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Q1 2022 Synalloy Corp Earnings Call

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CORPORATE PARTICIPANTS

Aaron M. Tam *Synalloy Corporation - CFO*
Benjamin L. Rosenzweig *Synalloy Corporation - Executive Chairman*
Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Cody Cree *Gateway Group, Inc. - Director*

PRESENTATION

Operator

Good afternoon, everyone, and thank you for participating in today's conference call to discuss Synalloy's financial results for the first quarter ended March 31, 2022. Joining us today are Synalloy's Executive Chairman of the Board, Ben Rosenzweig; President and CEO, Chris Hutter; CFO, Aaron Tam; and the company's outside Investor Relations adviser, Cody Cree.

Following their remarks, we'll open the call for your questions. Before we go, first, I'd like to turn the call over to Mr. Cree as he reads the company's safe harbor statement within the meaning of the Private Securities Litigation Reform Act of 1995 that provides important cautions regarding forward-looking statements. Cody, please go ahead.

Cody Cree *Gateway Group, Inc. - Director*

Thanks, Adrienne. Before we continue, I'd like to remind all participants that the discussion today may contain certain forward-looking statements pursuant to the safe harbor provisions of the federal securities law. These statements are based on information currently available to us and are subject to various risks and uncertainties that could cause actual results to differ materially. Synalloy advises all of those listening to this call to review the latest 10-Q and 10-K posted on its website for a summary of these risks and uncertainties. Synalloy does not undertake the responsibility to update any forward-looking statements.

Further, the discussion today may include non-GAAP measures. In accordance with Regulation G, the company has reconciled these amounts back to the closest GAAP-based measurement. The reconciliations can be found in the earnings press release issued earlier today and posted on the Investors section of the company's website at synalloy.com. Please note that this call is available for replay via a webcast link that is also posted on the Investors section of the company's website.

With that, I'd like to turn the call over to Synalloy's Executive Chairman of the Board, Ben Rosenzweig. Ben, over to you.

Benjamin L. Rosenzweig *Synalloy Corporation - Executive Chairman*

Thank you, Cody, and good afternoon, everyone. Synalloy had a very strong start to 2022, leading to our fourth consecutive quarter of year-over-year growth and second consecutive quarter of record results for revenue, net income and adjusted EBITDA. We're very pleased that our dedicated employees are able to see the fruits of their labor manifest in our record results. They worked tirelessly to set this company up for sustained success and continue to transform Synalloy into the premier provider of pipe tube and specialty chemical solutions.

Throughout the quarter, we capitalized on a favorable pricing environment due to the significant progress we've made in our operations since the start of our turnaround. This market dynamic drove higher-than-expected margins and allowed us to benefit at a much greater rate from the continued elevated demand we experienced. We believe we can continue to improve productivity, but I'm pleased with our efforts in enhancing our sales and operations planning to unlock greater efficiency within our platform.

A prime example of this has been our efforts across both divisions to break down prior silos and operate as one cohesive unit. We've made meaningful progress in manufacturing and selling certain products across multiple sites in order to better control costs and improve lead times. And I wanted to take a moment to commend Tim and John for the one team unified mentality that they bring to their respective organizations, ensuring that we fully capitalize on our broad manufacturing and distribution capabilities to become a full-service solutions provider for our customers.

Providing solutions will always prove more durable and profitable than just selling products. Our finance team continues to focus on monitoring the pricing environment and developing better ways to refine our pricing adjustments in real time. We continue to prioritize investments that automate our forecasting processes, allowing us to reallocate resources to growth-related pursuits.

As you may remember, we made substantial progress updating our inventory accounting system beginning in January. We've already seen the benefits of doing so as our operators now have better insight into their costs, enabling them to make more informed pricing and production decisions. Further to improving our decision-making, we've identified multiple lessons learned from the integration of DanChem that we plan to leverage for future acquisitions.

We remain opportunistic in our M&A strategy and have found several potential prospects that we believe to be additive to our growth plans. We'll continue to be disciplined with how we allocate our capital and look to focus on both organic and inorganic growth. We have ample liquidity available and plan to continuously assess what offers our shareholders the highest return on incremental capital deployed.

We're cognizant of the tailwinds that have helped us to achieve our record results. We remain focused on capitalizing on the market conditions while prioritizing longer-term initiatives like diversifying our revenue streams in both segments, continuously improving core operational efficiencies through automation and disciplined process control levers as well as developing best-in-class commercial and consumer excellence to retain our loyal customers and further cement ourselves as a premier solution provider.

The work that we've been performing these past 18 months has revolved around building a company that can withstand the inevitability of cyclical pricing environments. We feel good with where we sit today, but there is certainly more work ahead to drive long-term value for our shareholders.

Now I'd like to pass the call over to Chris to provide greater details on our operations across both segments, but I'll be available later on to answer any questions. Chris, over to you.

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Thanks, Ben, and thank you all for joining today's call. Like Ben said, we continued our momentum and capitalized on the strong market environment to drive our record results for this quarter.

Let's start by discussing our Metals segment. While the entire supply chain experienced higher material costs, we worked with our customers to pass through the increased indirect expenses, often realizing a greater contribution margin on those incremental sales taking place at higher prices. With our improved delivery time lines, reliability and overall product quality, our hope is that we can provide some level of differentiation so that pricing becomes stickier even as the macro environment normalizes.

We've previously discussed several initiatives that we were working on that will help position this segment for long-term success. We maintain our focus on improving manufacturing efficiency and prudent cost control procedures, which includes finding favorable material costing in our supply chain, investing in new technologies and automation upgrades and having disciplined inventory management systems. Also with our capacity growing each day, we have and will continue to invest in our sales and business development teams to go out into the market and secure orders from large blue-chip customers in the space.

We anticipate material pricing may begin to normalize for the second half of 2022, and we have made good progress in our deliberate shift from producing to stock to producing for specific orders. We are optimistic that moving toward a manufacturing model where we do not even begin to order certain materials until the booking is in hand will help us to remove certain portions of the earnings risks that come with a volatile raw material pricing environment.

Obviously, that shift cannot be successful unless we are dialed in with our sales and operations planning so we can effectively manage our production costs along the way, even if we are not operating at full capacity. So far, we're very pleased with the efforts of Clint Skipper, who is leading the operational execution for Tim's team, and we think the best is still to come.

Throughout the quarter, we have also been thoughtful about strengthening our supply chain by broadening and diversifying our supplier base as we look to mitigate potential disruptions. We hope to continue to wield our increased purchasing power to drive favorable volume discounts and procurement rebates. We absolutely believe there are more opportunities for cost savings in our supply chain, and we will continue to aggressively pursue them.

Technology and automation are also an area that we continue to invest in that will allow us to drive better operational margins. At our North Carolina facility, we have developed a road map that will guide us towards ramping automation to increase our operational margins. I expect we will see the additional benefits of reduced labor and overhead expenses slowly roll through towards the end of the year and into next. Given our current assets were assembled in a bit of a piecemeal fashion, we believe there will always be future opportunities for targeted technological and automated improvements if we are willing to get creative and aggressive.

As Ben stated earlier, we are pursuing a high-growth strategy for this segment, and we invested heavily in our sales personnel over the past few quarters. Our overall capacity is improving. And in conjunction, our expanded sales team has seen encouraging results. Our business development efforts in this quarter resulted in over 120 new customers, and we expect to continue organically growing this number. I am proud of the progress we've made in our Metals segment in the quarter. We made key foundational changes that have allowed us to take advantage of an attractive market to maintain the upward trajectory that we are on.

Moving into our Chemicals business. We continue to execute on our initiatives by improving our overall capacity and optimizing our processes to drive growth, increase profitability and enhance our operational resiliency. Much like the Metals segment, alongside rising costs of material and labor, we made competitive price increases and achieved higher margins as a result. We drove higher year-over-year sales at all 3 sites while continuing to invest in our operations. Through this, we are prioritizing an organizational structure that can promote our high-growth mindset and set up our company for long-term success. While we are experiencing higher headcount costs in the near term, these additions are necessary and congruent with our expansionary efforts and we anticipate will ultimately lead to robust pipeline opportunities, additional operational efficiency and increased margins.

Under John's leadership, we are investing in our engineering and process development team by adding process engineers to our South Carolina and Tennessee facilities. We are going to be utilizing a 24/7 work cycle in Tennessee to handle the increased volume. Our engineers will ensure that we maintain our growth mindset as we look to actively court our existing customers in order to win new programs.

Our Virginia plant, which we acquired through DanChem, has been at the forefront of our engineering efforts, and we've been able to exploit our other sites in order to grow the overall pie for the entire division.

Lastly, we have made meaningful changes to our South Carolina site, transforming our go-to-market strategy away from tolling and towards contract manufacturing. With our focus on scaling of the site's hot oil and reactor capabilities, we are already winning new specialty manufacturing business at a significantly improved margin. Our sales team has worked tirelessly to build out a vastly improved sales pipeline, and we expect a strong ramp-up in the coming quarters and years. We are continuously investing in our sales ecosystem and plan to enhance our team through our quality, service and safety. Our chemicals team is truly proving they are the other go-to solution provider in the specialty chemicals space.

Our DanChem acquisition continues to exceed our expectations. We are driving growth through our increased capacity and have utilized the team's expertise to develop higher value-added products. An improved product mix is going to be essential in driving our margins through a normalized pricing environment. We continue to look for any and all opportunities to expand our overall capacity and have identified areas to upgrade our legacy equipment to operate in line with our automation efforts.

With the success of DanChem, we remain committed to reviewing potential acquisition opportunities that would complement our existing operations in the Chemicals segment. We believe we have better vision for value creation through our platform, and we will continue to be opportunistic, pursuing our M&A strategy. There is still much work to be done. But with a strong foundation in place, we are excited for what the future holds for Chemicals.

Overall, in both segments, we are proud of the record results we experienced. While we enjoyed our accomplishments for the past quarter, we will remain active in executing our strategy to position this company for long-term success. With our core operations solidifying every quarter, our company is poised to become the premier provider that we set out at the start of our transformation.

I'd now like to turn it over to our CFO, Aaron Tam, to walk through our first quarter financial results in more detail, then I'll return to answer any questions you may have. Aaron, floor is yours.

Aaron M. Tam *Synalloy Corporation - CFO*

Thank you, Chris, and good afternoon, everyone. Let's jump right into our first quarter financial results.

Net sales increased significantly to \$116.2 million compared to \$69.8 million in the prior year period. The increase was primarily attributable to continued strong demand and increased input prices, which drove favorable average selling prices. Also, it's important to note that our net sales included \$7.5 million in DanChem sales that obviously weren't there in the prior year period.

Gross profit increased significantly to \$22.5 million compared to \$8.7 million in the first quarter of 2021, while gross margin increased 690 basis points to 19.4% from 12.5% in the prior year period. The improvement in both gross profit and gross margin was primarily attributable to the aforementioned strong pricing environment, partially offset by increased raw material and freight costs.

Net income in the first quarter increased considerably to \$10.3 million or \$0.99 diluted earnings per share compared to net income of \$1.1 million or \$0.12 diluted earnings per share for the first quarter of 2021. The increase was primarily driven by record revenue and gross profit results, partially offset by increased SG&A spending from the hiring of additional sales and operational personnel in both segments.

Adjusted EBITDA in the first quarter increased significantly to \$17 million from \$4.9 million in the year-ago quarter, and adjusted EBITDA margin also improved 760 basis points to 14.6% from 7% in the year-ago quarter. For reference, DanChem contributed \$0.8 million in adjusted EBITDA for the first quarter of 2022.

Lastly, looking at our liquidity position as of March 31, 2022, total debt was \$71.1 million compared to \$70.4 million at December 31, 2021. As of March 31, 2022, we had \$38.6 million of borrowing capacity under our revolving credit facility compared to \$39.4 million at December 31, 2021. As you can see, we invested heavily in our working capital to support our strong sales demand. Even with these investments, we were still right about cash flow neutral for the quarter. I'd expect free cash flow to accelerate over the balance of the year in event pricing normalizes to some extent.

With that now, I'll turn it back over to the operator, Adrienne, for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from [David Siegfried].

Unidentified Analyst

I noticed you moved your corporate offices to Chicago. So my question is, the former corporate office in Richmond and also the manufacturing space there in Texas, that Palmer facility, and any other -- the extra footprint that you may have, have you been able to sublease some of that to free up some of that expense?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Yes. We've subleased a portion of our Texas facility, and our Richmond lease expires this year in a few months. So the obligation there terminates in a few months. And then we're working on -- there's a little bit of space left in our Texas, the former Palmer operation, that we're working on subleasing the balance of that.

Unidentified Analyst

Good. Okay. That new high-frequency mill that was discussed last quarter in Munhall, is that -- has that installation started yet?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Yes. We're in the process of mapping out in the facility where it's going -- installing the new mill, but that is anticipated to be operational this year.

Unidentified Analyst

Got it. Okay. And then the automation, the investments that you've been making in your facilities, what type of payback do you expect? Like a 1-year payback? Or is that something that's more long-term oriented?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Some of it is shorter term and then some of it is longer term. It depends on what we're installing or putting in place. Obviously, our preferred is the shortest possible payback as possible, but majority of it is 2 areas of focus. One is safety for our employees, taking out higher-risk repetitive tasks that can be accomplished through automation, which those -- some of those have a little bit longer payback. And the other is pure efficiency implementation of automation that has a shorter-term payback.

Unidentified Analyst

Got it. The earnout liability has -- that last one, is that dropping off here in the second quarter?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Aaron, I believe so.

Aaron M. Tam *Synalloy Corporation - CFO*

Yes, it is. We have just remaining -- ASTI is no longer obligated, and all we have left are a couple of payments for Munhall. Both of them will be booked in Q2, although the last one actually from a cash standpoint won't be paid until July.

Unidentified Analyst

Okay. All right. Another question. Recently, the administration has said that the infrastructure package -- product that needs to be -- that's procured through that package needs to be American-made. So my question is, can you source enough raw material from the U.S. to go into Chemicals and Metals to meet that demand?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Yes, it's a great question. From a supply chain, we're primarily procuring hot-rolled and cold-rolled stainless and we have sufficient North American supply base to handle the projects that we're looking at to be awarded from a production standpoint.

Unidentified Analyst

Okay. Has the internal control issues been rectified yet?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Aaron?

Aaron M. Tam *Synalloy Corporation - CFO*

We have developed a detailed remediation plan with the help of EY as well as our internal resources and been mapping out what's required to make sure that we remediate all of those internal control concerns. They will be tested internally by the end of the second quarter, and then we'll begin to work with our auditor, BDO, to test those thereafter to make sure that they are fully tested and vetted by year-end.

Unidentified Analyst

Okay. Good. So it's well in hand then.

Aaron M. Tam *Synalloy Corporation - CFO*

Correct.

Unidentified Analyst

One other -- 2 other questions. So regarding -- with the market turmoil recently, do you think some of the market turmoil can actually maybe soften up the pricing?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

I think the one thing it will definitely do is, obviously, with higher interest rates going into certain buyer profiles that competed against us for deals in the past, changes their economics and what they're willing to pay for on a multiple standpoint. But also, I think we're seeing some of the market participants from a competitive standpoint, from a bid side, you're seeing some of them fall out of the process. So I mean, anecdotally, I've seen a couple of transactions that are coming back to market because of failed processes. So I think hopefully, the deal flow does accelerate. And I think Ben and I are very involved in active discussions with potential targets, and it's significantly greater volume than it was 2 months ago.

Unidentified Analyst

Okay. Good. One last question. You did \$44 million in EBITDA in 2021, \$17 million adjusted EBITDA in first quarter and a market cap of \$150 million. Do you think that -- what do you think it will take for others to see the disconnect?

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

It's a great question. I wish I knew the answer. I complain about it to Ben all the time.

Benjamin L. Rosenzweig *Synalloy Corporation - Executive Chairman*

Yes. I mean, David, there's no question that the stock is way too cheap. We're expecting to generate more cash over the course of the year, as Aaron said. Right now, our LTM adjusted EBITDA is north of \$56 million. So we're, I guess, trading at enterprise value to LTM adjusted EBITDA of about 4x. It's a pretty conservative leverage profile, about 1.25x. So we're feeling really good about what we've done. We've done everything that we feel like we said we were going to do and hopefully more.

And now it's on us, right? We can't just sit here and wait for people to recognize that. We're going to go out and spread the gospel. We feel like we've been unfairly characterized as potentially maybe a metals company. Chris and I talk about this all the time. We're a manufacturing company. We've got a great presence in specialty chemicals. We're providing value-add solutions on the pipe and tube side with commodity inputs that are very unique and a pricing and solution provider that has an amazing reputation. So we feel like there aren't maybe a ton of pure-play type 2 or metals manufacturing peers that are out there, but we do feel the valuation is especially punitive and even more so potentially on the specialty chemicals side.

Unidentified Analyst

Yes. Well, I see you have a conference -- Sidoti conference Thursday, I believe, so -- or Wednesday. So that's -- I suppose that will help get some transparency and get the word out there. Great quarter. Excellent quarter. Good talking with you.

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Thanks, David.

Aaron M. Tam *Synalloy Corporation - CFO*

Thank you, David.

Operator

(Operator Instructions) And currently, we have no questions. This concludes our question-and-answer session. I'll now turn the call back over to Mr. Hutter for closing remarks.

Christopher Gerald Hutter *Synalloy Corporation - President, CEO & Director*

Thank you, Adrienne. We'd like to thank everyone for listening to today's call, and we look forward to speaking with you again when we report our second quarter 2022 results.

Operator

Thank you, ladies and gentlemen. This concludes today's conference call. Thank you for participating, and you may now disconnect. Speakers, please stand by for your post.

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