us to scale the business to a much larger segment of our portfolio over the next few years.

I'm also encouraged by the collaboration between Clean Earth and Harsco Environmental. What gets me excited about this transaction is the ability to realize commercial and operational benefits from this new partnership over time, particularly, as we sharpen our focus and grow both platforms.

Speaking of Harsco Environmental, the business witnessed the most difficult market conditions for its customers since 2016, especially in North America. Mill utilization rates in Q3 declined to 76% compared to an average figure of 82% over the past 4 quarters. Nevertheless, when excluding the impact of foreign currency movements, HE's revenues were unchanged and profit was up 10% in Q3 compared to the same quarter of last year. And profit margins were at the highest point in some time, reflecting add-on services, improved contract mix and ongoing cost-reduction initiatives. Overall, we expect HE to deliver its fourth consecutive year of profit growth in 2019 despite dramatic steel industry volatility over the period. As we look ahead to 2020, we expect continued growth in HE as a result of our increasingly -- our increasing backlog and visibility to new contract opportunities, and environmentally driven add-on services.

Turning to Harsco Rail. I'm confident in saying that the strength of our brand and the outlook for the business have never been stronger and the evidence is clear. The order backlog is at a record high. Our innovations in rail servicing and treatment lead the industry. And the preeminent state-owned railroads in the world, such as Deutsche Bahn, are increasingly looking to Harsco Rail to provide environmental and safety solutions across their networks. Our ambitious but realistic goal is to achieve $100 million of EBITDA in Harsco Rail in the next 3 years.

I'd like to make just a few comments on our outlook for next year. Although we will look much more closely at our expectations for 2020 over the next few months, we have a preliminary view based on our recent long-range planning process. First of all, we remain optimistic that each of our 3 segments will produce revenue and earnings growth in 2020 with the rate of growth in Rail and Clean Earth outpacing that of Environmental.

Importantly, our recent portfolio rotation actions, including the acquisition of Clean Earth and the divestiture of the Air-X-Changer business, are key factors supporting our positive outlook. Overall, on a consolidated basis, we expect top line growth on a comparable basis to be in the mid- to high single-digit range next year with earnings -- with the earnings growth rate outpacing that of revenue growth. With respect to financial leverage, we should end this year at around 2x and anticipate further improvement in this figure in 2020. Our leverage should also benefit from the divestitures of the remaining businesses in our Industrial segment over the next few months.

Before I turn the call over to Pete, I'd like to focus for just a minute on our environmental, social and governance initiatives. Earlier this month, we released our 2018-2019 ESG report, our most comprehensive sustainability report to date. Last 18 months have been an exciting period of change for our business and this expanded report tells a more comprehensive story about our strategy, the environmental solutions we are delivering to our customers, our corporate governance approach and the investments we are making in our people and in our communities.

As you can see on Slide 4, Harsco businesses are already delivering environmental products and services to our global customers. We are pleased to see -- to have seen a very strong positive response from a number of our investors, which reaffirms our recognition of the importance of sustainability and the increasingly critical role that we'll play in Harsco's go-forward strategy.

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I'll now turn the call over to Pete.

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

Thanks, Nick, and good morning, everybody. So let's start with Slide 5 and our consolidated financial summary for the quarter. Harsco's adjusted operating income in the third quarter was $57 million excluding acquisition amortization expense. This translates to a margin of 13.5% on revenues of $423 million. This income figure compares favorably with adjusted operating earnings of $45 million in the 2018 quarter, which excludes our prior Industrial segment now accounted for as discontinued operations.

Also, our Q3 operating results were within the guidance range we previously provided of $56 million to $61 million. We are pleased with this performance, given the external market pressures on our customers in Harsco Environmental, which intensified throughout the quarter. Lower services demand or steel output, commodity prices and foreign exchange negatively impacted our results by a few million dollars in the third quarter versus our expectations at the beginning of the quarter. However, despite these challenges, our business grew. Environmental results improved year-on-year, and the segment's adjusted operating income margin exceeded 13% for the quarter. This outcome illustrates the fundamental improvements we made within this business in recent years and our ability to manage through difficult conditions. It also reflects positively on the growth investments we started to make in Environmental.

Meanwhile, our Clean Earth and Rail segments both had very strong quarters that were consistent with our expectations. Rail's adjusted earnings were lower year-on-year. This comparison, as we've discussed before, is against a record quarter for the segment in Q3 of 2018, and this comparison challenge will reverse in the current quarter. Our optimism for Harsco Rail remains very high.

Clean Earth showed significant year-on-year growth in Q3. Clean Earth's revenues grew more than 20%, and its adjusted operating income increased more than 100% compared with its 2018 quarter. On a consolidated basis, Harsco's adjusted earnings per share from continuing operations was $0.36 compared with $0.32 in the prior year quarter. And this outcome also puts us within our guidance range of $0.35 to $0.41 per share.

Unusual items in the quarter totaled $0.09 per share and primarily included Clean Earth integration and acquisition-related costs and additional expenses to complete our productivity improvement initiatives in Harsco Rail. Other unusual items, including site exit costs and other adjustments, netted to a very small amount in the quarter.

Next, our free cash flow was $5 million in Q3, which was consistent with our expectations. In the current quarter of Q4, our free cash flow is expected to be materially better as is traditionally the case in our fourth quarter.

Lastly, before moving on to our segment slides, let me comment on our capital structure and share buyback activity. Given that we sold our Air-X-Changers business on July 1, the day after the second quarter close, it is understandable that there was some confusion about our capital structure following our Q2 results. Our Q3 balance sheet clarifies the situation. At the end of Q3 and in fact at the beginning of Q3, our net debt approximated $700 million, and our net leverage ratio was 2.2x. Liquidity at September 30 was over $600 million. As you can see, our capital structure as well as our financial flexibility remains very strong.

The balance sheet position also reflects that we repurchased 1.4 million shares of Harsco stock in Q3 for $26 million at an average cost of approximately $18 per share. At the end of Q3, $19 million was remaining under our current buyback authorization, and we've continued to repurchase our shares since the end of the quarter.

Now please turn to Slide 6 and our Environmental segment. Segment revenues in the third quarter were essentially unchanged compared with Q3 2018 after foreign exchange translation impacts. Meanwhile, adjusted operating income totaled $34 million, representing an increase of 8% versus $32 million in the prior year period, and our adjusted operating margin was just over 13%. There were a number of moving parts in the quarter, as you can imagine. A high-level summary from our bridge is that lower SG&A expenses, new sites, higher applied product contributions and improved services mix offset the impacts of lower steel output and commodity prices as well as foreign exchange rate changes and site exits.

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Given the challenging macroeconomic factors, we've been actively and rigorously managing our cost structure. These actions helped stabilize our results in the quarter, and as we move forward, we will continue to focus on these actions given the ongoing market conditions.

Steel output at our continuing customer sites declined approximately 6% compared with the third quarter of 2018. As a result, as Nick mentioned, facility utilization rates at our customer mills were the lowest we've experienced since early 2016. Also, commodity prices were lower year-on-year. Despite these trends, our profitability in Environmental improved versus 2018 and our adjusted operating margin exceeded 13%. Clearly, we view our Q3 results in Environmental as a positive achievement given the challenges facing our major customers.

Next please turn to Slide 7 and Clean Earth. As you know, this is our first quarter with Clean Earth, and it's off to a great start. Revenues grew 23% and profitability doubled, as I mentioned earlier. Processing volumes increased strongly for both contaminated and hazardous materials, and pricing trends were favorable in these business lines as well. Acquisitions completed in late 2018 also boosted these comparisons.

The segment's adjusted operating margin in the quarter was nearly 19%, the best of our 3 segments. Our Clean Earth management team executed well in the quarter. Our business and functional integration is largely complete and has been successful, and we are on pace to achieve the targeted run rate of synergies by the end of 2020.

Now please turn to Slide 8 regarding our Rail business. The segment had another strong quarter. Revenues reached $75 million, and Rail's adjusted operating margin exceeded 17%. As I mentioned, Q3 2018 was an unusually strong quarter and, therefore, a tough comp. The year-on-year change in profitability was driven by lower shipments and a less favorable product mix of equipment and parts, and these factors were partially offset by lower manufacturing costs.

Beyond the financial results, there were a number of other positive developments in Rail during Q3. Our initiative to consolidate our North American manufacturing footprint into our South Carolina facility is largely complete. We launched our next-generation tamper technology, which has been under development for some time, and we experienced a nice growth in our backlog. In particular, we won a large order in Germany, which we recently announced. And there are other significant wins in the quarter as well. As a result, Rail backlog increased 30% quarter-on-quarter to nearly $380 million. Year-on-year, our Rail backlog is up 45%. And importantly, this backlog provides us with tremendous visibility as we begin to think about 2020.

Next, let me discuss our outlook for the year on Slide 9. Our latest expectation is that our full year 2019 revenues will increase mid-single digits, and our adjusted operating earnings will grow nearly 10% at the midpoint of our guidance range. As a reminder, this outlook includes the results of our prior Industrial segment for the first half of 2019.

For the year, adjusted operating income is now anticipated to be within a range of $209 million to $214 million. The midpoint of this guidance is modestly lower than our prior midpoint, but in the context of the current steel markets and the sluggish global industrial economy, we view our outlook as positive for all 3 of our businesses.

The remaining guidance figures on the slide are updated to reflect the change in operating income. And in the case of free cash flow, our new range incorporates slightly higher growth-related capital spending. Our expectations for each of our segments is included in the appendix of the slide deck.

Let me conclude on Slide 10 with our fourth quarter guidance, which points to strong year-on-year growth in each of our 3 businesses. Q4 adjusted operating income before acquisition-related amortization is expected to range from $53 million to $58 million. Harsco Environmental's growth will be driven mainly by new site benefits and lower administrative spending, partially offset by lower services demand, foreign exchange and site exits.

Improved year-on-year performance for Clean Earth is anticipated as a result of strong volume growth and better results within its contaminated and dredged materials lines of business. Prior year acquisitions will also help comparisons. And Rail is expected to benefit from higher volumes and more favorable product mix for equipment, parts and Protran technology products.

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So that concludes our prepared remarks, and I'll now turn the call back to the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Jeff Hammond of KeyBanc Capital Markets.

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

Just want to understand -- I'm struggling to get into the 4Q guide a little bit. So just on Environmental, I think, you said it'd be flat to up on op income ex FX. Can you just quantify what the -- or what you think the FX profit headwind is going to be?

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

Yes. Jeff, it's Pete. So on the revenue side, for Q4, the FX headwind using the end of quarter rates is going to be about anywhere from $6 million to $9 million, and the OI impact would be about $1 million for Q4.

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

So that puts it what, like, $4 million for the year?

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

The full year FX will be about $5 million in total at the operating income level, $45 million at the top line.

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

Okay. So just to be clear, your op profit is going to be flat to improve ex that $5 million?

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

We should be up mid-single digits in Environmental in Q4, Jeff, from the prior year. And that's really a combination of -- despite the FX headwind and the commodity headwind, which is a little bit. We've got some good service mix. We're anticipating some growth in Applied Products. And I think we have some cost improvements that we have undertaken that will offset and generate the mid-single-digit growth for Q4.

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

Okay. And then on Rail, it looks like you're going to -- your 4Q is going to be up 100% to get to the 30% to 35%. So can you just -- I mean, it sounds like mix is going to be favorable. What do you think the EBITDA margin range is to think about for -- on that big growth number?

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

Yes. So first of all, you're absolutely right. That's the kind of growth we're expecting. It's going to be darn near close to 100% year-on-year. EBITDA margin for Rail is going to be somewhere in the neighborhood of 16%, 17%, which is about what we've experienced the first half. Actually, it will be a little higher than that, Jeff, closer to 19%.

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

Okay. Okay. Great. And then just kind of -- Nick, I appreciate the 2020 color. Can you just talk -- within that comment that you think you can grow in Environmental, how should we -- how are you thinking about or how should we think about LST volumes within the context of that? And maybe you can just break out what you think Altek and the net new contracts can add and maybe what you can grow in kind of a flat steel production environment?

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

Yes. We're -- Jeff, this is Pete. We don't really have all the details on that yet. Obviously, we're still early days in kind of finalizing our 2020 outlook. But clearly, we remain optimistic, even with some expectations that there will not be a lot of production growth from our customers in terms of steel production. The Applied Products is going to contribute a good portion of the growth for us. I think we'll continue to the cost reductions that we've expected. And these factors together, I think, will provide us a good bit of tailwind. Now certainly, the new contract wins, we won 35 new contracts over the last couple of years. And a lot of those, if not a significant portion of those, will be fully ramped up by the end of 2020. So we will definitely start to see the impact of that contract win rate in 2020. All those factors together kind of support the growth that Nick alluded to.

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

Okay. If I could sneak one more in, just Rail, you sound pretty positive on the outlook, certainly over the next 3 years, maybe just give us a little bit better picture of how you think about the growth into 2020?

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

Yes. So Jeff, we -- given the record backlog that we have expected at the end of '19, we're looking at pretty strong double-digit top line growth in Rail next year, and it's really across the different segments of the business, both products and geographies. So it's really a very strong outlook in Rail.

Operator

Your 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*

Just staying with Rail a little bit, what kind of gives you the optimism there? Is it an overall environment improvement? Or is it some product gains? Or what's sort of the driver of the optimism there?

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

I would say it's 2 things, Rob. Certainly, the innovations, the launch of new tamper that Pete referenced is getting an awful lot of interest from the Class 1s. We also outside the U.S. in utility vehicles and other vehicles have built a very strong backlog, both in Europe and Asia, and there's some optimism in South America as well. So -- even though the kind of the macro factors within the Rail industry -- freight industry in the U.S. are somewhat

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mixed. Again, we can look to our backlog in innovations. And also in our Protran segment, some of the safety and technology products that we're increasingly selling to municipalities is quite positive.

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

Okay. Great. And then on the Clean Earth business, could you remind us again where you're at in terms of getting synergies? And I think you said that was on track, but how is that going? And then second, how do you see that business growing over the next couple of years and sort of where you are at in thinking through M&A as well?

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

Yes. Rob, it's Pete. I'll answer the first part of the question and certainly Nick can add any additional color, commentary. I think with respect to synergies, we had targeted looking for kind of a run rate of $10 million of synergies, and we're on pace to get those by the end of 2020. So I think the integration efforts that we've done to date with respect to the funnel -- the functional integrations are kind of well on target, maybe even slightly ahead of target. Those we feel pretty good about.

In terms of the growth factors here, it's -- the organic growth rate we saw this year when you carve-out the acquisitions, just in Q3, it was about 14%, which is certainly not out of the realm of possibility going forward. We don't expect quite that degree of organic growth, but it should be kind of high single digits, maybe even low double digits. So I think -- and that will be coming from all 3 of the lines of business contaminated, hazardous and probably even to a larger degree the dredged materials business. So I think those look pretty good.

As far as M&A goes, maybe Nick, I'll let you comment on that.

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

You may recall, Rob, that some of the commentary around the announcement of the acquisition was the industry itself the Clean Earth participates in remains kind of highly fragmented. And Clean Earth has been somewhat successful making largely smaller acquisitions over the past 5-or-so years. We certainly see that opportunity continuing, but even larger opportunities, we believe, may well be available. So I think relative to HE, Harsco Environmental, you'll see us allocating more M&A capital to Clean Earth.

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

Okay. Good. And then I think you touched on the remaining Environmental -- sorry, the remaining Industrial businesses, divesting those. How do you see the timing on that? And can you remind us what those are doing in terms of revenue and EBITDA?

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

So full year, those businesses, the remaining businesses, as you know, the Paterson-Kelley industrial and the IKG business, they're accounted for in our discontinued operations. The full year EBITDA impact of those businesses is lower $20 million. They're both actively being marketed for sale, Rob, and we fully expect that we will have these transactions done by the end of the year.

Operator

(Operator Instructions) And you have a question from the line of Jeff Hammond of KeyBanc Capital Markets.

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

Just a couple on Clean Earth. So I think you talked about that as being kind of a 7% core growth kind of business. How are you thinking -- as you start to look at 2020, how are you thinking of your growth shaping up relative to that kind of long-term growth rate?

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

I think the 14% as much as we would like to say that sustainable. I think the more likely organic growth rate for Clean Earth is probably mid- to high single digits, probably high single digits. And so that would be the expectation for 2020.

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

Okay. And then how soon would you expect, whether it be bolt-on or something bigger to feel comfortable doing some M&A in the Clean Earth space?

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

I think we feel prepared to continue on the M&A in that segment at this point. As I said, we largely have executed the integration of the business and feel quite good about the underlying processes and the team that we have. So I think we feel prepared to take that next step.

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

And then Nick, you mentioned in the prepared remarks about kind of collaborating with the HE and Clean Earth. Can you just talk about maybe some early observations and where you're seeing opportunities for synergies for collaboration?

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

I think the opportunities are more with Clean Earth supporting Applied Products initiatives within Harsco Environmental. So whether it's other byproducts or waste streams at our customer sites or even with our Reed Minerals business, I think, we've been quite pleased with the -- some of the solutions that Clean Earth is suggesting on some issues that we've had a difficult time tackling ourselves. So it's mostly on the Applied Products side.

Operator

There are no further questions at this time. Mr. Martin, you may proceed with any closing remarks.

David Scott Martin - *Harsco Corporation - Vice President of IR*

Yes. Thank you for joining this call. A replay of this call will be available later today through November 12, and replay details are included in the earnings release. Also, please contact me with any follow-up questions. And again, we appreciate your interest in Harsco, and have a great day.

Operator

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

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