Final Transcript

Sylvamo's 2nd Quarter Earnings Call

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SPEAKERS

Hans Bjorkman – Vice President of Investor Relations
Jean-Michel Ribieras – Chief Executive Officer
John Sims – Chief Financial Officer

ANALYSTS

Paul Quinn – RBC Capital Markets
Cole Hathorn – Jefferies
Jonathan Luft – Eagle Capital Partners

PRESENTATION

Moderator	Good morning, and thank you for standing by. Welcome to Sylvamo's 2nd Quarter 2022 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, we will have an opportunity for questions. [Operator instructions]. I would now like to turn the call over to Hans Bjorkman, Vice President of Investor Relations. Sir, the floor is yours.
H. Bjorkman	Thanks, Tawny. Good morning, and thank you for joining our call today. Our speakers this morning are Jean-Michel Ribieras, Chairman and Chief Executive Officer, and John Sims, Senior Vice President and Chief Financial Officer. Slides 2 and 3 contain important information, including certain legal disclaimers. For example, during this call, we will make forward-looking

statements that are subject to risks and uncertainties. We will also present certain non-US GAAP financial information. Reconciliations of those figures to US GAAP financial measures are available in the appendix.

Our website also contains copies of the second quarter 2022 earnings press release, as well as today's presentation.

On Slide 4, we want to provide a brief update on our Russian business. As communicated in our first quarter earnings call, we made the decision to exit Russia, and began conducting a process to sell our Russian business. In the second quarter, we have transitioned the Russian operations into discontinued operations. It is important to note, now that our Russian operations are reported in discontinued ops, all earnings and figures for current and prior periods, as well as our outlook in this presentation, exclude our Russian business, unless otherwise noted.

The process to sell the business continues, and we will provide an update on any material developments when appropriate. Please keep in mind that the situation in Russia is complex, and continues to change frequently. In the meantime, we will continue to comply with all regulations and sanctions.

With that, I will now turn the call over to Jean-Michel.

J. Ribieras

Thanks, Hans. Good morning, and thank you for joining our call. I'll begin my comments on Slide 5. I'm very pleased to share our second quarter highlights. We continue to have good results, with another quarter of excellent commercial and operational execution. Quarter-over-quarter, we had a 290 basis point improvement in our margins, and we grew our adjusted EBITDA to $189 million, a 29% improvement.

Our adjusted earnings per share grew 51% quarter-over-quarter to $2.02 per share. We generated $39 million in free cash flow, and we repaid $48 million in debt. We initiated a dividend with the first payment in July, and our Board also authorized a share repurchase program of up to $150 million. Our strong performance is a result of our low cost asset base, talented people, and our continued efforts to help our customers succeed.

Let's move to Slide 6. We continue to execute and deliver on our three-prong strategy of commercial excellence, operational excellence, and financial discipline, which resulted in a 20.7% adjusted EBITDA margin. Demand for uncoated freesheet continued to strengthen in Latin America

and North America, as schools and offices reopened. Our volumes remain strong, we remain at full capacity in all regions, and we outperformed industry demand across our regions by 260 basis points with our customer focus.

In fact, year-to-date, in Europe, our branding sales, as a percentage of overall mix, is up almost 10% against last year. And in Brazil, our cut size sales are now back to pre-pandemic levels. We operated well in the current supply chain environment, where the availability of many raw materials remains stretched. We continue to realize the benefit of prior price increases, result in price mix outpacing cost inflation.

I'm proud of how our teams navigated the current landscape and they worked to take care of each other, as well as our customers. Executing this strategy generated significant free cash flow that we have used to pay down debt and pay a dividend.

Slide 7 highlights our key performance metrics and our strong results for the quarter. Net sales were $912 million, which was up 11% quarter-over-quarter. As mentioned earlier, we generated an adjusted EBITDA of $189 million, which was an improvement of 29% over the first quarter. Our adjusted EBITDA margin was strong at 20.7%, especially since the second quarter was a heavier maintenance outage quarter. We have not seen margins this high since before the pandemic.

We generated $39 million in free cash flow, up 22% quarter-over-quarter, and delivered adjusted operating earnings per share of $2.02, which is up 51%.

Slide 8 summarizes our performance for the first half of the year. We delivered an adjusted EBITDA of $335 million, achieving an adjusted EBITDA margin of 19.3%. We generated $71 million in free cash flow, after several substantial one-time spin-related payments. And we continue to strengthen our balance sheet by paying down $81 million of debt. This strong performance demonstrates our ability to continue to deliver on our investment thesis. Our teams performed well, creating value for all of our stakeholders.

I'll now turn it over to John to discuss our second quarter performance in more detail. John?

J. Sims

Thanks, Jean-Michel. Good morning, everyone. Let's turn to Slide 9. As Jean-Michel mentioned, we generated $189 million in adjusted EBITDA, with a margin of 20.7%. Again, this was a 290 basis point improvement over the first quarter, as our gains in pricing, commercial excellence, and operational excellence are outpacing cost inflation. We improved price and mix by $73 million, as price realizations exceeded our forecasts, and we have benefited from several mix optimization initiatives.

Volumes increased by $2 million, with stronger seasonal demand in Latin America, as back-to-school book publishing was strong. Our order backlog remained strong in all regions.

Operations and costs also improved by $2 million. Overall, our operations ran well. We successfully conducted planned maintenance outages at our Eastover and Ticonderoga mills, and spent $17 million more on outages than in the first quarter. Input and transportation costs increased by $16 million, with rising cost of chemicals, energy, fiber, and distribution.

Let's take a look at our regional results on Slide 10. Each region continues to perform very well, demonstrating the strength and resilience of our talented teams, our low-cost mills, iconic brands, as well as favorable industry conditions. We continue to win with customers, and increase our positions in key segments.

For example, in Brazil, we are expanding our presence in high-margin food retail channel, and in North America, we are growing on-demand book publishing. We remain focused on earning the right to be our customers' supplier of choice.

Our volumes remain strong in all regions, and we continued to outperform industry shipments. Our commercial performance reflects our compelling customer value proposition, as well as continued price increase realizations.

Operations were good in all regions, while executing two large annual outages in North America. Supply chain costs remain under pressure. However, we're seeing truck availability starting to improve in North America.

One of the competitive advantages of Sylvamo is our global footprint. And I want to remind you that our European team has been selling product from Brazil into Europe for over a decade. Now that our Russian business

is in discontinued operations, the Brazilian volume represents a much higher percentage of our total European sales, and impacts our reported EBITDA margins in Europe.

So, if we exclude the Brazilian volume sold by our European team, where they only receive a sales commission, Europe's second quarter adjusted EBITDA margin would have been closer to 20%. The appendix contains additional details on our regional performance.

So, let's turn to Slide 11. Six months into the year, global uncoated freesheet industry conditions continue to be favorable, as demand continues to rebound from the effects of COVID, and operating rates remain tight, particularly in the regions where we operate. It should be noted that industry inventory levels are below historical levels across all our regions due to tight supply conditions.

Year-to-date, through June, North America industry demand growth is 2%, while Latin American industry demand growth is positive 16%. Western Europe industry demand declined 2.7% in the first half of the year, but the prior shutdown of high-cost capacity still results in favorable supply and demand balance there. It is believed that this tight supply is negatively impacting European demand.

Selling prices remain favorable, and we expect to continue to realize prior increases throughout the third quarter. Our price and mix improvements continue to more than offset input and transportation costs.

So, let's move to Slide 12 and look at our third quarter outlook. In the third quarter, we expect to deliver an adjusted EBITDA of $205 million to $215 million. Price and mix is projected to improve by $40 million to $45 million, as we continue to realize price increases already communicated to our customers in all regions.

We expect volume to improve by $5 million to $10 million, with seasonally stronger volume in North America. Operations and costs are projected to increase by $5 million to $10 million. We expect input and transportation costs to increase by $35 million to $40 million, largely due to higher chemicals, energy, fiber, and transportation costs.

Maintenance outage expenses are projected to decrease by $14 million, as we conduct less planned maintenance outages this quarter.

Slide 22 contains further details on additional financial metrics for the third quarter outlook. Now let's turn to Slide 13.

I want to remind you how we are planning to allocate cash to create value. This slide frames up how we plan to allocate our capital. We intend to use our cash to strengthen our balance sheet, invest in high-return projects, and return cash to shareowners.

Let's start by diving into how we plan to strengthen our balance sheet on Slide 14. Last quarter, I shared with you that we are now targeting gross debt of $1 billion. We believe this will achieve the following: It reduces our risk and our cost of capital; reduces our interest expense; puts us in a position to invest in businesses throughout the cycle; and increases our flexibility for other value-creation opportunities through the business cycle.

As you can see on the slide, we have repaid $225 million in debt since our spin, and we have steadily driven down our gross debt to adjusted EBITDA ratio every quarter.

In addition to the $48 million repaid in the second quarter, we also repaid another $20 million in the month of July. This now puts our gross debt level below $1.3 billion. We were able to accomplish all of this within our first ten months of being a standalone public company.

Here on Slide 15, we will take a closer look at how we plan to invest in high-return projects to improve our business, lower our costs, and make our assets even more competitive. We are developing a portfolio of high-return cost reduction and strategic volume and mix-related capital projects.

Over $100 million of capital projects with high returns have been identified so far. Thirteen cost-reduction projects have been approved at this point, with a total capital cost of $33 million. These projects will be executed over the balance of 2022 and 2023. This slide shows six of these projects to illustrate some of what we are working on.

We expect to achieve in excess of $12 million in annual savings from these investments, with most of the projects starting to return savings in the second half of 2023. All these projects are focused on reducing energy, fiber, and chemical costs, as well as indirect cost savings. These projects have an investment range of $200,000, up to $2.5 million, and have internal rate of returns ranging from 20% to 80%.

Let's turn to Slide 16 to discuss returning cash to shareowners. On our last call, we mentioned that we were conducting Board-level discussions around returning cash to shareowners. In May, our Board approved a quarterly dividend of $0.1125 per share that was paid in July. Our Board also authorized a share repurchase program of up to $150 million.

Let's turn to Slide 17. So, as we look at the balance of the year and beyond, you can see that our debt maturity profile, that we do not have any significant maturities due until 2027. It is also important to note that we have $128 million of spin-related payments in 2022 that will not repeat. These include $77 million of day-one Riverdale and Georgetown inventory payments, $29 million of one-time spin-off expenses, and $22 million of transition service agreement costs.

We'll also benefit from our high-return projects pipeline as that ramps up, as we now have the option to opportunistically buy back shares to help create further value. Also note that in Brazil, a settlement program became available for dispute over the amortization of goodwill, and it expired in July. International Paper, which directs our goodwill tax dispute there, determined not to settle the dispute through the program.

I'll now turn the call back over to Jean-Michel.

J. Ribieras

Thanks, John. I'll conclude our remarks on Slide 18. We are well-positioned to continue to create value in 2022 and beyond. We remain committed to generating strong earnings and cash flow, and confident in our ability to achieve pre-pandemic earnings levels in 2022. In fact, we are increasing our full-year adjusted EBITDA guidance from a range of $725 million to $775 million, to $740 million to $780 million. We are also increasing our full-year free cash flow guidance from a range of $160 million to $180 million, to $170 million to $180 million.

Our reasoning is as follows: We see favorable industry conditions, and expect that to remain in the second half; our customer value proposition has continued to strengthen; we continue to have excellent commercial and operational execution; our price mix continues to outpace inflation.

In the second half, we expect improving adjusted EBITDA margins, and strong sustainable free cash flow. Our strategy has not changed. Also, we are now targeting a gross debt level of $1 billion. We are accelerating our

high-return projects, and we continue to work hard to strengthen our company and improve the business.

Our ability to navigate dynamic industry conditions and achieve success is because of our talented and engaged teams. We appreciate their dedication to working safely, while delivering on our promises to our employees, customers, and shareowners. We are committing to delivering value for all of our stakeholders by continuing to deliver on our investment thesis. We remain confident in our ability to achieve our vision of being the employer, supplier, and investment of choice.

With that, I'll turn the call back over to Hans.

H. Bjorkman — Thanks, Jean-Michel, and thank you, John. Okay, Tawny, we're now ready to take questions.

Moderator — Thank you. [Operator instructions]. Our first question will come from the line of Paul Quinn with RBC Capital Markets. Please go ahead.

P. Quinn — Yes, thanks, guys, and good morning. Just a question on price increases. I've seen a number of competitors in North America introduce September price increases in the marketplace. Just wondering if you followed suit, and what's the status in Latin America?

J. Ribieras — I think we don't comment on pricing, but there's been some press or media or specialists which have informed our price trends. So, I think it's public knowledge for North America.

P. Quinn — Okay. And then, just maybe, just a bonus question here just on guidance. I think I made this wrong last quarter, but essentially, you've moved up guidance by $10 million on the midpoint, right? But I was assuming that Q1's reported 187 was in your guidance, as opposed to the 143 that's ex-Russia, right?

J. Ribieras — Yes, this is all ex-Russia. And you're correct, we've upgraded especially the midpoint by about $10 million, a bit more.

P. Quinn — All right. That's all I had. Thanks.

J. Ribieras — Thanks, Paul.

Moderator

Thank you. [Operator instructions]. Thank you. I'll now turn the call back over to Hans Bjorkman for closing comments.

Oh, one moment. We do have a last moment question that just come in, and that's from Cole Hathorn with Jefferies. Please go ahead.

C. Hathorn

Good morning. Thanks for taking my question. I'd just like to follow-up on the wood cost trends that you're seeing by region, particularly interested in hearing what you're seeing in the European markets for wood costs. Some of your competitors are calling out wood cost inflation.

And then, following up on that, like to hear a little bit more about the office paper demand trends that you're seeing in Europe relative to North America. Are you seeing any divergence from your customer base in the strength of those office paper order books? Thank you.

J. Sims

Yes, Cole, it's John Sims. On the wood cost, we're seeing wood cost increase across all our regions, but mostly that's driven by transportation costs due to diesel. Although diesel is going down, it's lagged, because mostly it's indexed to that. And particular to Europe, our sources of wood is from the Saillat mill in France, and we actually have a wood harvesting operation there. We're not seeing the pressures that you see in other places, particularly like you're seeing in Poland and other places. That's being impacted either because of the Russian ban on wood to the Nordics, and some other things that are going there.So, we're not seeing that increase, other than transportation cost in Europe, in Saillat.

In terms of your question around uncoated freesheet demand in Europe, it is. As we mentioned, the demand, in Western Europe, uncoated freesheet is down. It's down 2.5%. And as we also mentioned on the call, we believe that despite the conditions are so tight there, that you have a lot of stockouts in shelves, and we've reported that some of availability of paper is not there. We think that that is impacting demand. How much, we don't really have a view on that, but we do think that that is impacting it.

The most significant demand decline, though, we're seeing is in Eastern Europe, and that's mostly driven because of the Ukrainian situation. I believe that's been reported almost down 10%, but that really doesn't impact us from Saillat, which our shipments there is predominantly Western Europe.

C. Hathorn — Thank you. If you permit one follow-up, given your regional producing in France, I imagine you don't have any water level or drought issues. Are you seeing any water level issues impacting, potentially, some of your competitors' production for the market? Any color you give on that would be helpful.

J. Ribieras — Yes, we don't know about competition on drought. There is, as you know, in France, some drought, also. It might not be as bad as some other countries of Europe. There is lot of people making attention, and government has given instruction on water. So, we're not too affected right now, but we're paying attention to that.

The one thing which we are paying more attention, which is not impacting us directly yet, but could, is the fire, the wood fire, the forestry fire. As you know, there's especially one big one in the Southwest of France. There's been a lot this summer, and that has created some disruptions. So far, we've been able to manage it, but it has created some disruption on the wood side.

C. Hathorn — Thank you.

Moderator — Thank you. [Operator instructions]. And we do have a question from the line of Jonathan Luft with Eagle Capital Partners. Please go ahead.

J. Luft — Hi, guys. Thanks for taking my question. The first question I have is maybe just talking about Europe and the energy situation. Can you just walk us through your exposure there?

J. Sims — Yes, Jonathan. This is John. We're well-positioned, if you will, with our Saillat mill, because we're an integrated mill and produce most of our energy needs. We do have some demand for gas there, but it really represents almost 10% of our energy needs.

J. Luft — Perfect. And now that Russia is part of the discontinued operation, can you maybe talk to us a little bit about what the business would've looked like without Russia, if we went back to 2019, 2020, pre-pandemic, and how the business, the guidance this year, and how it relates to ex-Russia?

J. Sims — Yes, Jonathan, I mean, I think, and we mentioned it, is that our earnings, even without Russia, is approaching, or actually better than almost in pre-pandemic levels, even back in 2019 where we actually had another machine. We had at Riverdale 15 machine that was producing. Where,

today, we're projecting to produce more earnings and have higher EBITDA margins than we did back then.

So, if you think about what Russia contributed in terms of EBITDA margin during that timeframe pre-pandemic, it was north of $120 million to $125 million.

J. Luft — Okay. That's very helpful. And then just a last question from me is, if you could talk about the competitive environment, given that margins are pretty attractive now, pricing is up, are you seeing people trying to turn on machines, or sell some incremental capacity into the market? What are you seeing there?

J. Ribieras — We're not seeing any major changes. And I think if you are in a non-integrated position in Europe with the energy, wood, and chemical price, and the bulk right now, your position remains difficult, I will say, probably. And there is no change in capacities in the other main regions. So, we're not seeing anything significantly right now. Operating rates remains very high in every regions we operate.

J. Luft — All right. Well, thank you so much.

J. Ribieras — Thank you.

Moderator — Thank you. I'll now turn the call back over to Hans Bjorkman for closing comments.

H. Bjorkman — Thank you, Tawny, and thank you, everyone, for joining us today. We do appreciate your interest in Sylvamo, and we look forward to continuing the conversations in the coming days, weeks, and months ahead. Have a great day. Thank you.

Moderator — Once again, we'd like to thank you for participating in Sylvamo's 2nd Quarter 2022 Earnings Call. You may now disconnect.