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High Yield | Specialty Chemicals
North America

HXN and MOMENT Post Call Recaps

Epoxy Under Pressure, Silicone Wants to Break Free of Supply

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- **Citi's Take**: Momentive Specialty Chemicals (HXN) and Momentive Performance Materials (MOMENT) hosted their respective earnings calls this morning. HXN's results beat lowered expectations on improved Forest Product Resins and proppants results. MOMENT, on the other hand, continues to tread water and maximize liquidity as silicone operating rates remain below 90% and demand for quartz products from the semiconductor industry has yet to rebound.
- **Call Replay**: We summarize the highlights of each call in the following pages.
  - **MOMENT:** 888-286-8010 or 617-801-6888, PIN: 57978927.
  - **HXN:** 888-286-8010 and 617-801-6888, PIN: 60462189.
- **Credit Implications**:
  - **MOMENT:** We maintain Marketweight on the name, Buy on the 1st, 1.5 lien and 2nd Lien Notes and Neutral on the Subs.
  - **HXN:** We maintain Underweight on HXN, Buy on 1st, Neutral on 1.5 Lien and Sell on the 2nd Liens.

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Momentive Specialty Chemicals (HXN)

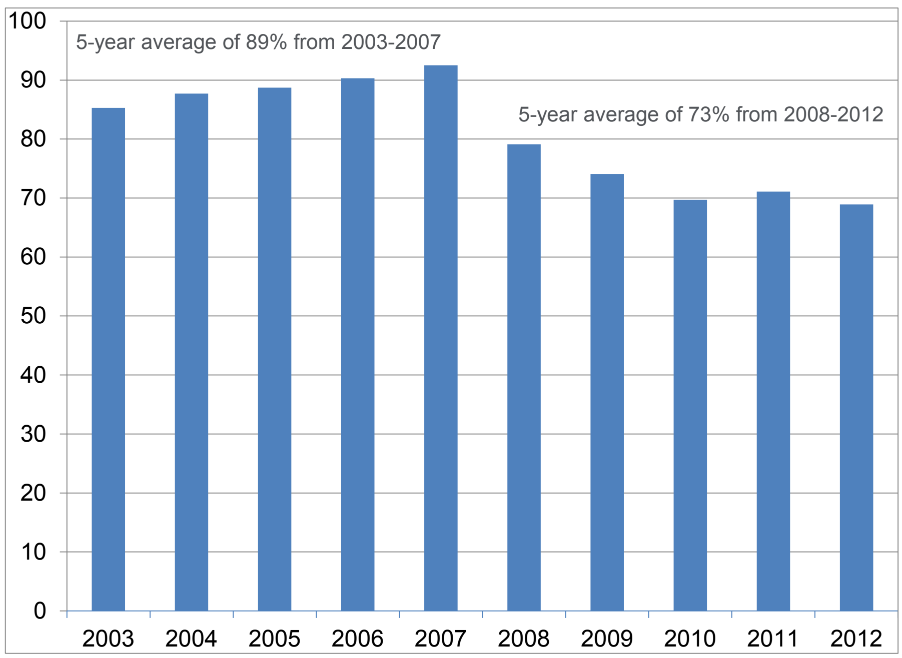
- **Segment Commentary**: Better results in Oilfield and Phenolic Specialty Resins were offset by cyclical weakness in Base Epoxy Resins.
- **Epoxy, Coatings and Phenolic Resins:** Volume gains of 9% offset by price declines of 4%. Downstream commoditization poses a threat, although management highlighted there are examples of products which have been commoditized where EBITDA margins are 20%+.

  – **Base Epoxy**: EBITDA margins were slightly positive and flat sequentially, which HXN views as a minor positive. HXN consumes 30-40% of their LERs in the Specialty Epoxy business, and are looking to expand that organically although this is likely to occur incrementally. Base Epoxy is a sizable business for HXN which is more cyclical than its specialty applications

China's Chlorine operating rates have dropped from 90% in 2007 to below 70% on lower construction demand. China has added base epoxy resin capacity to utilize excess chlorine.

  – **Increased Chinese Base Epoxy Capacity a Problem:** Management agreed with our suggestion that increased Chinese capacity, which resulted from a need to find a home for excess Chlorine supply, could extend the current trough beyond historical norms (Figure 1).

Figure 1. China Chlorine Utilization Rate, %



Source: Citi Research and IHS.

We believe the base epoxy industry lacks barriers to entry. A new world scale plant (50k tons) could be built for ~$100mm. In fact low cost Phenol and plentiful Chlorine supply would invite capacity additions if demand rebounded.

  – **Lack of Barriers to Entry:** When asked about the barriers to entry present, management chose instead to talk about moving further into specialties. We believe the base epoxy industry could see further supply additions if demand improves, due to lack of barriers, which would cap any increase in operating rates and profitability.

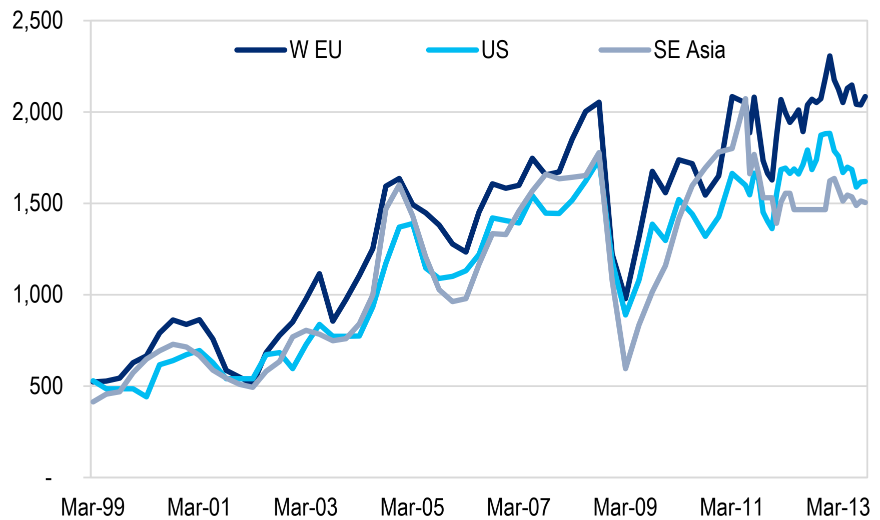
  – **Positive Catalysts:** Management pinned their hopes for improved margins in base epoxies on 2 things which are hard to predict: **(1)** Equalization of phenol prices with Asia with EU and the US (seems unlikely in the near-term with new capacity weighing on NE Asian prices). **(2)** Something that would drive demand for ECH. Management referenced the example of a past regulation change related to water purification in China that increased demand.

Phenol capacity additions in Asia have resulted in a sizeable raw material advantage for Chinese base epoxy resin producers.

– **Cheap Asian Phenol a Problem:** Management highlighted the cost advantage currently enjoyed by Asian producers as the result of lower Phenol prices (key raw material) as the key reason for weakness. NE Asia phenol prices are currently over $700 and ~$250 per metric ton lower than those in EU and the US (implies a 34% and ~16% discount) and have traded at a discount since 2011 as the result of increased supply of Phenol in Asia has (Figure 2 & 3). See below notes published by our global equity team highlighting Phenol capacity additions:

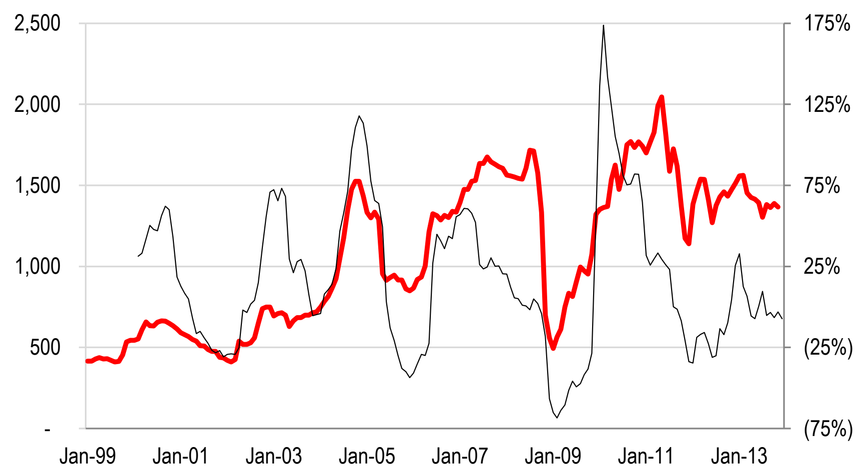
- Mitsui Chemicals (4183) - Staying Neutral: Deterioration for phenol, urethane; some businesses strong, some weak
- PTT Global Chemical (PTTGC.BK) - New Investments to Underpin Volume Growth
- PTT Global Chemical (PTTGC.BK) - PTTGC Gives Nod to Phenol Expansion

Figure 2. Western EU, US & SE Asia Phenol Prices ($/MT)



Source: Citi Research and Nexant,

Figure 3. NE Asia Phenol Price ($/MT)



Source: Citi Research and IHS.

- **Oilfield Products:** HXN's goal is to shift towards wet plays (was 80-20, now 75-25).

- **Forest Products:** Continued weakness in Europe and Asia. HXN saw growth in EBITDA in Europe, not due to the market improving but via a better product mix and cost structure. European forest products are more industrial or commercially based, vs. housing based in the US.

  - **Anticipate Normal Seasonality in 4Q13:** Anticipate normal seasonality in 4Q13, and FY14 growth in N.A. / Latam markets.

- **Capacity**: Most recent growth initiatives include non-binding initiatives with a Formaldehyde and Phenol Specialty Resins JV in India, HXN's recent board approval for their new forest products plant in Brazil to support future growth. Less than $50mm in FY14 for these two projects.

- **Increased BRIC Exposure:** Long term growth highest in the world, though some softness in China. New site in Thailand will support medium term target of deriving 40% of sales from BRICs/emerging markets vs. 25% today. Phenolics Specialty Resins JV in China remains on track, and expects to be operational by year end.

- **Raw Materials Remain Volatile**: Generally moderated during 3Q13 but remained volatile on a YoY basis. YTD HXN has seen a 6% increase in Phenol, a 16% increase in Methanol and a 26% decline in Urea.

- **Liquidity Preferred over Debt Reduction**: HXN continues to have the goal to delever over time; however there are no plans at this point to buy back debt. Focus is on preserving liquidity and available borrowings to fuel reinvestment and growth.

- **Lowered 2013 CAPEX Guidance Slightly:** $96mm spent YTD. Lowered FY13 guidance by $5mm to $145mm. Expect increase in 2014.

- **Working Capital Expected to Be a Source in 4Q13:** $591mm in 3Q13, 12% of sales, improved by $37mm in 3Q13 vs. 3Q12. Seasonal swing into 4Q13 will look similar to prior years in terms of magnitude.

- **Limited Near Term Debt Maturities:** Nothing material pre-2018.

Figure 4. HXN 3Q13 Results

	3Q13	Citi HY 3Q13E		2Q13	SEQ Chg	3Q12	YoY Chg
Revenue	$1,249	$1,173		$1,250	(0%)	$1,177	6%
Segment EBITDA	120	110		118	2%	115	4%
Segment EBITDA (%)	9.6%	9.4%		9.4%	17bp	9.8%	-16bp
Total Debt (Including Affiliated)	$3,786			$3,785	0%	$3,505	8%
LTM Segment EBITDA	427			422	1%	512	(17%)
Net 1st Lien Debt/Seg EBITDA	2.9x			2.9x	0.0x	2.0x	0.9x
Net 1.5 lien Debt/Seg EBITDA	5.7x			5.8x	-0.1x	4.0x	1.7x
Net 2nd Lien Debt/Seg EBITDA	7.0x			5.8x	1.3x	4.0x	3.1x
Net Senior Unsecured Debt/Seg EBITDA	7.8x			7.9x	-0.1x	6.0x	1.8x
Net Non-affiliated Debt/Seg EBITDA	8.1x			8.2x	-0.1x	6.2x	1.9x
LTM EBITDA/Interest	1.5x			1.5x	0.0x	1.9x	-0.5x
Cash	$332	$363		$332	0%	$337	(1%)
Availability on RCFs	430	288		436	(1%)	254	69%
Total Liquidity	**$762**	**$651**		**$768**	**(1%)**	**$591**	**29%**

SEGMENT DATA

SALES	3Q13	Citi HY	% Diff	2Q13	SEQ % Chg	3Q12	YoY % Chg
Epoxy and Phenolic Resins	806	751	7%	799	1%	751	7%
Formaldehyde and Forest Product Resins	443	422	5%	451	(2%)	426	4%
Total	**$1,249**	**$1,173**	**7%**	**$1,250**	**(0%)**	**$1,177**	**6%**

EBITDA	3Q13	Citi HY		2Q13	SEQ % Chg	3Q12	YoY % Chg
Epoxy and Phenolic Resins	77	68	14%	73	5.5%	76	1%
Formaldehyde and Forest Product Resins	58	53	10%	59	(1.7%)	49	18%
Corp & Other	(15)	(10)	44%	(14)	7%	(10)	50%
Total	**120**	**110**	**9%**	**118**	**1.7%**	**115**	**4%**

EBITDA Margin	3Q13	Citi HY	Diff	2Q13	SEQ % Chg	3Q12	YoY % Chg
Epoxy and Phenolic Resins	9.6%	9.0%	55bp	9.1%	42bp	10.1%	-57bp
Formaldehyde and Forest Product Resins	13.1%	12.5%	59bp	13.1%	1bp	11.5%	159bp
Adj	-	-		-	0bp	-	0bp
Total	**9.6%**	**9.4%**	**24bp**	**9.4%**	**17bp**	**9.8%**	**-16bp**

Source: Citi Research and Company Filings.

Momentive Performance Materials (MOMENT)

- **Segment Commentary**: Segment EBITDA up 13%, volumes up slightly. Expecting seasonally modest improvement in 4Q13, although this may not hold for Quartz.
- **Silicone: Sales** gained 7% YoY due to increasing volume (+9% YoY) primarily in N.A. which was partially offset by decreasing price and mix shift. Improvement driven by regaining market share and productivity initiatives.
  - **Operating Rates**: Not at an appropriate operating rate where producers have significant pricing power. MOMENT would need to see operating rates above 90% to get there (looking at 2010 time frame), currently below that point. Management believes operating rates are in line with competitors.
  - **Commodity Silicones Prices Stable QoQ**
  - **New Products**: Tire based products and agricultural products, currently MOMENT's % of sales from 'new products' is in the upper teens, management is hoping to get that number to the low 20s.
- **Quartz:** Sales fell 7% YoY on a 6% decline in volume and a 1% hit from FX. Lower EBITDA reflects lower volumes and weak demand for end goods. Feels the segment is stabilizing at the trough. Management has not seen any signs of catalysts that would indicate a rebound is near.
- **Raw Materials**: Methanol (+16% YTD) and Silicon Metal (moderated from YE12).
- **Capacity**: ~1/3 of new capacity from 2011-2012 additions has been absorbed. MOMENT believes it will take 2-3 years for this capacity to be absorbed and for margins to return to normalized levels based on current level of demand. Timing could change based on pace of global economic growth.
- **Normalized EBITDA Margins Still Possible:** Management believes that once S&D normalizes that they can attain EBITDA margins approaching 20%.
- **Liquidity**: Cash and available borrowings at $245mm. More than adequate to operate over next 12 months. Noted that there is ~$25mm of cash overseas that is trapped (cannot be repatriated).
- **Lower 2013 CAPEX Guidance**: Guidance lowered to $90mm from $100mm. Has spent ~$56mm YTD. Reiterated maintenance CAPEX of ~$50-55mm. Most of the growth CAPEX is focused on Silicones segment.
- **Net Working Capital**: Increased by $63mm to meet customer demand and to mitigate work stoppage at a major US plant. There will be an inflow from working capital in 4Q13, but 4Q13 volumes will be higher than 4Q12 so the benefit may not be as significant. Expect to continue working off inventory in 4Q13. Also noted they plan to work off excess inventory built up ahead of labor negotiations which could benefit cash flow but be a drag on EBITDA.
- **Additional Availability to Issue Debt**: MOMENT believes they can issue an additional $100mm of 1st lien debt based on their interpretation of the covenants in the bonds.
- **2014 Cash Flow Items to be Similar to 2013.**

Figure 5. MOMENT 3Q13 Results

	Actual 3Q13	Citi HY		2Q13	SEQ % Chg	3Q12PF	YoY % Chg
Revenue	$604	$605.0	(0%)	$610	(1%)	$571	6%
Adj EBITDA	55	59.0	(7%)	63	(13%)	51	8%
Adj EBITDA (%)	9.1%	9.8%	-65bp	10.3%	-122bp	8.9%	17bp
Total B/S Debt	$3,207			$3,146	2%	$3,013	6%
LTM Adj EBITDA	**$236**			**$232**		**$199**	
Net 1st Lien Debt/Adj EBITDA	4.8x			4.7x	0.1x	5.3x	-0.4x
Net 1.5 Lien Debt/Adj EBITDA	6.3x			6.3x	0.0x	7.0x	-0.7x
Net Secured Debt/Adj EBITDA	11.6x			11.5x	0.0x	13.2x	-1.6x
Net Senior Unsecured Debt/Adj EBITDA	11.6x			11.5x	0.0x	13.2x	-1.6x
Net Opco Debt/Adj EBITDA	13.2x			13.2x	0.0x	15.1x	-1.9x
Net Opco + Holdco Debt/Adj EBITDA	16.7x			16.7x	0.0x	18.9x	-2.2x
LTM Adj EBITDA/Interest	0.8x			0.8x	0.0x	0.8x	0.0x
Cash	$92			$118	(22%)	$104	(12%)
Availability on RCFs	153			206	(26%)	253	(40%)
Total Liquidity	**245**			**324**	**(24%)**	**357**	**(31%)**

SEGMENT DATA

SALES	**3Q13**	**Citi HY**	**Diff**	**2Q13**	**SEQ Chg**	**3Q12PF**	**YoY Chg**
Silicone	549	550	(0%)	559	(2%)	512	7%
Quartz	55	55	0%	51	8%	59	(7%)
	-			-		-	
Total	**$604**	**$605**	**(0%)**	**$610**	**(1%)**	**$571**	**6%**

EBITDA	**3Q13**	**Citi HY**		**2Q13**	**SEQ Chg**	**3Q12PF**	**YoY Chg**
Silicone	55	55	0%	63	(13%)	44	25%
Quartz	11	12	(8%)	11	0%	16	(31%)
Adj	(11)	(8)		(11)		(9)	
Total	**55**	**59**	**(7%)**	**63**	**(13%)**	**51**	**8%**

EBITDA Margin	**3Q13**	**Citi HY**		**2Q13**	**SEQ Chg**	**3Q12PF**	**YoY Chg**
Silicone	10.0%	10.0%	2bp	11.3%	-125bp	8.6%	142bp
Quartz	20.0%	21.8%	-182bp	21.6%	-157bp	27.1%	-712bp
Total	**9.1%**	**9.8%**	**-65bp**	**10.3%**	**-122bp**	**8.9%**	**17bp**

Source: Citi Research and Company Filings.

Summary of Recommendations

Figure 6. Summary Bond Recommendations

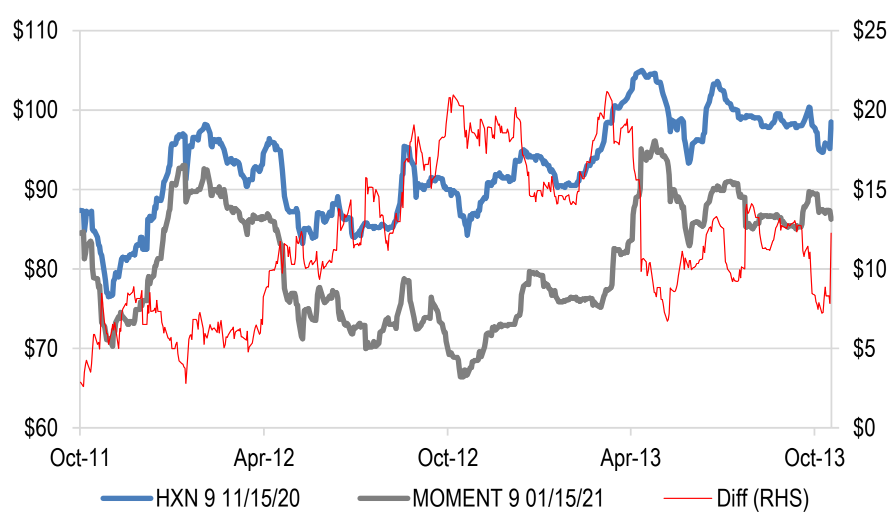
MOMENTIVE PERFORMANCE (MOMENT)				Marketweight				
Coupon	Type	Rating	Maturity	Ratings	Outstanding	Bid Price	Bid Yield	Net Leverage
8.875%	1st Lien Nts	*Buy (1)*	10/15/2020	B1(N)/CCC+(N)	$1,100	$104.0	7.87%	4.8x
10.000%	1.5 Lien Nts	*Buy (1)*	10/15/2020	B2(N)/CC(N)	$250	$104.0	8.97%	5.9x
9.500%	2nd Lien Nts		1/15/2021	Caa1(N)/CC(N)	€ 132.8			11.6x
9.000%	2nd Lien Nts	*Buy (1)*	1/15/2021	Caa1(N)/CC(N)	$1,161	$86.25	11.90%	11.6x
11.500%	Sr Sub Nts	*Neutral (2)*	12/1/2016	Caa3(N)/CC(N)	$382	$70.5	26.16%	13.2x

MOMENTIVE SPECIALTY CHEM (HXN)				Underweight				
Coupon	Type	Rating	Maturity	Ratings	Outstanding	Bid Price	Bid Yield	Net Leverage
6.625%	1st Lien Nts	*Buy (1)*	4/15/2020	Ba3(S)/B-(S)	$1,550	$101.5	6.23%	2.9x
8.875%	1.5 Lien Nts	*Neutral (2)*	2/1/2018	(S)/CCC+(S)	$1,200	$103.75	7.53%	5.8x
9.000%	2nd Lien Nts	*Sell (3)*	11/15/2020	Caa1(S)/CCC+(S)	$574	$98.5	9.30%	7.0x
9.200%	Sr Nts		3/15/2021	Caa2(S)/CCC+(S)	$74			7.9x
7.875%	Sr Nts		2/15/2023	Caa2(S)/CCC+(S)	$188			7.9x
8.375%	Sr Nts		4/15/2016	Caa2(S)/CCC+(S)	$59			7.9x

Source: Citi Research and Company Reports

We reiterate trade idea of buying MOMENT 2nd Lien Bonds vs. Selling HXN 2nd Liens. We believe that over the next several years the leverage differential on the 2 bonds will close as MOMENT EBITDA rebounds while HXN EBITDA growth is held back by base epoxy resins.

Figure 7. HXN 2nd Lien vs. MOMENT 2nd Lien (Price)



Source: Citi Research and Citi Velocity.

Related Research

- **Momentive Specialty Chemicals (HXN)**

  – Results: HXN: First Look at 3Q13 Results - Sales & EBITDA Ahead of Estimates;

  – Polyurethane (PU) Conference Call Recap - PU Passes the Smell Test

  – Downgrade HXN 2nd Lien to Sell from Neutral - Poor Epoxy Outlook Confirmed by Peers

  – Dow Chemical Read-Throughs for HY - DOW Reports Challenged Epoxy Outlook and Positive Signs from Dow Corning JV

  – Huntsman (HUN) 3Q13 Post Call Recap - Solid Quarter Despite Weak Liquid Epoxy Resin Market

  – Epoxy Resin Call Recap: Downgrade HXN 2nd Lien to Neutral

  – Momentive Specialty Chemicals (HXN) - Un-Foxy Epoxy Outweighs Tailwind from Housing

  – Momentive Specialty Chemicals Inc. (HXN) Initiating Coverage - Results Resin-ate with Investors

- **Momentive Performance Materials (MOMENT)**

  – Results: MOMENT: First Look at 3Q13 - Inline Quarter, Liquidity Down

  – Silicone Industry Update - Waiting on a Friend; Operating Leverage Yet to Kick In

  – Momentive Performance Chemicals (MOMENT) 2Q13 Post Call Recap - Running to Stand Still

  – Momentive Performance Materials Inc. (MOMENT) Initiating Coverage - Emerging From a Silicone Valley

- **Industry**

  – High Yield Chemicals 3Q13 Earnings Preview

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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	Rating		
Data current as of 30 Sep 2013	**Buy**	**Hold**	**Sell**
Citi Research US High Yield Issuer Coverage	30%	56%	13%
% of companies in each rating category that are investment banking clients	70%	64%	63%
Citi Research US High Yield Issue Coverage	27%	53%	20%
% of companies in each rating category that are investment banking clients	83%	77%	75%

Momentive Performance Materials Inc. (MOMENT) — Issuer Portfolio Weighting and Issue Rating History
High Yield Credit Research
Analyst: James P Finnerty

Issuer		Issue				
Weighting	**Date**	**Coupon**	**Description**	**Maturity**	**Rating**	**Date**
MW	11-Jul-13	11.500%	Sr Sub Nts	01-Dec-16	Neutral (2)	11-Jul-13
		8.875%	1st Lien Nts	15-Oct-20	Buy (1)	11-Jul-13
		9.000%	2nd Lien Nts	15-Jan-21	Buy (1)	11-Jul-13
		10.000%	1.5 Lien Nts	15-Oct-20	Buy (1)	11-Jul-13

Momentive Specialty Chemicals Inc. (HXN) — Issuer Portfolio Weighting and Issue Rating History
High Yield Credit Research
Analyst: James P Finnerty

Issuer		Issue				
Weighting	**Date**	**Coupon**	**Description**	**Maturity**	**Rating**	**Date**
MW	11-Jul-13	6.625%	1st Lien Nts	15-Apr-20	Buy (1)	11-Jul-13
UW	18-Oct-13	8.875%	1.5 Lien Nts	01-Feb-18	Neutral (2)	11-Jul-13
		9.000%	2nd Lien Nts	15-Nov-20	Buy (1)	11-Jul-13
					Neutral (2)	09-Oct-13
					Sell (3)	31-Oct-13

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Neutral (2): The analyst expects the six-month total return of the rated debt security or instrument to be in line with the market value weighted average total return for the analyst's sector or comparable sub-index of the Citi High Yield Market Index
Sell (3): The analyst expects the six-month total return of the rated debt security or instrument to be below the market value weighted average total return for the analyst's sector or comparable sub-index of the Citi High Yield Market Index
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Marketweight (MW): Over the next six months, the recommended sector or issuer is expected to perform in line with the returns on the relevant index or benchmark based on valuation and methodology provided below;
Underweight (UW): Over the next six months, the recommended sector or issuer is expected to underperform the returns on the relevant index or benchmark based on valuation and methodology provided below;
Under Review: Citi Research has suspended the investment rating for this issuer because there is not a sufficient fundamental basis for determining an investment rating. The previous investment rating is no longer in effect for this issuer and should not be relied upon. To satisfy regulatory requirements, we correspond ‘under review' to Hold in our ratings distribution table. However, we reiterate that we do not consider ‘under review' to be a recommendation.
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