THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

HSC - Q4 2017 Harsco Corp Earnings Call

EVENT DATE/TIME: FEBRUARY 22, 2018 / 2:00PM GMT

CORPORATE PARTICIPANTS

David Scott Martin *Harsco Corporation - Director of IR*

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

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

CONFERENCE CALL PARTICIPANTS

Bradley James Vanino *KeyBanc Capital Markets Inc., Research Division - Associate*

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

PRESENTATION

Operator

Good morning. My name is Steve, and I'll be your conference facilitator.

At this time, I would like to welcome everyone to the Harsco Corporation Fourth 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. Mr. Martin, you may begin your call.

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

Thank you, Steve, and welcome to everyone joining us this morning.

I'm Dave Martin, Director of Investor Relations for Harsco. With me today is Nick Grasberger, our President and Chief Executive Officer; as well as Pete Minan, Harsco's Senior Vice President and CFO.

This morning, we will discuss our results for the fourth quarter of 2017 and our outlook for 2018. We'll then take your questions.

Before our presentation, however, let me highlight a few administrative items. First, a PDF of our quarterly earnings release as well as the slide presentation for this call have been posted to the IR section of the Harsco 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 risks and uncertainties, see the Risk Factors section and our most recent 10-K and most recent 10-Q. The company undertakes no obligation to revise or update any forward-looking statement.

Lastly, on this call, we will refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to U.S. GAAP results is included in our earnings release as well as the slide presentation.

Now I'll turn the call over to Nick to begin his remarks.

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

Thanks, Dave, and good morning, everyone, and thanks for joining us.

I'll start with a brief summary of 2017 and then share my perspective on this year and beyond. Put simply, 2017 was a great year for Harsco across our portfolio of businesses. We finished the year on a very positive note and expect the momentum to carry throughout 2018. Year-over-year, our consolidated revenue grew over 10% and our adjusted operating income increased nearly 30% while profit margins jumped more than 1 point. Adjusted EPS grew in excess of 50% and return on capital, a metric of primary focus, increased to 11.5%, just near the high end of our guidance, our target range established 3 years ago, and nearly double the 2015 figure. The improvements in cash flow and financial leverage were also material.

I'll next provide a few comments on each of our 3 segments. In M&M, for the second straight year, our profit was up mid-double digits, and we experienced strong margin growth. In fact, our operating margins are at their highest level in over a decade. Cash flow was again well above historical levels, and key wins for M&M during the year included the renewal of about 30 contracts and the signing of 10 new contracts. Innovation and our broad geographic footprints are increasingly critical growth drivers for M&M as evidenced by these contract wins. We plan to allocate significantly more resource this year towards innovation and our developing markets.

Similar to M&M, our Industrial segment delivered strong profit and margin growth last year. Investments that we have made over the past few years have led to margins above those realized at the prior cyclical peak in 2015 even though revenues were about 25% off-peak levels. Innovation and customer intimacy will continue to drive these businesses.

In our Rail segment, profit improved in a low double-digit rate despite a weak North American market. The new leadership team has made significant improvements in management talent, core processes and structure that have enabled the business to outperform. We've also made notable progress in positioning the business to achieve a better balance between revenues, products and geographies.

So following 2 years of meaningful improvement in earnings and cash flow, our focus in 2018 and beyond is squarely on growth. We entered 2017 with a high degree of confidence in the foundation we had built in terms of the management team, process discipline and values, and now further improvements to our balance sheet and the construction of new growth strategies over the past several months have put us in the position to invest. Each business has an attractive pipeline of growth opportunities, and we expect to invest at a rate not seen at Harsco in many years.

Specifically, in 2018, we expect each business to again grow both revenues and earnings due to supportive market dynamics and the success of internal initiatives in the productivity, innovation and market share gains. Overall, operating income should improve over 10% on a consolidated basis while EPS should jump about 50% and cash flow should also be strong. These figures reflect the dampening effect of the growth-oriented investments we plan to make in people, innovation and new M&M contracts to support customer productivity. It's also worth noting that we expect the impact of Section 232, if enacted, and global trade policy to be a net positive for Harsco.

Looking beyond this year, we expect to generate healthy returns in our growth investments just as we have realized healthy returns in our restructuring programs over the past few years. Our bottoms up long-range planning process suggests that annual operating income growth should be in the mid to high teens for the next few years. And we project revenue, excluding the acquisition -- the impact of acquisitions, to be above $2 billion and EBITDA in excess of $400 million. And of course, our focus will remain on generating strong cash flow. We plan to provide further details in our growth plans and our long-range financial targets within a few months.

In closing, the Harsco management team could not be more enthusiastic about the opportunities in front of us. While we are pleased with both the level and the consistency of our performance over the past few years, we have been eagerly awaiting to reach this point where we have the strategies and the balance sheet to invest upon the foundation that we have built. And I'd like to thank the roughly 10,000 Harsco employees for their dedication and commitment to our mission and to our values. We have a great deal to look forward to as a team.

Over to Pete.

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

Well, thanks, Nick. And good morning, everyone.

So let's start with Slide 4. Our operating income in the fourth quarter was $38 million, which exceeded our guidance range for the quarter of $28 million to $33 million. The better results were driven by each of our 3 segments and, as you appreciate, given the diversity of our businesses, a variety of factors. In our Metals business, these factors included higher steel production in North America and Southern Europe as well as service levels and mix in other regions. Overall, our operational execution was very strong as were our spending controls near year-end. Our stainless steel-related operations also benefited from higher nickel and other commodity prices and more favorable metal yields. In Industrial, demand for each of our major product lines was better than anticipated. And in Rail, the quarter was helped by stronger equipment sales and by the mix of these sales, both in the U.S. and internationally. Shipment timing again helped Rail this quarter. But nevertheless, it was nice to see a stronger quarter for equipment sales, particularly in the U.S., given the cyclical pressures in our home market over the past couple of years.

Revenues in the fourth quarter totaled $455 million, an increase of 26% compared with the prior year quarter. This total included equipment-related revenue of $42 million from the Swiss National Railway, or SBB, within our Rail segment. If you exclude this SBB amount, which has no margin impact, the business unit sales increased 15%. Metals and Industrial also realized nice top line growth in the quarter.

Across our business portfolio, higher steel output, rising demand for heat exchangers and metal grating and higher machine sales in Rail were the primary drivers of the revenue growth. And compared with the prior year period, operating income of $38 million represented an increase of 37% versus our adjusted operating income in the fourth quarter of 2016. And again, each of our segments contributed to the improvement.

Our reported or GAAP loss per share was $0.42 in the fourth quarter. This figure, as stated in our release, includes the costs related to our very successful term loan repricing as well as a noncash adjustment to revalue our deferred tax assets, following the recent U.S. tax reform. Excluding these amounts, earnings per share was $0.20, which was well above our guidance range of $0.11 to $0.15 per share. Adjusted earnings per share was $0.16 in the fourth quarter of 2016.

Free cash flow was $63 million in the fourth quarter, a meaningful increase over the prior year quarter due to anticipated working capital changes in Rail and higher cash earnings. This resulted in free cash flow for the year near the high end of our guidance range. And as a result, our free cash flow exceeded $90 million for the second consecutive year. We see this as a great accomplishment and a reflection on how tightly we've been managing this aspect of our business.

Let's turn now to Slide 5. In the fourth quarter, revenues in the Metals segment increased 6% and operating income rose to $22 million from an adjusted figure of $19 million in the prior year quarter. This earnings increase can be mainly attributed to higher steel output and demand for our services. Customer steel output on a continuing site basis rose 5%, which is consistent with global steel trends in the quarter. And the net impact of new and exited sites was minimal in the fourth quarter. The positive impacts from underlying market trends were partially offset by higher incentive and professional fees, which had been anticipated. Lastly on Metals, free cash flow for the year totaled $106 million. As we've discussed previously, the cash flow change relative to 2016 is attributable to growth capital spending and anticipated movements in working capital. And overall, we certainly see this cash flow performance in 2017 as a positive and sustainable outcome for Metals.

Let's turn to Industrial on Slide 6. Revenues rose 46% compared with the prior year quarter. Roughly 2/3 of this increase is attributable to heat exchanger sales and the remainder was driven by strong demand growth for IKG grating and Patterson-Kelley boilers. Operating income increased from $3 million to $10 million as a result of higher sales and a more favorable sales mix. Industrial's operating margin was nearly 13%, which is among the segment's highest quarterly margin over the past 2 years. And more broadly, market conditions for our Industrial segment remain very positive and encouraging. Our bookings in the quarter increased more than 40% and our backlogs are now roughly 60% higher than a year ago. As a result, we expect Industrial to have a strong year in 2018. Lastly on Industrial, its free cash flow increased to $34 million in 2017 due to the cash earnings improvement throughout the year and continued strong working capital management.

So moving to Rail on Slide 7. It's worth highlighting that Rail had its best quarter of the year. Revenues increased 77% in total and 17%, excluding the SBB revenue, in the quarter. Adjusted operating income, meanwhile, increased by 41% from the adjusted figure in last year's fourth quarter.

Higher equipment sales, timing and the mix of these sales were the primary drivers of the revenue and the operating income change. We also had an improved mix of service work in the quarter. These factors offset higher administrative expenses, which included compensation and professional fees as well as a lower contributions from aftermarket purchase sales. As a result, our Rail margin totaled 11% in the quarter, and our margin was 17% if you exclude the SBB equipment revenue. Free cash flow in Rail was strong in the fourth quarter, as I mentioned earlier. And as a result, the segment's free cash flow surpassed $20 million and improved for the year. The improvement in free cash flow in the quarter was largely the result of milestones reached under our contracts with SBB. We transferred 6 base vehicles and other related equipment to SBB during the quarter, which drove the working capital changes and revenue recognition. Overall, we continue to make good progress with SBB. We remain very pleased with the quality and capabilities of our machines, and we look forward to further advancing this important relationship [for us] in Europe and elsewhere.

Let's move to Slide 8. Here, we see a high-level summary of our full year results. I won't spend much time on these details, although I would like to highlight the nearly 30% increase in adjusted operating income and over 50% increase in adjusted earnings per share for the year. As you know, our guidance or outlook improved as the year progressed during 2017, and each of our segments reported a solid increase in sales and an improvement in operating income. I'd say this performance begins to illustrate our earnings leverage potential from a cycle recovery, which in 2017, was limited to some modest improvement in the steel and energy markets. These results also reflect the benefits of our many tactical and strategic actions over the past couple of years. If 2015 and '16 were transition years for Harsco, then 2017 was the year we began to really see the fruits of our efforts.

In Metals & Minerals, our operating practices continue to improve and our portfolio of sites is strong. Also, our competitive market position continues to strengthen and the execution against our growth initiative accelerated in 2017. Nick commented on the renewals and new contracts, and I'd like to emphasize that our win rates remain quite high. During the year, we renewed 28 contracts with a total estimated contract value of over $300 million. We also signed 9 new contracts, which passed through our capital approval process and are valued at approximately $250 million.

In Industrial, we benefited during the year from product introductions and an improved operating footprint in heat exchangers.

On Rail, we certainly didn't see much of an inflection in the domestic rail market, where we are just now beginning to see the benefits of the actions taken by our new management team. The segment's profitability improved during the year, resulting from our investments in safety and diagnostic products and efforts to grow the aftermarket parts business.

Finally, before I move on to guidance, let me say that we held our controllable corporate costs essentially unchanged for the year. We also experienced a meaningful improvement in our balance sheet and our leverage position during the year. We ended the year with net debt of approximately $525 million and a net leverage ratio of 1.9x. We expect our leverage to decline further in 2018, and our financial flexibility will certainly support the growth initiatives and long-term strategy that Nick discussed. Also related to our capital structure, the funding position of our pension plans improved by more than $60 million due primarily to actual asset returns.

So turning to our summary 2018 outlook on Slide 9. Let me start by highlighting a few items and the impacts of various accounting and regulatory changes. First, for comparison purposes, note that the 2018 figures incorporate the impact of a new pension reporting standard, which reclasses some results outside of operating income. The 2017 figures included here are not adjusted to reflect these reclassifications. Also, the impacts of the new revenue recognition standard adopted in 2018 will be largely limited to a few large contracts in Rail and to heat exchanger sales in Industrial. However, overall, these impacts are very small in the context of our outlook. Operating income for the year is projected to be between $150 million and $170 million, an improvement versus our adjusted figure of $147 million in 2017.

Secondly, we are expecting diluted earnings per share of between $0.97 and $1.14 as compared with $0.74 per share in 2017. Within these earnings per share figures, we've assumed an effective tax rate of 26% to 28% versus an adjusted 36% last year as a result of the recent tax reform. This range also reflects lower interest expense, following our recent debt repricing. Interest costs are projected to decline roughly $10 million versus 2017.

Next, we are forecasting free cash flow of between $80 million and $100 million, which is unchanged from 2017. Higher capital expenditures will essentially be offset or funded by higher cash earnings and working capital. Our net capital spending is anticipated to be between $125 million and $145 million, including growth capital spending of between $45 million and $50 million and renewal capital in Metals & Minerals of between

$10 million and $15 million. Our free cash flow before growth capEx, as a result, is expected to increase to a range of between $125 million and $150 million. As I mentioned earlier, we expect to use our cash flow this year to further strengthen our balance sheet.

Slide 10 provides high-level details that support our outlook for each business unit. Starting with Metals & Minerals, we expect adjusted operating income to increase low single digits at the midpoint of our guidance. Customer steel output is anticipated to increase 3% to 4% on a continuing site basis. Our customer sites operated at less than 77% of capacity in 2017, so there's ample room for us to benefit as steel consumption strengthens. We assume that the benchmark nickel price will average roughly $5.60 per pound for the year, which is up from the $4.70 per pound in 2017. We also expect Metals operating income to benefit from new sites and contracts. And this positive net impact will grow as the year progresses. Also, our Reed Minerals business is projected to have a better 2018.

In addition, we're targeting gross cost savings of more than $5 million for the year throughout the Metals business unit, and these positives will be partially offset by a less favorable mix of services and SG&A investments to support our growth initiatives. Now lastly on Metals, I'll note that the new pension standard I mentioned earlier is negative to M&M operating income comps by roughly $3 million year-on-year.

For Industrial, we project that earnings will increase significantly and margin should rise roughly 200 basis points. We expect revenues to grow single digits for IKG and Patterson-Kelley while a much larger increase is expected at Air-X-Changers. Also, we anticipate that an improved product mix in IKG and some technology and automation investments in Air-X-Changers will also benefit Industrial during the year.

In our Rail segment, adjusted earnings are also projected to increase slightly at the midpoint of our guidance. Rail revenues are to increase roughly 5% in total and 10% when excluding the SBB equipment sales. As this would suggest, equipment sales to SBB will be slightly lower this year partially due to the impact of the new revenue recognition standard. SBB revenues are expected to be approximately $30 million this year, and most of that is anticipated in the second half of the year. Aftermarket parts, Protran and equipment sales are all expected to increase compared with 2017. And this outlook anticipates that the domestic market will stabilize in 2018 with a modest anticipated uptick in domestic equipment sales. These positives will outweigh the impact of a less favorable equipment sales mix and anticipated lower contributions from contract services.

And for corporate, projected costs will be in the range of $28 million to $30 million. Now the last topic to mention for the year is phasing. We do expect our earnings will be higher in the second half of the year, as was the case in 2017, due mainly to our Rail segment and the ramp up of growth in Metals & Minerals.

So looking to slide 11. Regarding our first quarter outlook, we expect operating income to be between $30 million and $35 million as compared to operating income of $28 million in the first quarter of 2017. We expect that our financial performance will improve year-over-year in Industrial as a result of both higher demand for and a better sales mix of heat exchangers. Rail results are anticipated to be much lower than 2017 due mainly to equipment mix. M&M income is projected to be up modestly compared to the prior year quarter as new sites, operating benefits and positive market trends are partially offset by growth investments and a less favorable services mix. And lastly, corporate costs should be similar to the year-ago period.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from Rob Brown with Lake Street Capital.

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

Just wanted to get a little more color on your growth kind of investments and your change in strategy now that you've got the business running well. Maybe just kind of characterize the buckets of growth investments. Are these acquisitions? Or are these kind of new contract investments in additional new product development? Or maybe just categorize and give some color on the growth strategy now.

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

Well, in M&M, I'd say there are really 3 buckets of growth opportunity. The first being in the core business. The traditional mill services opportunities that we're seeing in primarily developing markets but also elsewhere are at quite a high level and we are allocating additional resource -- front-end resources this year to capture those opportunities. So that would be the first bucket. The second would be innovation. We are significantly stepping up our investments in innovation. We have a rather attractive backlog of innovation that we need to get through our pipeline and get to market. And so we believe there to be kind of a sizable opportunity in our industry based on Harsco innovation. And third would be M&A. And I think M&A would likely be oriented around technology, both in the existing industry and also perhaps in adjacent industries where what we do today is, we believe, somewhat transferable. In the Industrial, the growth drivers around M&A will mostly be around adjacent businesses in the Air-X-Changer space. And in Rail, I think the M&A would be focused also on products to complete the portfolio.

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

Okay. Good. And then on the heat exchangers business, you talked about significant kind of growth there. How do you see that playing out? And sort of where do you see your capacity utilization growing to in '18 and then setting up for '19?

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

Well, we have significant capacity. We, a few years ago, you may recall, combined 5 facilities into 1 quite large facility. And so we still have quite a bit of capacity in that facility in Tulsa. And so I really don't see that being a constraint over the next cycle. The growth this year is certainly reflective of the rig count and the increased exploration activity here in the U.S. as well as outside the U.S. We export through our agents our products outside the U.S. as well. So we're not expecting anytime soon to get back to the peak of 2014 in terms of revenue, but you can see from our guidance that we certainly expect healthy double-digit top line growth this year.

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

Okay. And what sort of are your current view on the operating margin potential in that business? Is it sort of...

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

Well, it's certainly been in kind of a mid to high teens, high teens at the peak of the cycle. We're there now. And I think we're quite happy with the margins being in the high teens. And is there opportunity for the margins to move up a bit as we leverage the fixed cost base and the plans? Sure.

Operator

Your next question comes from Jeff Hammond with KeyBanc Capital Markets.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is Brad Vanino filling in for Jeff. Just centering in on Rail. You mentioned last quarter maybe a disconnect between what we're seeing in rail fundamentals and the flattish customer capEx levels. Have there been any change there that's been factored in the guidance? Or are you seeing anything that sentiment wise that, that could lead to maybe a positive -- more positive to you for 2018 with regard to the capEx levels?

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

Well, it is a bit more positive in '18 than it was last year. But the balance is somewhat muted as far as we can tell in speaking with our customers in terms of their capEx spending on maintenance of way equipment. So while it is better, it's still quite a distance from the peak of about 3 years ago.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

And is there anything that you could point to that could maybe kickstart that? Like I mentioned there, with the fundamentals seem to be improving and getting there. Is it just more consistent improvement there? Or can you point to anything that would translate into an improvement of capEx, a greater improvement?

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

Well, our customers tend to establish their capital spending budgets late in the year, so they've been established for this year for a few months now. And generally speaking, they stick to those capital plans. So is there a potential for it to move north? Yes. But I think using history as a guide, the best data we have is their capital spending plans that are in place.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay. And then within Industrial, I think you mentioned that backlogs are up 60% entering the year. Could you break that out by heat exchangers and the 3 businesses there? And I think you mentioned before that heat exchangers might be a little bit lower than the rest or I was just wondering if there's any kind of disconnect between the 3?

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

Brad, it's Pete. So backlog for the entire business unit is about 80 -- $85 million at the end of the year, which is -- which, as I said, is up 60% from the prior period and roughly consistent with last quarter sequentially. Air-X-Changers is the biggest component of that. It's about $60 million to $65 million of the total. And that's up 90% from the same time last year, and sequentially up as well.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay. Thanks. And then quickly on SBB contract. I think you mentioned close to a $50 million run rate. And it seems like for this year, you're building a $30 million. Can we assume that's the new run rate moving forward? Or is there any reason for the fluctuation there?

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

Yes. Brad, it's Pete. That's -- as I mentioned earlier, is largely the result of the new accounting standards -- that's the impact of it. But that is more or less what the run rate will be for the next 2 years based on our outlook at this stage under the new standard, about $30 million per year. And as you know, that's a 0 margin contract there.

Operator

(Operator Instructions) And there are no further questions. I'll now turn the call back over to Dave Martin.

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

Yes. Thank you for joining us this morning. A replay of this call will be available later today through March 8, and the replay details are included in our earnings release. Also, if you have any follow-up questions, please contact me. Again, we appreciate your interest in Harsco, and we look forward to speaking with you again in a few months and have a great day. Thank you.

Operator

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