

Orion Engineered Carbons: Idea Summary as of 8/30/2019

Porter Street Research

By Alex Jones alex.jones@porterstreetresearch.com

Orion Engineered Carbons (Ticker: OEC) Idea Summary

- Orion Engineered Carbons “OEC” is a specialty chemical company that manufactures Carbon Black (CB). CB is an elemental carbon in the form of particles that appears like a fine powder. It is made by decomposing, heating, treating and transforming other, mostly heavy, hydrocarbons. The business is broken into two divisions:

Specialty Products: # 1 market share globally. Top 3 industry producers globally > 70% market share. Accounts for 25% of volumes, 35% of revenue, 50-60% of EBITDA. Low volume, high value, sticky contracts, spec'd in to customers work flow, with high degree of pricing power. Often sole source and regional with less than 40% of contracts as pass through.

Rubber Black: 75% of volume, 65% of revenue, 40-50% of EBITDA. #4 player globally. 75% of demand is for tires, driven by replacement tire demand. Commodity product, but regional and dependent on feedstock availability and contract structure; mostly pass through. US market is very tight, with high utilization and limited capacity additions. Demand in 2019 and 2020 for replacement tires is outrunning RB capacity leading to price increases and near record profitability.

- CEO Corning Painter joined in 2018 from Air Products, where he thrived under a famously difficult CEO Selfi Chashemi. Since becoming CEO, Painter has bought \$3mn worth of shares on at least three occasions in the open market. We find these buys to be significant in absolute terms and relative to what we can assess is Painter's net worth relative to prior compensation that was disclosed while at APD.
- The specialty business within OEC is a world class asset. While operating in a commodity industry, the overall business has high barriers to entry, long term and sticky customer relationships. The pass through nature of some contracts helps protect margins in certain environments and OEC's margins in both segments could benefit structurally from the increased discounts in heavy crudes following the implementation of IMO 2020.

Key Stats, What is Priced in?

- Shares trade at 5.0X EBITDA, less than a 7.0X PE and a 6% dividend yield. Shares appear to imply a significant forthcoming negative revision in earnings. OEC's lack of free cash flow generation *after* a 6% dividend payment in 2019/2020 as a result of mandated EPA cap-ex is hurting sentiment. Investor had hoped for additional capital allocation moves including an elevated buyback
- Debt is manageable at 2.5X gross debt/EBITDA with interest covered >15x.

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Ticker	OEC
Price	\$ 13.7
Shares	60
Market Cap	\$ 824
Debt	\$ 699
Cash	\$ 53
Enterprise Value	\$ 1,469

Key Stats

52 Week High	\$ 36.5
52 Week Low	\$ 12.6
Debt/EBITDA	2.5
EBITDA/Interest	15.3

Cap- IQ Consensus		2018	2019	2020	2021
Revenue	\$	1,562	\$ 1,579	\$ 1,660	\$ 1,718
EBITDA	\$	296	\$ 275	\$ 295	\$ 314
EBIT	\$	202	\$ 174	\$ 195	\$ 213
NI	\$	121	\$ 109	\$ 122	\$ 133
EPS+	\$	1.99	\$ 1.83	\$ 2.07	\$ 2.25
DPS			\$ 0.81	\$ 0.84	\$ 0.91
Dividend			\$ 49	\$ 51	\$ 55
FCF Ex EPA Cap-Ex			\$ 80	\$ 90	\$ 102
Growth		2018	2019	2020	2021
Revenue			1%	5%	3%
EBITDA			-7%	7%	6%
EPS				13%	9%
Margin		2018	2019	2020	2021
EBITDA		19.0%	17.4%	17.8%	18.3%
Valuation		2018	2019	2020	2021
EV/EBITDA		5.0	5.3	5.0	4.7
EV/Sales		0.9	0.9	0.9	0.9
P/E			7.5	6.6	6.1
Div Yield			5.9%	6.1%	6.7%
Debt/EBITDA		2.4	2.5	2.4	2.2
FCF Yield			10%	11%	12%

Note: Data as of 8/30/2019

Source: CapitalIQ

What is Creating an Opportunity

Orion Engineered Carbons Share Price 2014- 2019



Source: Yahoo Finance

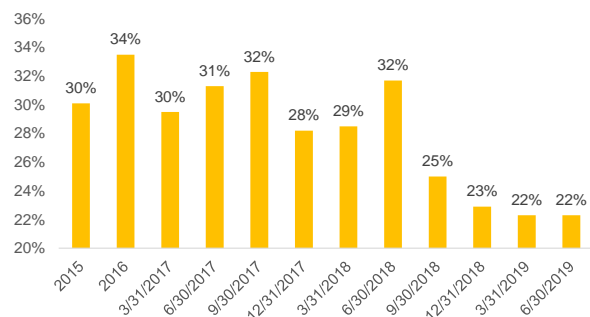
- Shares are down over 60% since mid-2018 on the back of a high starting valuation, weakness in specialty division profitability and concerns about OEC's exposure to Europe, China and automotive industry

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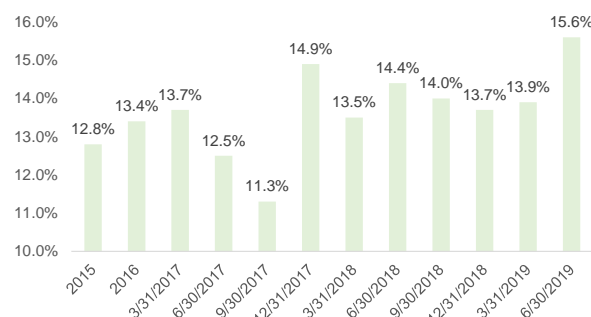
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Specialty EBITDA Margin



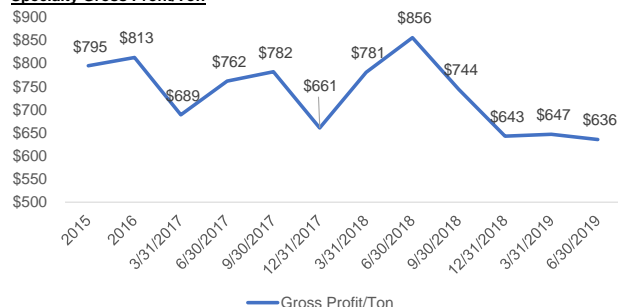
Rubber Black EBITDA Margin



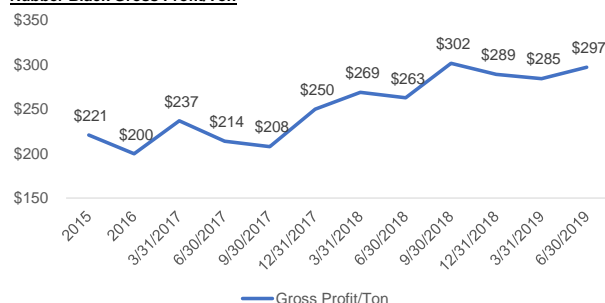
Source: OEC

- Specialty margins are approaching all-time lows as Gross Profit/Ton is near its lowest levels since pre 2014 (based on available data). Mix issues as a result of low volume, high margin products as well as regional feedstock costs and FX have hurt specialty EBITDA. Volumes have increased sequentially and the initial read through is that the mix issue, while a drag in short term, highlights how profitable certain low volume products are
- Rubber black is performing at near record profitability as conditions in the industry remain extremely tight, particularly in North America. Tire producers continue to add capacity without a corresponding increase in RB capacity. Between the cost of new build capacity, environmental regulations and current utilization, pricing looks set to remain favorable for years to come. According to management, OEC's US RB division is operating below its cost of capital. OEC is in the process of re-negotiating guaranteed baseload, take or pay contracts that could alter the segments profitability in a positive way in years ahead

Specialty Gross Profit/Ton



Rubber Black Gross Profit/Ton



Source: OEC

The Following Are Creating an Opportunity For Additional Due Diligence

1. Underfollowed and Under-owned

- OEC is a complex business to understand, model and assess earnings power
- Until July 2019, OEC was not a member of any index. Estimated that 30% of peer's shares are owned by index funds. In today's passive dominated market, these anecdotes can be relevant.

2. Weakness in Specialty Division as Commodity Business Performs Near Record

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- Specialty contributes greater % of gross profits but smaller revenue and volume. Even small declines in volume and mix can have disproportionate effect on profits
- Europe and Korea are > 65% of revenue. Weak euro is hurting reported financials. Greatest regional exposure is to Germany, which is nearing technical recession.
- Underlying exposure to the automotive sector, primarily through polymers and coatings is weighing on reported numbers and sentiment
- China exposure, as highlighted by CEO Painter on his first conference call as a CEO, is 6% of direct revenue but > 20% by volumes via exports and larger than most investors realized

3. New Management: New CEO in 2018 and CFO Retired in 2019

- Shuffling decks creates uncertainty in near term

4. EPA Liability Related Cap-ex and Evonik Overhang

- OEC must spend \$190mn total to comply with the EPA. \$20mn spent, \$170mn remain to be spent over next 3 years
- Normalized cap-ex is \$70-\$90mn of which about \$30mn is maintenance
- Indemnification with Evonik (former owner) means OEC will get between \$110-\$140 at some point in next 2-3 years or there could be a settlement. OEC eats any amount above \$140mn

5. Lack of Free Cash Generation in 2019/2020

- EPA cap-ex + dividend and small working capital use limit reported free cash flow in 2019. Ex EPA cap-ex, FCF in 2019 is close to \$80mn. Market appears to ignore the dividend of 6%, which itself is a 6% FCF yield. Excluding the EPA cap-ex and before the dividend OEC has a 14.5% FCF yield

Near/Long Term Positives That Are Creating Opportunity

1. New CEO: Focus on Reducing Business Cyclicity, Adding Growth and Improving Corporate Returns

- Corning Painter comes from APD where he thrived under a very difficult CEO
- Painter has been a significant buyer of shares in the open market making buys on three separate occasions. Painter made around \$24mn total comp (not all cash) in last five years at APD. The dollar value of these insider buys appears significant as a percentage of his net worth
- OEC is introducing APD's incentive compensation metrics to include TSR and ROCE
- Management is also pushing down incentives within business to factory level vs. total firm in attempt to change how employees are compensated
- Painter would like the business to become more focused on ROCE. OEC is already a high ROE/ROCE business and the challenge is limited growth and re-investment options. If he solves the re-investment question capex is the highest and best use of capital. His current focus is on getting the US rubber black business to operate at or above its cost of capital. Any progress on the division earning its cost of capital over time could increase estimates of mid-cycle EBITDA and EPS well above prior cycles

2. Conversion of Factories from Rubber to Specialty

- OEC's RB facilities are small relative to larger industry competitors. The size disadvantage and lack of scale leads to lower margins. However, it also creates flexibility as OEC has the potential to invest capital to convert the plants from RB to Specialty. This shift can allow for a meaningful

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upgrade in the overall margin profile and profitability. Larger RB facilities that rely on running near full utilization to spread fixed costs can't do this

- OEC is the only competitor globally to use lamp black and other highly complex techniques to produce specialty CB. Competitors are not using these technologies and aren't able to which leads to high margin, custom formulations for OEC and a sustainable competitive advantage

3. Contract Re-Negotiations

- Painter is working with clients to change the current passthrough formulas to allow for more predictability in volumes. Doing so can allow OEC to plan its business better and add flexibility into production schedules while also cutting overhead. Painter would like to get 6-10 year contracts.
- Early stages in negotiations but longer term this can help reduce cyclicity of the business

4. Improved Working Capital/Cash Flow Management

- Recent investor decks and transcripts have highlighted initiatives to reduce working capital
- OEC will always have fluctuations in working capital values as a commodity producer. Still, there are ways to manage this using Lean techniques we suspect Painter is familiar with implementing. The move to levelize production volumes, get longer term contracts and plan production runs can help here. Less cash tied up in inventory = more for investors

5. Underappreciated Sources of Growth in Auto

- OEC bought SN2A in 2018, for \$30m. SN2A has acetylene black production assets which gives OEC another entry point into the lithium ion battery market. While small today with revenue of just \$10mn in 2018 the business does create the potential for a very high margin platform to build
- The shift to electric and hybrid vehicles, which are heavier, implies greater wear and tear on tires. Replacement tires drive 75% of tire demand, which is regional. Also benefit from additional coating formulas.

6. Capital Cycle Opportunity: Limited Capacity for New Carbon Black Supportive of RB Pricing

- Tire capacity in US/North America expected to continue to increase through 2020
- There has not been same level of RB capacity added and pricing is favoring CB producers
- Capital cycle: Given the costs to comply with EPA + cost of greenfield development, particularly in US where it is almost impossible to build new CB facility, there is little ability and or risk of meaningful capacity coming on-line in the US
- Globally, China is reducing capacity/focusing on environmental concerns and other larger players in RB in Russia and India are mostly to feed internal demand

Risks

- Return on time. OEC is a difficult business to understand. There are well paid industry consultants that some investors are paying for the key industry data, capacity forecasts and pricing information. The myriad of spreads, input costs and regional feedstock formulas make it difficult to assess the impact on OEC's earnings. However, given where we are currently, understanding what the bias and logic is over a reasonable time frame for a recovery in the Specialty division's profitability makes taking a 3-5 year view a worthwhile risk. Particularly when compared to what is priced in today, the return on time appears adequate despite a possible information disadvantage.

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- OEC may not be able to re-capture or recover any of the liability/indemnification payment from Evonik and have to eat the entire cost of new EPA related cap-ex. Low probability but could happen. Further, the business could be subject to additional regulations and required spending which would hurt cash flow
- Impact of IMO 2020 on high/low sulfur feedstocks. Feedstock availability could make the cost structure, despite being regional in nature worse than in the past. This is most relevant in the case of an increase in the price of low sulfur feedstocks which will hurt specialty margins. Efforts to secure long-term supply of feedstock and structure contracts to limit fluctuation in margins could also fail. Understanding and trying to forecast the change in feedstock and the effect on margins/business is going to be difficult. Must get comfortable knowing what you don't know.

Back of Envelope Upside/Downside

Simple Orion Earnings Model				
	2019	2022 (Base)	2022 (High)	2022 (Low)
Volume				
Specialty	254	278	286	241
Rubber	803	852	877	763
<i>Growth</i>		3.0%	4.0%	-5.0%
<i>Growth</i>		2.0%	3.0%	-5.0%
Total Volume	1057	1130	1163	1004
Total Growth	0.0%	6.9%	10.0%	-11.1%
Gross Profit/Ton	2019	2022 (Base)	2022 (High)	2022 (Low)
Specialty	\$ 636	\$ 716	\$ 800	\$ 700
% Change from 2019		13%	26%	10%
Rubber	\$ 297	\$ 265	\$ 300	\$ 250
% Change from 2019		-11%	1%	-16%
Total Gross Profit	\$ 400	\$ 425	\$ 492	\$ 360
SG&A	\$ 226	\$ 234	\$ 234	\$ 234
R&D	\$ 20	\$ 20	\$ 20	\$ 20
EBIT	\$ 154	\$ 171	\$ 238	\$ 106
Interest	\$ 20	\$ 20	\$ 20	\$ 20
Tax	\$ 40	\$ 45	\$ 65	\$ 26
Net Income	\$ 94	\$ 105	\$ 152	\$ 60
Fully Dilluted Shares	61.1	61.1	61.1	61.1
EPS	\$ 1.79	\$ 1.72	\$ 2.50	\$ 0.98
PE	10.3	10.7	7.4	18.9
Implied EPS Cut from 2019		-6%	36%	-46%
LT Fair Value Multiples				
PE	2019	2022 (Base)	2022 (High)	2022 (Low)
12.5	\$ 22.3	\$ 21.6	\$ 31.2	\$ 12.3
Upside/Downside	21%	17%	69%	-34%
Total Return w/ Dividends	23%	30%	82%	-20%
IRR	23%	9%	22%	-7%
EV/EBITDA	2019	2022 (Base)	2022 (High)	2022 (Low)
7	\$ 18.9	\$ 24.4	\$ 32.1	\$ 16.9
Total Return w/ Dividends	4%	46%	87%	5%
IRR	4%	13%	23%	2%
EBITDA	\$ 254	\$ 271	\$ 338	\$ 206
<i>Decline in EBITDA from 2018</i>	<i>-14%</i>	<i>-9%</i>	<i>14%</i>	<i>-31%</i>

- Above is a simple earnings model to see what the market could be pricing in over next few years as well as assess what we think Orion's mid-cycle earnings power is

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- Within the “low” scenario we are trying to see a few years out how bad things can be and how that compares to today. Volumes declined 14% in 2008-2009 for reference. Our key takeaway is shares aren’t too far from the our “low” price target implying there is significant bad news priced into OEC shares today
- The key assumptions are volumes + price. Our general view is that pricing in specialty can/will be higher in 3-5 years but I can see a scenario where rubber is lower/normalizes. We give little credit to volume growth in all scenarios
- 12X PE and 7 EV/EBITDA are consistent with long term average multiples
- The bottom line is a lot of bad news appears priced in and over a reasonable time frame OEC is very cheap. Over the next cycle, with the addition of some real growth, contract re-negotiations and pricing improvements, OEC could be a \$40 stock compared to around \$14/share today

Free Cash Flow Potential

Free Cash Flow Reconciliation + Forecasts				
	2019	2020	2021	2022
EBITDA	\$ 275	\$ 276	\$ 290	\$ 335
Growth Cap-Ex	\$ 40	\$ 40	\$ 40	\$ 40
Maintenance	\$ 35	\$ 30	\$ 30	\$ 30
OEC Biz. Cap-Ex	\$ 75	\$ 70	\$ 70	\$ 70
EPA Related	\$ 60	\$ 37	\$ 37	\$ 37
Total Cap-Ex Spend	\$ 135	\$ 107	\$ 107	\$ 107
EBITDA-Cap-ex Core	\$ 200	\$ 206	\$ 220	\$ 265
EBITDA- Cap-ex w/EPA	\$ 140	\$ 169	\$ 183	\$ 228
Depreciation	\$ 78	\$ 80	\$ 80	\$ 80
Amortization	\$ 18	\$ 16	\$ 14	\$ 12
Total D&A	\$ 96	\$ 96	\$ 94	\$ 92
R&D	\$ 20	\$ 20	\$ 20	\$ 20
EBIT	\$ 159	\$ 160	\$ 176	\$ 223
Interest	\$ 18	\$ 18	\$ 18	\$ 18
Tax Rate	30%	30%	30%	30%
Cash Tax	\$ 33	\$ 43	\$ 47	\$ 62
Net Income	\$ 109	\$ 99	\$ 111	\$ 144
FCF Pre-Cap-Ex/WC/Div	\$ 205	\$ 195	\$ 205	\$ 236
Total Cap-Ex	\$ 135	\$ 107	\$ 107	\$ 107
Dividend	\$ 48	\$ 50	\$ 53	\$ 56
Debt Service	\$ 8.0	\$ 8.0	\$ 8.0	\$ 8.0
Change in WC	\$ -	\$ -	\$ -	\$ -
FCF Pre Dividend	\$ 14	\$ 30	\$ 37	\$ 65
FCF ex EPA	\$ 74	\$ 67	\$ 74	\$ 102
FCF ex EPA pre Div	\$ 122	\$ 117	\$ 127	\$ 158
Equity Yield	2019	2020	2021	2022
FCF pre Dividend	1.2%	2.7%	3.3%	5.8%
FCF ex EPA	6.5%	5.9%	6.5%	9.0%
FCF ex EPA pre Div	10.7%	10.4%	11.2%	13.9%
Est. EPA Re-Imbursement	\$120			
% of current market cap	10.6%			