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TimkenSteel Corporation

Third Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tina Beskid, *Vice President, Corporate Controller and Investor Relations*

Ward J. "Tim" Timken, Jr., *Chairman, Chief Executive Officer and President*

Chris Holding, *Executive Vice President and Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Novid Rassouli, *Cowen & Company*

Seth Rosenfeld, *Jefferies & Company*

Justin Bergner, *Gabelli & Company*

Phil Gibbs, *KeyBanc Capital Markets*

PRESENTATION

Operator:

Good morning, my name is Denise and I'll be your conference operator today. At this time, I would like to welcome everyone to the TimkenSteel Third Quarter 2017 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. If you would like to ask a question during this time, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Tina Beskid, you may begin your conference.

Tina Beskid:

Good morning, and thank you for joining TimkenSteel's Third Quarter 2017 Earnings Call to discuss our financial results. I am joined here today by Tim Timken, our Chairman, CEO and President, as well as Chris Holding, Executive Vice President and Chief Financial Officer.

During today's conference call, we may make forward-looking statements as defined by the SEC. These statements relate to our expectations regarding future financial results, plans and business operations, among other matters. Our actual results may differ materially from those projected or implied due to a variety of factors, which we describe in greater detail in today's press release, supporting information provided in connection with today's call, and in our reports filed with the SEC, all of which are available at www.timkensteel.com.

Where non-GAAP financial information is referenced, we have included reconciliations between such non-GAAP financial information and its GAAP equivalent in the press release and/or supporting information, as appropriate.

With that, I'd like to now turn the call over to Tim.

Ward J. "Tim" Timken, Jr.:

Good morning, and thank you for joining us today. I'd like to start today's call with some comments about our team in Houston. The recent hurricane impacted employees at our facilities there, some in a pretty significant way. At this stage, I'm happy to tell you all that they are doing well and beginning to get back on their feet. Our team there also worked very hard to quickly get our facility back in full operation. I want to wish our employees and their families well and thank them, and all of our employees, for rallying together at such a tough time.

The hurricanes also affected customers in the area and we saw some delay in their ability to receive product, which had a modest impact on shipments in the quarter. We're still feeling the effect of the hurricanes on transportation, with some limited availability of trucking services. Given the magnitude of the situation in Houston, and elsewhere, we are fortunate and thankful that these weather events only had a minor impact on our business.

So, that brings us to our earnings performance. To put it simply, what a difference a year makes. Sales and shipments are up over 60% for the third quarter, over the third quarter of 2016. The magnitude of the year-over-year change has brought challenges, but even more opportunities. Our Sales Team not only has captured business from improving industrial and energy end markets, but they've also won new business and increased penetration across all of our market segments. Two quick examples.

You might remember last year that we developed an advanced manufacturing process for high-pressure tubing used in the production of low-density polyethylene. The process improvements not only paved the way for our high-performance deals to re-enter the polyethylene market, but it also enabled us to explore additional markets for pressure tubing. We can now produce more standard types of high-pressure tubing with equal efficiencies and short lead times. As a result, we recently won new business from an energy distributor who had previously bought imported tubing. It's a great example of how our competitive advantage and process technology, supply chain and services are winning new business.

Another example is oil country tubular goods. After we entered the OCTG market with billet sales, we found additional applications where we can deliver value. We're now selling quench-and-temper thick-wall tubing for coupling stock found in drill strengths. We see this as a great opportunity to expand our presence in the oil patch.

Constant innovation in our product, process and commercial strategies is opening up many new prospects for us, which, collectively, will contribute to growth over time.

A related focus is on our product mix, which will evolve over the course of the next year. This includes our high-performance SBQ products, which lead the market, as well as a broader base of business that our new assets produce with greater efficiencies. Our Sales Team is pursuing and interesting paths to business and we expect to see our mix begin to improve in the coming year.

When it comes to pricing, you saw we put in place another increase on spot business this quarter, which was the third increase this year. The announcement covered SBQ and seamless mechanical tubing, with a $40 per ton increase effective in October and January, respectively. We started the year with an increase that went into effect in April and covered both SBQ and tubing. We followed that with an SBQ increase that went into effect in June. We're making positive improvements on spot market pricing. We're also doing well in our talks with customers about contract pricing for 2018.

To support all of these sales efforts, we met demand with one of the fastest ramps in our history. Increasing production that quickly is never easy, but it has gone well. Our Sales Team has done a great job in both safety and productivity, especially given the many new employees we have, the number of experienced employees in new positions, and our new asset, with most plants running around the clock.

During the quarter, we also began hot commissioning our new advanced quench-and-temper facility, which will produce some of the most sophisticated product lines in our mix and provide additional capacity to better serve demanding application. Commissioning is going smoothly and we expect to begin shipping to customers in November.

Looking ahead, we continue to see positive signs in many of our markets. The auto markets remain healthy. We anticipate that even with some cooling, the SAAR rate will remain at high levels relative to historical standard. The trends in oil and gas markets are positive, with the price of oil increasing, rig count up year-over-year, and inventory levels coming down, and we continue to see bright spots in industrial markets. Mining is strong, with both increasing production of earth-moving equipment and the replacement of components in existing vehicles. We're also seeing some maintenance and component replacement creating demand in general machinery. In rail, there's been an uptick due to bearing replacement and other refurbishment.

Before I wrap up, I want to touch on our labor agreement with United Steel Workers. Company and union representatives negotiated what we both thought was a fair agreement, but, unfortunately, the membership failed to ratify the contract in last week's vote. We continue to operate uninterrupted, under the terms of the 2012 labor agreement, and are already back in discussions with the USW to work towards a new tentative agreement.

At this point, I'll turn it over to Chris to talk through the quarter in more depth.

Chris Holding:

Thank you, Tim. Good morning. Our third quarter results were in line with our expectations and structurally similar to the second quarter. Total shipments of 290,000 tons in the quarter were 63% higher than last year and slightly lower than the second quarter. The year-over-year improvement was the result of strengthened end market demand and increased market penetration.

Mobile shipments were down about 7% from the second quarter 2017. We had anticipated the sales decrease due to the decline in the North American light vehicle production rate, as the OEMs began to rebalance inventory levels. Despite the lower production forecast, build rates remain at historically high levels. The projected SAAR of 17.3 million units for the year represents the third highest rate in over a decade. We continue to increase our participation on new programs, which helps to offset lower vehicle production rates. For the quarter, we expect mobile shipments to be similar to the third quarter.

Industrial shipments increased about 3% from the second quarter 2017, primarily due to market share gains and fundamental end market demand. Global commodity markets stabilized in the first half of the year, which positively impacted our industrial end markets. Moving into the fourth quarter, we expect

industrial shipments to be about 5% higher than the third quarter, as the general economic sentiment remains positive in most of the industrial sectors.

Third quarter shipments to the energy end market increased about 4% sequentially, as customer inventory positions became more balanced with demand. We remain encouraged by the steady improvements in market supply and demand dynamics in the energy sector, and expect fourth quarter energy shipments to be similar to the third quarter.

Net sales for the quarter were $339 million, with base sales of $261 million and surcharges of $78 million. Base sales per ton were $13 per ton higher than the second quarter 2017, primarily due to increased pricing in the spot market.

Gross profit for the quarter was $19 million and about flat sequentially, excluding a $5 million one-time supplier refund received in the second quarter. Melt utilization was 74%, which was slightly down from the second quarter.

SG&A for the quarter was about $22 million, which was similar to the second quarter 2017. While our base sales increased by almost 40% over 2016, our SG&A was only 3% higher, which is testament to the hard work of our employees and our focus on cost control.

In the third quarter, we reported a net loss of $6 million, or a loss of $0.13 per share, including approximately $2 million for a non-cash pension remeasurement expense. The expense was related to lump sum pension payments made from our salary defined benefit plan.

Adjusted EBITDA for the third quarter was about $19 million, compared to EBITDA of $20 million in the second quarter, excluding the supplier refund.

Free cash flow for the quarter was a $5 million use of cash, which included a $19 million build in net working capital to support growing demand. Additionally, we spent $5 million on cap ex in the quarter and expect the majority of our capital spending will take place in the fourth quarter. We maintain our full year capital spending guidance at about $40 million.

The balance sheet remains in good shape, as we entered the quarter with $190 million of liquidity and a net debt to capital ratio of 18.3%.

Turning to the outlook for the fourth quarter, shipments are expected to be approximately 3% to 5% higher than the third quarter, based upon positive sentiment across most of our markets. Our outages for plant maintenance are all scheduled in the fourth quarter this year, unlike prior years, and we expect to incur between $8 million and $12 million of maintenance expenses. As a result, we expect the EBITDA range to be between breakeven and $10 million, excluding any remeasurement impact from pension and other post-employment benefits.

In conclusion, the fourth quarter should be structurally similar to the third quarter, Adjusted EBITDA of $19 million, adjusting for material spread headwinds and cost related to scheduled outages. As we wrap up 2017, and look forward, we are excited about our improving prospects from more positive markets and the actions we have taken to position the business.

This ends our prepared statements. We'll now take your questions.

Operator:

At this time, I would like to remind everyone, in order to ask a question, press star, then the number one on your telephone keypad. We'll pause for a moment as the questions compile.

Your first question comes from Novid Rassouli with Cowen & Company. Your line is now open.

Novid Rassouli:

Good morning, Tim, Chris and Tina.

Ward J. "Tim" Timken, Jr.:

Good morning, Novid.

Chris Holding:

Good morning.

Tina Beskid:

Good morning.

Novid Rassouli:

Starting with energy shipments, we were up slightly quarter-over-quarter, you know, essentially flat, and it looks like the rate of recovery of energy shipments appears to be kind of flattening relative to the past few quarters. Chris, you mentioned that energy shipments will be kind of flat sequentially in the fourth quarter. I was wondering if you guys could provide maybe some color here on what you're seeing with respect to buyer sentiment and the order book, and maybe what we would need to see in order to get shipments kind of moving closer to the level that we saw during the previous up cycle.

Ward J. "Tim" Timken, Jr.:

Yes, I think if you—this is Tim—if you start with the market dynamics, you know, rig count is up year-over-year, breakevens are down, inventory levels are down, you're hearing a lot about OPEC holding, a lot of the higher level industry dynamics seem to continue to work in our—are working in our favor. I think you're hearing from the distribution channels that the inventory balance is pretty good. If you look at what the market's saying about oil next year, they still have it trading in a band between what, $50 and $70. So, I mean, all of those are positive dynamics for us. I think there's a little bit of a breather going on, I think probably a little bit of some of the post-hurricane recovery, trying to kind of figure out what's going on from an inventory, supply chain point of view. None of that really troubles me all that much at this point. So, as I look out, I think it's still a pretty good-looking market for us. Chris, do you want to add anything?

Chris Holding:

No, other than to reiterate the supply/demand characteristics continue to improve and the inventory continues to come out of our channels. So, those are positive for us going forward into 2018.

Novid Rassouli:

Would you guys expect 2018, in total, to be higher than your current run rate, based on what you're seeing?

Chris Holding:

It's probably a little bit too early to make that call. I mean, that's going to be resolved off those supply/demand characteristics, which are seemingly improving, and those drive oil price, and, obviously, if oil price goes up, shipments will be better, too.

Novid Rassouli:

Got it, and then just one more on energy, just more nit-picky. It looks like base sales prices moved down about 5% for energy shipments. I just wanted to see if you can comment on that. I wasn't sure if it's just some more spot tonnage being sold, or any comments there?

Chris Holding:

Yes, it's a one-offer. I mean, you make a great point, Novid. If you look at sequential base sales per ton in our sectors, industrial and mobile are up, and energy was down, but that's not a trend, that's a one-offer related to some specific items that we shipped and did not ship in the quarter.

Novid Rassouli:

Perfect. Thanks for taking my questions, guys.

Ward J. "Tim" Timken, Jr.:

Thanks, Novid.

Operator:

Your next question comes from Seth Rosenfeld with Jefferies. Your line is open.

Seth Rosenfeld:

Good morning, and thanks for taking my question. I'd like to dig a little bit more into the outlook for your cost base, please. You had commented in past quarters you saw, obviously, elevated ramp-up costs during each one, as your utilization rate increased dramatically. Can you give us a better sense of how you feel about your cost base now moving forward, as utilization rates are already back to a very healthy level? Is there still more upward pressure on op ex or should we start to see better fixed cost leverage, given the continued expectation for higher shipments going into Q4, and into '18, as well? Thank you.

Chris Holding:

Yes, Seth, I'll start, and then you can remind me, because I think you had a couple of questions there. I think our cost base is in line with where we were in the second quarter, and the fourth quarter will be similar to the third. I think what we're finding is we're going to be more efficient in the fourth quarter. If you look at the tons we guide to, it'll be the highest tons for the year, by quarter, and that's with fewer ship days, and I think a lot of that is the result of, as we've gone through the change and hired 12% more employees, they're now settling into their new jobs and producing at a higher rate.

Seth Rosenfeld:

Okay, that's great, and from a headcount size, with the 12% growth that you mentioned, should we expect any incremental growth, or is that now at a steady rate going into 2018?

Chris Holding:

Yes, it's a steady state going into 2018, Seth.

Seth Rosenfeld:

Okay, great, and just one last follow-up. With the new Q&T facility, if you can give us a bit more color on the ramp-up progress, what sort of volumes we should expect, perhaps, in the next one to two quarters from that business?

Ward J. "Tim" Timken, Jr.:

Yes, as I said, Seth, in my comments, we're in the ramp process right now. We do expect to begin shipping product in November, but it's going to be a nice kind of slow steady ramp through '18.

Seth Rosenfeld:

That's great. Thank you very much.

Ward J. "Tim" Timken, Jr.:

Thanks.

Operator:

Your next question comes Justin Bergner with Gabelli & Company. Your line is open.

Justin Bergner:

Good morning, Tim. Good morning, Chris. Good morning, Tina.

Ward J. "Tim" Timken, Jr.:

Good morning.

Chris Holding:

Hi, Justin.

Tina Beskid:

Good morning.

Justin Bergner:

The first question just relates to the third quarter volume. I guess it came in a fair degree softer than what you had expected; I guess, notably, I think, on the industrial side. What was the contributing factor there and was any of that pushed out to the fourth quarter?

Chris Holding:

Yes, I'll take a shot at that, Justin. For all of our sectors, the hurricane hurt us a little bit in a couple of sectors, so that hurt our shipping, it was hard to get some trucks, and then, by and large, I think there's probably some level of efficiencies that we had anticipated that we didn't gain.

Justin Bergner:

Okay. Were those hurricane-delayed shipments, then, are those going to help the fourth quarter?

Chris Holding:

Yes, and those are built into the fourth quarter. As I mentioned to Seth, our fourth quarter shipments are pegged to be the highest of the year.

Justin Bergner:

Okay. So, I guess, would it be safe to sort of take an average of the third quarter and the fourth quarter as a run rate, as we look into 2018, then?

Chris Holding:

Well, I'd like to think fourth quarter is a better indication, because our issue hasn't been enough market, our issue has been ramping up to be able to produce the product to get it out, so I would say fourth quarter is a better look than the third.

Justin Bergner:

Okay, that's helpful. Then, secondly, the other tonnage, is that going to ramp in the fourth quarter or be relatively similar to the third quarter?

Chris Holding:

It'll be very similar.

Justin Bergner:

Okay, and are there other opportunities in that other business that are going to materialize, you know, as you look into 2018? Is that lower margin business something that you want to expand or are you at sort of the level of utilization where you're happy where it is, to the extent that opportunities are low margin in nature?

Ward J. "Tim" Timken, Jr.:

Well, with markets recovering, obviously, we're looking pretty closely at our mix as we roll this year into next year. We're right in the middle of contract period, so we're making a lot of those decisions as we

speak. With industrial markets recovering, that tends to hit us positively on the larger size of our mix. Those are all moving pieces in the puzzle that will be '18.

Justin Bergner:

Okay. On the pricing side, I guess the presentation alluded to a price increases that begin October 1, 2017, and one that should take effect January 1, 2018. How are those being received by the market? How much of your business is sort of benefiting from those price increases?

Ward J. "Tim" Timken, Jr.:

Yes, you remember about 15% of our book right now is spot, the rest is—85% is contract. So, on that 15%, you would begin to have the impact in October on bar product, and then tubing product gets the January 1 increase.

Justin Bergner:

Great. Thank you.

Ward J. "Tim" Timken, Jr.:

Great. Thanks.

Operator:

Again, to ask a question, please press star, one on your telephone keypad. Your next question comes from Phil Gibbs with KeyBanc Capital Markets. Your line is open.

Phil Gibbs:

Good morning.

Ward J. "Tim" Timken, Jr.:

Hey, Phil.

Chis Holding:

Hi, Phil.

Phil Gibbs:

I just have a question on the union negotiations and whether or not there were any specific costs we should have thought about for 3Q with those, and if there are any that we should be thinking about for the fourth quarter.

Chris Holding:

Yes, it's hard to tell, because they're still negotiating, so I think there's a possibility, but we really don't know at this stage.

Phil Gibbs:

But there wasn't anything material in the third quarter?

Chris Holding:

No.

Ward J. "Tim" Timken, Jr.:

No.

Phil Gibbs:

Okay. Then, with regard to the maintenance, it sounds like everything, from what you're saying, is extremely back-end loaded this year. Is that $10 million, call it at the midpoint of your $8 million to $12 million, a good rate to use moving forward in terms of how we should think about the annualized spend for you?

Chris Holding:

Yes, remember, this is not an annualized spend, this is just an adder. We do outages on an annual basis for our plants, and we typically do them in the third and fourth quarter, but this year, as the order book came back so strong and to meet our customer obligations, we would push all the outages back to the fourth quarter. We have maintenance costs in every quarter. That $8 million to $12 million guidance is just over and above our normal maintenance.

Phil Gibbs:

It's over and above your normal maintenance, okay.

Chris Holding:

Yes, right.

Phil Gibbs:

Got it. Then, in terms of the other piece of the volume here, which is just the billet business, which we've talked about in the past, is there a thought that that picks up a little bit into the fourth quarter, Tim, or is that going to be fairly similar to the rate that we see here today?

Ward J. "Tim" Timken, Jr.:

Yes, I'd say it's fairly flat over the third quarter.

Phil Gibbs:

Okay, and then last question for me, from more of a strategic perspective, is what opportunities do you see out there for increased penetration of SBQ products, whether it be small diameter or large diameter, in terms of what's coming up the pike for new usages. Thanks.

Ward J. "Tim" Timken, Jr.:

Yes, it's a great question, Phil. We're seeing a lot of opportunities, obviously, on the larger size of our mix right now, as industrial markets recover and oil and gas comes back, and so that's creating a lot of opportunities. I talked about coupling stock during my comments. It's a relatively new market for us and we're seeing some really good business there. You might have seen a release we put out yesterday on our new Endurance steel, which is ultra-strength, ultra-toughness material, going into the gearing applications. So, we're seeing great opportunities there, not only in automotive, but really across all of our mobile markets. Anything that turns with a gear, we see as a target opportunity. Those are the kind of places we're looking at. On the tubing side, there's pressure tubing, that I referenced earlier, I think has got a lot of opportunity. Polyethylene is a great business for us, but it's relatively small. When you start getting into some of more standard pressure tubing, you end up with a lot of opportunity there, as well. So, we're seeing a lot of places to go as markets recover and we're taking advantage of them.

Phil Gibbs:

Thank you.

Ward J. "Tim" Timken, Jr.:

Thanks, Phil.

Operator:

Your next question comes from Justin Bergner with Gabelli & Company. Your line is open.

Justin Bergner:

Hi, everyone. Thanks. One follow-up here. As I look at the sequential EBITDA trend, I guess it's indicated that it should be flat, sort of excluding the outages and excluding the raw material spread, as we look into the fourth quarter. What's holding it back from being up, given that shipped tonnage is supposed to increase 3% to 5% in the fourth quarter, on that apples-to-apples basis?

Chris Holding:

Yes, Justin, as much as anything else, right, our melt utilization will decrease in the fourth quarter. So, as much as anything else, it's fixed cost leverage on lower melt utilization in the fourth quarter.

Justin Bergner:

Okay. So, at a normal melt utilization, a normal seasonal melt utilization, we would, potentially, have higher EBITDA than what you're guiding towards for the fourth quarter?

Chris Holding:

Yes. So, if you compare it to the third quarter, we'll be down melt utilization, so that's what we would anticipate.

Justin Bergner:

Okay. Thanks for the follow-up.

Operator:

Again, to ask a question, please press star, one on your telephone keypad.

There are no further questions queued up at this time. I'd like to turn the call back over to Tim Timken, Chairman, CEO and President.

Ward J. "Tim" Timken, Jr.:

Well, thanks again for your questions today and for your interest in TimkenSteel. I'll say it again, what a difference a year makes. Looking ahead, we're encouraged by the positive market dynamics and what that will mean for our business. Thank you again to all our employees for their work in the quarter and for all that they do to make us successful, and for you for calling in today. Any questions going forward, please do not hesitate to call Tina. Thank you very much.

Operator:

This concludes today's conference call. You may now disconnect.