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PRESENTATION

Operator

Good morning. My name is Rocco, and I will be your conference facilitator. Welcome, everyone to the Harsco Corporation Fourth Quarter Release Conference Call. (Operator Instructions) Please note, this event is being recorded.

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

Thank you, Rocco, and welcome to everyone joining us this morning. I'm Dave Martin, VP 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 fourth quarter and our outlook for 2023. We'll then take your questions.

Before our presentation, however, let me mention a few items. First, our quarterly earnings release and slide presentation for this call are available on our website. Second, we will make statements today 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 from those 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.

Lastly, on this call, we will 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 and slide presentation. With that being said, I'll turn the call to Nick.

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

Thank you, Dave, and good morning, everyone, and thanks for joining us today. I'd like to begin by acknowledging the efforts of our Harsco Environmental colleagues in supporting the people impacted by the earthquake in Southern Turkey. We have nearly 200 employees working across 3 sites in the area with our partner, Tosyali. Thankfully, none of our employees or their immediate families was killed, but many have lost their homes and living conditions are very difficult. So we are doing what we can by providing temporary accommodations and other necessities.

Now on to the past quarter. The fourth quarter was above our guidance expectations as adjusted EBITDA improved year-over-year as did revenue and margins. These results reflect the continued improvements in our Clean Earth segment due to numerous ongoing operational initiatives, as well as pricing actions implemented in the previous quarter.

Harsco Environmental also performed somewhat better than we expected as declining steel production over the previous few quarters stabilized in most of our markets.

The Clean Earth team executed a very impressive turnaround in the second half of the year. Adjusted EBITDA margins, which were below 4% in the first half, grew to over 12% in the second half of the year. Adjusted EBITDA and free cash flow were also about 3x higher in the second half of the year.

The external forces that affected our first half performance, namely inflation, a tight labor market and severely limited incineration capacity largely continued through the remainder of the year. However, our team moved aggressively to mitigate the impact and executed the action plan that we developed extremely well.

Of equal importance, service levels to our customers reach new highs, and our safety culture took a big step forward in Clean Earth following the lead of Harsco Environmental, which delivered record safety performance for the year.

Changes in leadership structure and process along with the heightened emphasis of the Harsco values have been the underlying foundation of our success in Clean Earth. We certainly expect this momentum to continue throughout this year as we validate our strategy of building a leading platform in the hazardous waste sector.

Turning to Harsco Environmental, while service volumes remain weak compared to last year, particularly in Europe, steel production appears to be stabilizing and was a bit higher than we anticipated in Q4. We continue to remove costs and boost productivity across our platform. And at the same time, we were improving our competitive position in light of the bankruptcy of Phoenix Services, the third largest mill services business.

We see an opportunity to gain new contracts as a result without relaxing our standards for economics and risk protection.

At Harsco Rail, which is accounted for as a discontinued operation, let me address opportunities and then challenges. Our Rail business is solid and demand is growing. In fact, we are experiencing our highest backlog for standard equipment in several years. To alleviate some of the growing backlog, we will reopen our Ludington, Michigan manufacturing facility in the second quarter which we expect to be a net positive as it will alleviate some constraints in other parts of the Rail business.

Our aftermarket business, which accounts for about 2/3 of our Rail profit has also remained strong in the past few years, and we expect growth in 2023. The challenges for the Rail segment continue to be our long-term contracts for highly engineered and specialized equipment due to the impacts of inflation, supply chain disruptions and design changes. To mitigate these challenges, we are negotiating new delivery schedules, a reduction in penalties and price increases with many of our customers.

To be very clear, divesting Harsco Rail remains a priority. We are focused on value creation and are being thoughtful in our approach, given the division's unique attributes and positive outlook and we plan to reengage on the sale process with prospective buyers in the second half of the year.

Our 2023 outlook for continuing operations reflects improvements in all key financial metrics for each segment, namely adjusted EBITDA, margins and free cash flow, even with limited volume growth. In terms of adjusted EBITDA margins, we anticipate growth of about 150 basis points, led by a 300 basis point jump in Clean Earth margins.

Importantly, we also anticipate a strengthening of the balance sheet, driven both by operations as well as by the future Rail divestiture. Adjusting for the impact of an accounts receivable securitization program last year, the cash flow from our two segments is expected to improve by more than $100 million.

As Pete will discuss, we expect strong revenue and earnings growth in Clean Earth and while Harsco Environmental is holding its own, segment growth is expected to be slower given the difficult market conditions it faces.

So before I turn the call over to Pete, I'd like to thank our 12,000 employees for mitigating the many challenges of the past year and also identifying the opportunities for future growth in both revenue and productivity. I'll now turn the call to Pete.

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

Thanks, Nick, and good morning, everybody. So let's start by turning to Slide 4. Harsco fourth quarter consolidated revenues from continuing operations increased to $468 million, up 1% compared with the prior year quarter, or 6% if you exclude the impact of foreign exchange.

The increase was primarily driven by the higher pricing that we implemented in both our Clean Earth and Environmental segments. Adjusted EBITDA totaled $61 million, which is above our prior guidance range and represents an improvement from the prior year. Each of our segments showed stronger-than-anticipated performance, although Clean Earth was the larger and largest contributor to the beat. Clean Earth results were better than expected due to lower operating costs as well as the timing and volume of dredge-related work, while Environmental benefited from lower spending and the mix of services performed during the quarter.

And lastly, corporate expense was lower than anticipated given our continued discipline on our functional spending.

Relative to the prior year quarter, the EBITDA increase was driven by Clean Earth as a result of price increases and cost improvements initiated midyear. The success of these efforts is apparent in our results for the past 2 quarters and we're pleased that Clean Earth adjusted EBITDA margin exceeded 12% in the second half of the year. Our adjusted earnings per share was $0.01 for the quarter. The unusual items in the quarter included $4 million of restructuring costs in Environmental, which will boost its performance going forward and a noncash impairment charge of $15 million related to ALTEK.

Free cash flow for the quarter was $3 million. This result was lower than our expectations due mainly to some delayed payments from China-based customers, some of which have since been paid in early 2023. Please turn to Slide 5 in our Environmental segment.

Segment revenues totaled $257 million, and adjusted EBITDA was $43 million for the quarter. Adjusted EBITDA decreased by $6 million year-on-year. The decrease from prior year was largely driven by foreign exchange translation, lower commodity prices and the impact of prior year Brazil tax credits, which did not repeat in 2022. And these headwinds were partially offset by higher service activity at certain sites, better site performance as well as new contracts.

Overall, steel output at our customer sites remained stable year-on-year and sequentially, which compares favorably to the overall steel industry. Production performance varied by region, with weak production in Europe offset by growth in India, China and Latin America.

Considering the headwinds faced during the quarter, we are encouraged by the solid execution and overall performance of Harsco Environmental. So next, please turn to Slide 6, and we'll discuss Clean Earth.

For the quarter, revenues totaled $211 million and adjusted EBITDA was $25 million. Compared to the fourth quarter of 2021, revenues increased 9%, largely as a result of price.

Hazardous materials revenues reached $169 million, up 8% year-over-year, with the growth led by industrial markets, followed by retail. Meanwhile, soil and dredge revenues totaled $42 million, representing an increase of 13% over the prior year quarter. Clean Earth's adjusted EBITDA increased $8 million year-on-year and margin improved over 300 basis points. This improvement reflects the benefits of our price and efficiency initiatives across the business, including the restructuring program we introduced in Q3 which we expect to deliver annualized benefits of over $7 million. So now please turn to Slide 7.

For the full year, revenues from continuing operations increased almost $1.9 billion, and adjusted EBITDA totaled $229 million. As you are no doubt aware, 2022 presented some unique and unprecedented challenges. The Russia-Ukraine war had a profound impact on steel volumes, particularly in Europe, where our customer production declined more than 10% for the year and the financial impacts of inflation were significant as well.

We responded quickly and aggressively to these challenges, leading to a dramatic improvement in financial results during the second half of the year. Our actions to push price and manage costs while the lasting impact on Harsco and we believe will position us to create additional value for shareholders in the future.

Moving on, our free cash flow was $75 million for the year, including $145 million from our accounts receivable securitization program. We ended 2022 with net debt of just under $1.3 billion which in part reflects Rail's operating performance and delays in cash collections during the year. Also, we recently executed a variable to fixed interest rate swap for $300 million which will benefit us in 2023 given the recent and anticipated movement in interest rates.

Lastly, on pension, higher rates have positively impacted our pension funding status. Our funded status at year-end improved by $71 million from year-end 2021 to an underfunded position of $22 million. Our annual cash contributions of $24 million for pensions are unchanged from the prior year and will actually decrease by more than 50% in 2 years.

Now let's turn to our 2023 outlook, starting with our segment guidance on Slide 8. Both segments are expected to realize growth in adjusted earnings in 2023. For Harsco Environmental, revenues are expected to grow at a low single-digit rate. The foreign exchange headwind is estimated to be roughly 100 basis points using the 2022 year-end rates. Profitability for Environmental is expected to be slightly above 2022 levels at the guidance midpoint.

The business drivers for Environmental in the year will be pricing as well as cost and site improvement initiatives, partially offset by foreign exchange, commodities price increases and service mix. Environmental recently implemented a restructuring program, which included headcount and other spending reductions. The annualized benefits from this program are estimated to be $10 million. Customer steel output is anticipated to be largely consistent with 2022.

For Clean Earth, revenues are anticipated to grow mid- to high single digits, with the primary driver being price. And EBITDA margins are expected to increase 200 to 300 basis points for the full year. Beyond higher revenues and price, EBITDA drivers for Clean Earth include various efficiency initiatives with anticipated benefits of over $10 million for the year.

And lastly, corporate costs are expected to be between $40 million and $42 million versus adjusted corporate costs of $33 million in 2022. And the change in corporate costs can be attributed to normal compensation increases, including incentive compensation as well as travel, IT spending and other smaller items.

So turning to Slide 9, which is our consolidated 2023 outlook. Harsco's full year adjusted EBITDA is now expected to be within a range of $240 million to $260 million, up 9% year-on-year at the midpoint. This EBITDA guidance translates to adjusted loss per share of $0.23 to $0.52. And this per share range contemplates year-on-year headwinds from interest and pension expense.

Net interest expense is expected to be $100 million to $105 million, including securitization fees compared with $75 million in 2022. And pension expense in 2023 should be in the range of $20 million to $22 million versus pension income of $9 million in 2022, largely the result of higher discount rates. These items create a headwind of approximately $0.70 per share relative to 2022.

Lastly, we're targeting free cash flow of $20 million to $40 million. As Nick mentioned, improving our free cash flow is an important priority for us, along with lowering our leverage. By the end of 2023, we are targeting a leverage ratio of near 4x and even better when considering the sale of Rail. For 2023, we are expecting considerable underlying improvement in operating cash flows with both Environmental and Clean Earth expected to show significant year-on-year improvement.

Adjusting for the accounts receivable securitization last year, the underlying improvement will be roughly $100 million despite the fact that our cash interest will increase more than $25 million in 2023. A portion of this improvement will be driven by earnings. However, the majority will be working capital with much of that coming from Harsco Environmental. This improvement will be a step in the right direction, and we are targeting even better performance in the coming years.

So let me conclude on Slide 10 with our first quarter guidance. Q1 adjusted EBITDA is expected to range from $45 million to $50 million. We expect Clean Earth adjusted earnings to be significantly above prior year results due to our pricing and cost initiatives. Meanwhile, Environmental results are anticipated to be lower year-on-year given the comparison to our relatively stronger Q1 in 2022. And specific headwinds for Environmental include foreign exchange rates, commodity prices and product volumes.

Sequentially, and as is typical in the first quarter, results are anticipated to be negatively impacted by seasonal volumes, weather-related challenges, lower commodity prices as well as the timing of certain expense accruals, including for incentive compensation and professional fees.

And lastly, corporate costs should be between $9 million and $10 million for the first quarter. Thanks, and I'll now hand the call back to Rocco for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Today's first question comes from Michael Hoffman at Stifel.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

So I'm impressed by -- you did react quickly to the cost side. I'm trying to understand global steel, world steel is saying steel production is going to be pretty muted. So are you expecting some rebound in Europe? Is that sort of what gives you a little bit more comfort, that's how to think about that? Is the mix within your customers? Everything is stable, that was good, and the thing that was weak gets better?

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

Yes. Michael, yes, that is true in the second half of the year. We have a very difficult comp in the first half of the year. And even though there's a lot of discussion amongst our European customers to restart or boost production, it actually hasn't yet started. But we do anticipate to see very modest volume improvement in the second half of the year.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

Okay. And then on Clean Earth, there's a lot of really strong volume activity in 4Q across the disposal end of the market and in their recurring business and you emphasized price, but I was wondering if we were sort of nuancing that. Did you, in fact, see volume as well, but price just overwhelmed that?

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

Volume was fairly modest. We continue to be revenue constrained because of the incineration capacity issue. Volume was a little better in soil and dredge. But overall, the driver of our EBITDA improvement really was price and cost.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

Okay. And then WTI is back online, but we're hearing that there's so much backlog that it's not really providing much relief yet. Would you concur with that probably is the scenario at least through the first half of the year before that incremental capacity really provides market relief?

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

Yes. We really are not anticipating in our outlook here any improvement in the incineration capacity or to be clear, more slots available to us that would enable us to take more business ourselves.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

Even by the second half of the year, so you think the whole year just remains constrained?

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

Largely, yes.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

Okay. And then you have shared with us in the past that there's some big infrastructure jobs with a lot of dirt that are kind of looming. The Moynihan tunnel for Metro North and LaGuardia next phase and Princeton University. Any visibility on either the IIJA driving things or those projects where there is some more activity around that part of the model?

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

Yes, Michael, as you've heard from us, and I'm sure others, the delays in these projects are quite frustrating. So we've assumed a pretty modest degree of incremental volume from those projects this year. Will we see some? I certainly expect to. But in the past couple of years, we've also built some of that upside into our outlook and it hasn't materialized. So we're being fairly cautious.

Michael Edward Hoffman ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research***

Okay. And last one for me. This industry on the Clean Earth side has not been noted for pricing as a driver of growth in the hyperinflationary environment, certainly had to change that. Do you see that, that now becomes a structural change in that -- and I ask it from two perspectives, you had to follow through with price ultimately because of the inflation. What was the impact of churn and by the way, do you think you can now use price as a form of sustained growth even as inflation ebbs.

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

Well, I certainly think we learned in the second half of the year that our value proposition and its importance to our customers enables us to get price when it's justified as it certainly was in the second half of the year. Now we're also increasing prices -- our annual price increase early this year, which we also expect to have a high realization rate. So yes, I would say that the value proposition that we have in both hazardous waste and contaminated soil is one that should enable us to gain price going forward.

Operator

The next question today comes from Larry Solow of CJS Securities.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

A couple of follow-ups on the Clean Earth. Essentially, are you saying that volumes are going to be -- at least on the hazardous side, pretty flat this year, and it's mostly price and then maybe a little incremental benefit from infrastructure and dredging, is that sort of the summary of the drivers of Clean Earth this year?

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

Yes, and cost reduction -- operational cost production. We have also removed some overhead costs. But the impact of those are largely being mitigated by inflation and some compensation related matters. But yes, the plan, the growth year-over-year is being driven by price and cost. I will say that our pipeline of growth opportunities, both in haz waste and in soil are quite robust. We're just simply not building in the benefits of those.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

And the limitation on growth in hazardous is, like you said, it's basically -- it's this capacity and ability to incinerate and make room for more stuff essentially for you to process.

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

As well as the overall economy -- sorry.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

Right. Fair.

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

In the overall economy, the outlook for retail and industrial, in particular.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

And basically, on the soil side, it's really -- it's more timing and your visibility on that is still limited, it sounds like.

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

Right. Better than it has been in the previous couple of years, I'll say. I think we're being a bit cautious on soil volumes.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

Sure. And then just switching gears a little bit. So on the Environmental side, obviously, I think it's just more a victim of just a slower production environment this year. Obviously done a great job on cost cutting and all that good stuff. What about just longer term, just ability to obtain new contracts? And I know it's sort of a fine line, but you're still fairly levered. Obviously, you want to kind of reduce this leverage, improve your free cash flow, but how do you kind of get new wins and new business wins without some investment?

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

Yes, it's a great question. It's something we're very focused on. If you consider how Harsco Environmental truly adds value to its customers, right? It's around engineering and know-how and new environmental solutions and the skill of our labor force, et cetera, et cetera. It's not right utilizing our balance sheet to fund these assets to perform the service.

So I think over time, and this Phoenix bankruptcy provides a bit of an opportunity, for us to drive our true value proposition. The fact is that our customers' balance sheets are healthier than ours, their cost of capital is lower than ours. And so you put all that together, and we're going to push pretty hard to see if we can win some new contracts here on more of a capital-light basis.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

Got you, that's fair enough. And just maybe a question for Pete. Could you just clarify, you said the -- you're targeting sort of getting towards or maybe even under 4x lever by the end of the year. So if I take the $260 million EBITDA, have I used the high end number, right now would suggest you're going to get your net debt a little over $1 billion or down like $225 million, $250 million. Is that right? And how do you view that?

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

Yes, you've got to recognize that the leverage ratio I quoted is the...

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

The bank covenant?

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

Yes.

Lawrence Scott Solow ***CJS Securities, Inc. - Senior Research Analyst***

That's fair. We could talk about it off-line. That's my clarification. Sounds great.

Operator

(Operator Instructions) Our next question comes from Rob Brown at Lake Street Capital Markets.

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

Just wanted to get a little more detail on the competitive environment and Environmental with the Phoenix bankruptcy. Are you seeing more opportunities sort of come to market? How has that changed things?

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

Rob, thanks for the question. Yes, it's a very dynamic situation now with the Phoenix bankruptcy and you really need to look at on a contract by contract basis. Of course, we all know that these mill services that we perform on behalf of our customers are extraordinarily critical to the production of steel. So our customers understandably need to be very cautious in how they navigate the situation with

Phoenix. And what, if anything, of Phoenix will survive and what the ownership structure will be and how they're going to approach their contracting function in the future.

So we are very focused on a handful of contracts or sites that we know well, that we think truly appreciate our value proposition. And so we're selectively targeting 6 to 8 contracts, which we would hope to secure at some point during the year. But it's a very unusual bankruptcy process in many ways, and it's going to take a little more time. And so we'll see how this plays out. But again, our focus is on the 6 to 8 sites where we think we can really add value and would be a good new business for our company and for our shareholders.

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

Okay. Great color. And then on the Rail sale process, you talked a little bit about re-energizing it later this year. Is that sort of dormant right now? How has that progressed? Is it waiting for certain things? Just an update on what's sort of driving that?

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

Yes. So it's certainly dormant from our standpoint. We continue to have a lot of interest expressed both to us and to our banker, from parties that want to re-engage. As I think both Pete and I mentioned, we're very focused on simplifying the core part of the business and also continuing to re-negotiate the delivery schedule and penalties and price on somebody's large longer-term contracts. And that is a frustratingly slow process, as Pete can attest, he's kind of on point for us there. But it's moving in the right direction.

The customers understand and it's -- of course, a situation unique to our Rail business. Many, many other suppliers to our Rail customers are facing similar situations. So our customers understand the need to provide a degree of relief and we're negotiating that as we speak, and we're confident that we'll be pleased with the outcome -- but that's going to take still a few months. And between wrapping up those negotiations and executing the simplification of other parts of the Rail business, we think we'll be in a very strong position to re-engage with buyers in the second half of the year.

Operator

Thank you. And ladies and gentlemen, this concludes today's question-and-answer session. I'd like to turn the conference back over to the management team for any final remarks.

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

Thanks, Rocco, and thank you for all that joined this call. Please feel free to contact me with any follow-up questions. And as always, we appreciate your interest in Harsco, and have a great day. Take care.

Operator

Thank you. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.