Vesuvius trading update – transcript
15 November 2022, 8am GMT

Attendance List: Patrick Andre – CEO, Vesuvius
Guy Young – CFO, Vesuvius

Coordinator: Good day, ladies and gentlemen, and welcome to the VESUVIUS Autumn Trading Update. At this time all participants are in a listen-only mode. Later, we will conduct a question and answer session through the phone lines, and instructions will follow at that time. I would like to remind all participants that this call is being recorded.

I will now hand over to the CEO of Vesuvius PLC, Patrick Andre, to open the presentation. Please go ahead.

Patrick: Good morning, everyone. My name is Patrick Andre, I'm the CEO of Vesuvius, and with me this morning on the line is Guy Young, our Chief Financial Officer. I will start by giving you the highlights of our trading performance since the start of the second half, and after that we will be happy to open the floor for questions.

The first message is that it was quite a busy year in trading performance, which we've had for the past four months, which now leads us to plan for our 2022 results to be somewhat above expectations of the market. You may know that the range of analyst consensus for 2022 was between £194m and £209m, we now expect to be somewhat above that, for the year 2022.

So what are the reasons for this quite significant trading update? Not that much the market, unfortunately. The market has been weakening, more or less as we had planned it will be when we had our latest update. There have been some regional differences from one region to the next. The market environment in Europe has been even a bit weaker than what we thought. Conversely, the market environment in other regions than Europe has been a little bit better than what we thought. But overall, when you take all the world together of trading environment or market environment, it has been more or less as weak as we have planned it would be.

The reason why our resilient results are many-fold. First, we have continued to make market share gains in all of our divisions and in particular in Flow Control in all regions of the world. The second reason is that we have continued to have efficient pricing management and we have been able to continue to increase prices, to continue to offset all cost increase, be it energy, labour, raw materials, that we were confronted with. At the same time, we have engaged into an important cost-cutting program, as we always do when markets start to weaken, and they are, so we have been able to start reducing our cost base. And we will continue to do so, as much as in history, in the coming months in case markets will continue to weaken.

Two other points. We have also benefited from a better than expected tailwind from foreign exchange, and Guy will help you during the Q&A if you are interested. And also, even as our inventory has been declining, we've been able to reduce our inventory, but we have reduced our inventory a little bit less than what we planned at the time of our latest trading update mid-year. So the negative fixed cost absorption impact, even if it has been significant, is less than what we planned in our last update. And all these reasons together have combined to help us achieve better results than what we initially planned, and this is what is supportive now of our forecast of results somewhat above expectations.

Our cash performance has also been quite good so far. Since the beginning of July we have started to reduce our inventory, even if it's a little bit less than what we would like. But clearly our inventory has started to reduce, and as a consequence we continue to generate good free cash flow. And we expect our leverage ratio, our net debt – to - EBITDA ratio to be significantly down end of the year as compared with this year we will have 1.3 at the middle of the year and we expect to be on or around 1 at the end of the year.

At the same time, even though markets have been weakening the fundamentals of the market had no chance, and we continue to be absolutely convinced that our market, both Steel and Foundry, are growing long term. And for this reason, even if we are cutting short term costs, we are absolutely continuing at the same pace all of our investment for the future, at least first investment in R&D, we are continuing to increase our R&D spend, which goes to the expense, in the way we are accounting for it. It's not capitalized.

We are increasing our R&D spend because we believe that is what will help us to continue to gain market share going forward and our expansion of investment in capacity expansion, in particular in Flow Control, to help us continuing to grow and gain market share in the fast growing regions of India, Southeast Asia, Turkey, Africa, Latin America. Our investments are continuing at pace, and our new investment, new capacity in Flow Control will hit the market progressively between the end of this year and the end of 2023, beginning of 2024, we believe just in time to enable us to fully benefit from the market recovery then.

We have also finalized a small acquisition, small but important to us from a strategy point of view, a small company in China called BMC, which is a producer of basic monolithic refractory materials. It has been a factory that has been a partner of Vesuvius for many years and it's a small company, £14 million turnover, but important for us strategically because it will enable us to expand our presence in basic monolithics, not only in China, but also in North Asia and in Southeast Asia. Now that we are fully 100% owner of this company we'll be able to introduce our latest recipes, which we could not do before for IP protection reasons, and this will support our growth and market share

gain in all this China, North Asia and Southeast Asia region going forward.

From a sustainability point of view, we are continuing to make progress. We will be in 2022, our CO_2 footprint will be 20% lower in 2022 than they were in 2019. So we are on the right track to reduce our CO_2 emissions and all the effort that we have been making in terms of sustainability over the past two years are now clearly recognized also by external agencies, because MSCI has been upgrading a few days ago our rating to AA, which is the second highest rating available for all countries worldwide. We are very pleased with this result.

Looking forward, we expect that the market will continue to weaken. In the coming months, I think we should have no revision on that. Both Steel and Foundry markets are in a weakening trend, so we expect the next few months to continue on that trend, especially in EMEA. There is nothing new there. It's more or less as we had planned it would be. And I would say a significant downturn, we are fully prepared for that.

For the year 2023, for these reasons it's uncertain and we'll refrain from giving you guidance at this stage because there is a high level of uncertainty about when the market will go the other way, when will be the inflection point and when the market will start to recover. What is clear today, and you may have seen the Arcelor Mittal trading update a few days ago, is that a significant part, especially in EMEA, of the weakness that we see in the steel market is due to destocking. And so apparent consumption, this is what is important for us, is relatively down, but real consumption is not down as much as apparent consumption, and at some point there will be a rebound.

But for this reason, it's very difficult today to know if it will take place in Q2 next year or end of next year. This explains a very wide range of consensus for the results in 2023. The range of consumption today is anywhere between £167m and £218m. We are relatively comfortable with that range because we don't have a crystal ball ourselves, so we refrain from giving guidance, but most probably the upper end of that range to correspond to a very optimistic assumptionsregarding when markets will recover, if it's true that markets will recover already in Q1 and Q2 next year, which we do not see as the most likely scenario out of cautiousness for the time being. And the lower end of that range will assume that markets do not recover until the end of 2023. So for the time being it's too early to give our own opinion about where we see that trend. But we believe that for a few months, and I think probably during the course of this one, we will be comforted with which end market, both in Steel and Foundry, but that at some point in time after that our market will recover and will resume their long term growth rate.

So I will end there and open the floor for questions, and Guy and I will be very happy to answer.

Coordinator | Thank you. [Operator instructions]. And we will take our first question from George Featherstone from Bank of America Merrill Lynch. George, please go ahead.

George | Good morning, everyone. Thanks for taking the questions. The first one would be a little bit of a follow up on your last comments there, Patrick, around normalization of inventory. So maybe starting with Vesuvius itself, where do you see your working capital percentage of sales ending this year? And then where do you expect it to trend in the first half of 2023? And then how much of the wider channel inventory do you expect to normalize and when, and if you'd be able to quantify how much destocking do you expect to see in the first half of next year?

Patrick | Thank you. I will hand over to Guy to give you some figures, but as far as all inventories are concerned, we have already clearly started to decrease because logistic and supply channels are improving, but not only because markets are declining. Also, logistics and supply chain are recovering, so we don't need to keep as much buffer or safety margin as we had over the past 12, 18 months due to the disturbances in the trade market in particular.

So things are clearly getting better, it opens new possibilities for us to reduce so we have started to reduce. We initially planned to completely reduce what we believe the normal level by year-end. I don't think we'll be able to do that. So we will significantly reduce, but not as much as we wanted to initially. We will still have some unwind of inventory during the first half of 2023, but already this year, and this is the reason why we are already generating good cash flow, we are starting to unwind our inventory.

So that's one. And I will hand over to Guy to give you some more figures. But regarding the steel inventory, it's clear that, if you remember, during the actual results I had indicated that the reality is that the steel inventories were clearly too high. They have clearly started to unwind and we have the suspicion that they are reducing relatively rapidly. It does not mean that the reduction is over, not yet, but officially in Europe there has been significant reduction in production of steel in Europe and also in other places and we believe that steel inventories are now relatively rapidly reducing, and it will probably take a few more months for them to reach the level at which the reverse trend will start.

But we are on a good track to reduce excess steel inventories also. So somewhere in H1 you will see in the steel industry, both the reduction in excess refractory and excess steel inventory will have been achieved sometime next year.

Guy, maybe you can give some more numbers regarding the working capital intensity.

Guy	Sure. Thanks, Patrick. Morning, George. I think the trade working capital sales for 2022 is probably more likely to be between 23.5% and 24%. We should see about half of our expected under-absorption of fixed costs flowing through into next year. But our trade working capital overall should be declining back toward its trend of around 21% as soon as supply chains and markets have normalized, which I would expect to be happening through 2023 and 2024. So up to 24% before coming back down to 21%, George.
George	Okay. Thank you very much. That's really useful. Then I just wanted to touch on the cost base reduction. I was wondering if you can give a bit of colour on where that's been targeted. And also in that context, you mentioned good price interaction covering the cost inflation that you've seen on labour, but on labour, what are you seeing as the cost inflation potential for next year? Is that part of the cost base reduction in the entirety and can you raise prices again to offset that in the context of volume declines you're expecting?
Patrick	It's a very good question. We are trying to reduce costs everywhere. What we are always too doing is of course travel, external professional fees, everything has been reduced. But also we have already started to put some of our people on furlough, so as we are reducing production in many of our plants, we have started furlough in several places to reduce our fixed cost base. And this is already helping us in our business and we'll continue this, as we had done during the pandemic. In fact, we are applying the same method of what we've done during the pandemic to conform to the drop in volume. We are doing that now, and this is contributing to maintaining, part of the negative impact of a declining market. Labour costs are increasing in the inflationary context, but we are being extremely reasonable in our labour negotiations. At the same time, we are setting up people normally well, but we are also reasonable in the way we are doing so. We have a lot of discussion with our people to agree together and we have always been able to agree so far on reasonable labour cost increase. And labour is a cost, as is energy, as is raw materials, and our pricing management is adapted to cover all of the cost components of our cost structure, meaning of course raw materials, freight, energy and labour, which are the four most important. Labour is taken into account in our pricing strategy.
George	Okay. Thank you very much.
Coordinator	Thank you. The next question is coming from Andrew Douglas from Jefferies. Andrew, please go ahead.
Andrew	Morning, gents. And well done for getting your technology to work. Can I ask a couple of questions, please? Firstly, going back to George's question on cost out, is there anything different in this cycle compared to prior cycles in terms of the levers that you have to pull if you do need to take additional cost out, and in terms of what needs to happen from

your end markets for you to take those decisions, or is it similar to prior cycles?

Secondly, I just want to touch on the small acquisition in China. I know it's small, but I want to understand your thought process going into next year with a healthy balance sheet just regarding M&A, whether there are more targets out there that are coming loose?

And further, a slightly lazy question but once for Guy, do you guys have any refinancing to do next year? It looks like there's only a small, I think it's $30 million to refinance, and if so, will you just roll it into your RCF, or do you have any other options? Thanks.

Patrick

Thank you, Andy. I will let Guy answer on the refinancing, but clearly we have a very solid balance sheet and very, very little refinancing in the years to come. But Guy will give you more flavour on that.

On your two first questions, first, it is very similar, we are battle-hardened now, as you can imagine, so taking cost out it's very similar to what we have been doing regularly over the past few years each time we had a downturn. These downturns are obviously a temporary one. I don't know how long it will last, if it will be six months, one year or 18 months, but it's not five years. So we are now well equipped to make the distinction between those costs which we can and should cut to adapt to this temporary downturn without negatively impacting our long term strategy.

And conversely, those other costs which are absolutely key to our long term strategy and which we never touch during a downturn, including a non-classical downturn like the pandemic, I'm thinking mostly about R&D, R&D, not only we are not cutting R&D, but we are continuing to increase our R&D expenses because we have very good projects. We have plenty of ideas of new product that we can put on the market in the coming years and we don't want to slow that down, because this is the key for us to continue to gain market share. But other costs, there is no sacred cow, all the other costs which can be reduced short term without impacting our long term strategy will be reduced in a very decided and proactive way because it is the only way to do it.

Regarding BRC, it's small but it's very important for our strategy because it will really help us accelerate all development in China, North Asia and Southeast Asia, which are very important areas for us. And yes, we have an appetite because we have a strong balance sheet and we have an appetite for other similar bolt-on acquisitions. We are currently looking at also mid-size opportunities, an order of magnitude of CCPI, Universal, BRC, are most likely the same order of magnitude. We have the balance sheet to do it, to absorb it, and we like them because they are generally high level synergies, integration risk is low, they are not stretching management teams, and so we have an appetite. So there is no guarantee that any of those will happen, but we are proactively looking for other opportunities going forward.

Now, Guy, I will hand it over to you to give some information about the financing.

Guy — Thanks, Patrick. Morning, Andy. Yes, you're absolutely right, we have very little in terms of refinancing requirements. We've got a small USPP note that's due for redemption at the end of '23 of around $30 million and yes, again, you're right, our intention is to utilize either internal cash resources or some of the RCF in order to do that redemption. So no major refinancing requirements during '23.

Andrew — Okay, that's really helpful. Thanks, guys.

Coordinator — Thank you. The next question is coming from Bruno Ghani from BNP Paribas SA. Bruno, please go ahead.

Bruno — Thanks for taking the question, guys. I was just wondering if we could go back to the under-production in H2 and if you can isolate and quantify the impact that you expect under-production to have on H2 profitability. And further, if you can expand on that and touch upon production expectations for next year. Are you reducing production in H1 '23 to a level that is below the Q4 level? So is it a sequential cut, or are you simply holding production at a lower Q4 level for longer? Thank you.

Patrick — I will pass over to Guy to complement with some numbers. But qualitatively first, we are producing less than what we sell. That's how we're reducing inventory. So we are producing less than we sell during H2 this year, and we will continue to produce less than what we sell in H1 next year. But what we sell in H1 next year, I don't believe it will be lower than Q4. Q4 is a very low quarter, I think it's more or less everywhere the same. And so I don't see us, again, I have no crystal ball, unfortunately, but I consider it unlikely that production and sales for Q4 will be higher than H1 because Q4 is very low in terms of production and sales, lower than Q3, its always like that in such a cycle and I would at this stage expect H1 to be a bit lower than H2, but higher than Q4.

Now, if I may hand over to you, Guy, to put more flesh around this.

Guy — Sure. Bruno, we spoke about a potential range of impact with regards to the under-absorption of fixed costs at H1 and we estimate that to be impacting us by between $8 million and $10 million in the second half. My expectation at the moment, although we've obviously still got two months to run and we are still looking to continue to reduce inventory, but my expectation is that about half of that under-absorption will flow into next year, so between four and five.

Bruno — Okay, that's helpful. Thanks, guys. I was just wondering if you can talk about perhaps why you didn't do that larger production cut in H2. Is it perhaps because demand surprised positively and market share

gains are more pronounced? Or is it to do with more favourable cost dynamics, say, perhaps contracted energy costs being lower this year for you, or did it just make sense to spread some of that burden that under-production presents on your margin over several periods and actually coincide that with a cost savings that might flow through? So just perhaps some colour around why not a larger cut in H2 and get it out of the way.

Patrick

I think it's a very good question. And believe me, if we could reduce production even more in H2, we would do it. But sometimes when you put people into furlough, you need to negotiate first, so you don't announce then from Monday to Tuesday, that we put 80% of people in the plant in furlough, so you need to negotiate with them to do that in, I would say, a responsible way, because we want to keep our people.

I repeat on that, it's not like we are shutting the operation and thinking that we'll never restart it. We want to keep our people. We have very qualified blue collar in particular, also white collar, but we have a very qualified, including blue collar, which we want absolutely to keep because they're key to the quality of our production, the quality of our operations. So when we reduce production in the plant, we don't do it in a difficult way, we discuss, we explain why we are doing it, we take the time to, I would never dare to say convince, because people are never happy to go on furlough, but at least it's important to take the time to explain, because in a few months from now we will start again. And we will need to have those people fully motivated, fully ready to ramp up production again, and with the best level of quality for our customers.

So the way we do the ramp down is very important for the quality and speed of the ramp up later on. So we are doing as much as we can, we are reducing as much as we can, but considering the decline in the market, especially in EMEA, it has not been as weak as we would have liked it to be. That's the reason why our ramp down of inventory will be serious, significant, but not as much as we wanted it to be during the second half of this year.

Bruno

Got it. That's very helpful. Thank you. And just a last one on pricing. I was wondering how pricing has developed sequentially. So Q3 over Q2, are prices stable or have they started to moderate lower already?

Patrick

It has moderated. Obviously if you compare the quarter over quarter evolution, it has moderated because our cost base has moderated. But our prices are still increasing because our cost base has still been increasing over the past few months. It may well start to decline sometime in the course of next year. When it does, as we have always said we would, we will start passing this through to our customers. But for the time being, our pricing has been between stable and slightly increasing. depending on the region, and because of cost base has not started to decline yet.

Bruno Just to follow up on that, so this year you would have seen very significant price increases to the tune of, I'd say, what, 16%, 17%? As you look forward to next year, how much of that do you expect to give back to customers? Any indication, or do you expect to hold it all? What are your thoughts on this?

Patrick It's too early to predict that, because it will determine what will happen on the cost base. I don't believe labour will decrease next year. I am sceptical about the fact that energy, there are several schools of thought, and as you can imagine, I don't have a crystal ball about the cost of energy. But I don't consider it, since from today, but it could change one month, or two months or not, seen from today I don't consider it as the most likely scenario that energy prices will decrease on average significantly next year as compared with what they are today, not as compared with what they were two months ago but as compared with what they are today.

And trades may be declining as we speak, trade is continuing to decline, so this is a positive factor in terms of cost base declines. And raw materials are not declining that much. Raw materials, excluding freight today, are not different, at least the raw materials we are using, industrial minerals, they are not declining actually for the time being.

So it's a mixed bag and it's very difficult at this stage and I'm going to be frank, to predict by how much it could decline next year. All in all, I hope it will decline a little bit, but it's too soon to tell by which percentage. And we will follow, we have something we are revising every month, and we are following that every month, if not several times a month, and we will adjust our pricing if and when we observe real factual cost declines in the market. But again, it's not the case for the time being.

Bruno Got it. Thanks for the colour. Much appreciated.

Coordinator Thank you. [Operator instructions]. And we will take the next question from Dominic Conway from Numis. Dominic, please go ahead.

Dominic Good morning, gents. Thanks for the questions. Just a couple, if I may. Just following up on Bruno's point really around the inflation expectations for next year, two-fold really. What wage inflation next year, how would you characterize your expectations? Would you say mid-single-digit or perhaps mid- to high single digit next year?

And looking it another way, as things stand, what level of price increases do you expect you will be required to put through next year to fully recover that weighted average cost increase? I'm just conscious that today we focus very much on our pricing models for 2022 and now it's a good time to review and just get our revenue line in shape for next year.

And then the third question, just in terms of shape, implied within the new guidance for this year, what is your expectation in terms of the performance of the last two months of the year relative to what you've already booked in the four months to October? Thank you.

Patrick

Regarding your first point, we do not have, as you can imagine, a single wage expectation for all countries everywhere in the world. And it's interesting because we see relatively large variations. There are some countries where we forecast wage inflation to be low double-digits, and there are some countries where we are forecasting wage inflation to be low to mid-single-digits. So it's a wide range. And we are looking country by country at the specific situation, the evolution of the currency, the specific level of inflation in such a given country and we have very, very significant variation. You still have countries that you know where inflation is still on the rise. You have also countries where inflation may have already peaked. So this also creates a difference in the dynamics of negotiations of discussions we have with our employees.

So we expect a relatively wide range of outcome from low to mid-single-digits to low double-digits next year in terms of wage inflation. But it is case by case, and we are looking at it on a case by case basis with our local managers being onboard to adapt their decision based on local circumstances. It is not something we are running from the headquarter, and we trust all leaders locally.

In terms of price increase, or price evolution, again, it's too soon to answer this question because even if wages is relatively, I would not dare to say predictable, but you can make some forecasts in terms of wage, wage is only one of many elements of our cost base, raw materials, freight and energy are also important ones. And this is changing materially by the day or by the week and we are adapting our pricing nearly every month.

So with other elements than wages more than compensate with the decline of other elements, more than compensate the decline in wages, the increase in wages, we see possible, not granted, we are monitoring this on a regular basis, and we will adjust our pricing strategy accordingly. But again, unfortunately, because I don't have a crystal ball, I cannot tell you what will be the resulting evolution of our price. We will see that when it's done going forward.

And to answer your question, we do not have, and we are not planning to have a lower unique margin in the later half, in the end of this year than what we have so far. Volumes are lower so you have a fixed cost absorption back, but in terms of unique margin, margin per unit, we are not planning to have lower profitability than what we have so far.

Dominic

Thank you.

Coordinator	Thank you. There are no further questions in the conference call. I will now hand over to the management for closing remarks.
Patrick	Thank you very much to all of you for attending the call today. I wish you a nice day and we are looking forward to seeing you when we announce our full year results at the beginning of March next year. Thank you very much.
Coordinator	Thank you. Everyone, that concludes our conference call for today. You may now disconnect. Thank you for joining and enjoy the rest of your day. *[END OF CALL]*