Univar, Inc.

First Quarter 2016 Earnings Conference Call

May 4, 2016

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Ryan Berney, *Goldman Sachs*

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PRESENTATION

Operator:

Good morning, ladies and gentlemen, and welcome to the Univar First Quarter 2016 Earnings Conference Call. My name is Dan and I will be your Host Operator on this call. At this time, all participants are in a listen-only mode. After the presentation, we will conduct a question and answer session. Instructions will be provided at that time. If at any time during the conference you need to reach an Operator, please press star, followed by zero.

I will now turn the meeting over to your host for today's call, David Lim, Vice President of Corporate Development and Investor Relations at Univar. David, please go ahead.

David Lim:

Thank you, Operator. Good morning and welcome to Univar's First Quarter 2016 Conference Call and Webcast. Yesterday afternoon we released our financial results for the quarter ended March 31, 2016, along with a supplemental slide presentation. The presentation should be viewed in conjunction with the earnings release, both of which can be found on our website under the Investor Relations section on Univar.com.

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With me today are Erik Fyrwald, President and Chief Executive Officer, and Carl Lukach, Executive Vice President and Chief Financial Officer.

As referenced on Slide 2, we may make statements about our estimates, projections or expectations for the future. All such statements are forward-looking and while they reflect our current estimates, they involve risks and uncertainties and are not guarantees of future performance.

In addition, we will also refer to certain non-GAAP financial measures, for which you can find the reconciliation to the comparable GAAP financial measures in our earnings release and the supplemental slide presentation which has been posted under the Investor Relations section at Univar.com.

With that, I will now turn the call over to Erik for his opening remarks.

Erik Fyrwald:

Thank you, David. Good morning, everyone. Before we get into our Q1 results, I'd like to take a brief moment to also acknowledge the announcement made earlier regarding my personal decision to accept the role of CEO of Syngenta and the very fortunate appointment of Steve Newlin as Univar's new CEO. I recognize you will have a number of questions around this transition, which I will cover at the end of our remarks and in the Q&A. So with that, let's move to the quarter's results.

In the first quarter, we continued to face two now familiar headwinds with the continued strength of the US dollar and tough year-over-year comparisons in the upstream oil and gas market. While Carl will get into more detail on the numbers, I wanted to touch on a few highlights for the quarter on Slide 3.

Through our focus on bringing value to our customers and suppliers, lowering our costs and driving higher margins, we had a solid quarter. Volumes were up 2% globally and up 3% in the US, excluding the impact of upstream oil and gas and our EMEA restructuring program. Our gross margins and Adjusted EBITDA margins were up nicely year-over-year in all segments, as we continued to benefit from mix improvements and the successful implementation of productivity initiatives. Outside the US, our Adjusted EBITDA grew 14% on a currency neutral basis, reflecting strong execution of our plans, and we generated strong cash flow due to our ongoing focus on managing net working capital and productivity improvements, and we continued to improve our execution through a very tough environment.

Last year's acquisitions contributed 1% to our top line and 4% to our Adjusted EBITDA in the quarter, reflecting our focus on growing our specialty chemical and value-added services platforms. We completed two new acquisitions during the quarter, Bodine Services, a US-based provider of environmental services, and Nexus Ag, a distributor of fertilizers and micronutrients to the Canadian ag market. These are terrific complements to our ChemCare waste services business and our Canadian Ag business. We have a solid pipeline of additional bolt-on opportunities and will continue to use cash flow from operations to fund them.

I will now turn the call over to our CFO Carl Lukach, who will provide more detail on our first quarter results. Carl?

Carl Lukach:

Thanks, Erik, and good morning, everyone. Please turn to Slide 4. I'll walk you through our consolidated and segment results and provide some insights for your better understanding of our performance in the quarter.

On a consolidated basis, our net sales were down 13%, but on a currency neutral basis down 10%. Of that decrease, about 5% was from lower volumes and 5% from lower average selling price. The 5%

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volume decrease was from a combination of lower demand from upstream oil and gas and our EMEA restructuring. Excluding these two factors, global volumes grew 2%. Also, our average selling prices globally were down about 5%, reflecting significant declines in certain chemicals whose price is highly correlated with oil. Likewise, our average purchase price for chemicals was also down, so we were able to mitigate almost all of the deflation impact on our gross profit.

Adjusted EBITDA declined from $145.7 million to $134.1 million, or 8%, but on a currency neutral basis down 4%, despite the difficult upstream oil and gas comparisons to last year.

The decrease in our GAAP EPS of $0.10 per share from $0.20 per share last year was largely due to the higher share count post IPO and changes in FX rates.

Now, I'd like to comment on what we're seeing in the marketplace.

First, upstream oil and gas. Demand for our products in the first quarter remained, as we expected, at the very low run rate from December last year, reflecting the 70% or more decline in rig count. We don't expect any improvement in the near term, but we also do not expect any further deterioration. Excluding upstream oil and gas, industrial demand in the first quarter was soft and bumpy and continues to be sluggish in the second quarter. January sales were flat, but February sales were down, when fears of recession were rampant. March improved a bit but still was sluggish, and April volumes were below our expectation for the normal seasonal uptick we usually see at this time of the year in industrial markets. Our sense is that chemical prices in the first quarter adjusted fully to lower priced oil. We still expect to see a seasonal uptick in the second quarter but have not seen it yet.

Turning now to Slide 5, in our USA segment Adjusted EBITDA declined 13% to $80.8 million, due to the decline in upstream oil and gas and lower selling prices. USA volumes were down 5%, but this was comprised of a 45% decline in our upstream oil and gas business and a 3% increase in the rest of our USA businesses and services. As we mentioned on our call last quarter, a year ago upstream oil and gas was contributing high teens as a percentage of our USA delivered gross profit, which we define as gross profit less delivery expense. At current run rates, it's contributing low single digits as a percentage of our USA delivered gross profit. Excluding the difficult comparisons in upstream oil and gas, our US business grew volumes 3% and delivered gross profit 2%, as we successfully offset lower selling prices with lower cost of goods sold.

Regarding our value-added services businesses—that's ChemCare, ChemPoint and Mini-Bulk—we continue to be excited about the accelerating growth and continue to invest in the future potential growth these businesses offer for us. ChemCare in the quarter benefited from the acquisitions of Weavertown and Bodine. At ChemPoint, we saw strong growth in the back half of the quarter as we gained momentum with new supplier authorizations from Afton and Bostik. In the quarter, our ChemCare, ChemPoint and Mini-Bulk services businesses, in aggregate, comprised approximately 11% of our US sales or 7% of our global sales. We will continue to look for opportunities to grow these higher margin, value-added services.

Let's move then to Canada on Slide 6. The underlying performance of our business in Canada was strong despite a weak economy, especially in Western Canada energy markets. Reported sales decreased 7% and gross profit declined 5%, largely because of a decline in the value of the Canadian dollar compared to last year. On a currency neutral basis, however, sales increased 3%, gross profit increased 5% and Adjusted EBITDA was up over 17%. Our Canada results benefited from an improvement in mix, as strength in industrial markets in Eastern Canada offset volume declines in our energy-focused Western Canada business and lower methanol sales due to warmer weather. Ag sales in Canada increased with warmer weather conditions, precipitating an early start to the growing season. We believe this may have shifted some demand for ag products typically sold in Q2 into the first quarter.

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As we mentioned last quarter, we continue to see a trend of higher volume in the industrial east of Canada that reflects increased US buyers of industrial products made by our customers in Canada taking advantage of the weaker Canadian dollar.

Moving then to Slide 7 and our results in Europe, Middle East and Africa, we felt approximately 3% foreign currency translation headwinds in EMEA in the quarter. On a currency neutral basis, our sales declined 5% and our gross margin increased 60 basis points to 22%, showing the benefits of our mix enrichment strategy and the restructuring program completed in 2015. Excluding the volume effects of restructuring, underlying volumes in EMEA increased 1%. Overall, our Adjusted EBITDA margin increased 80 basis points to 7%. Margins increased in a few key markets, like pharmaceuticals, and average selling price increased, reflecting change in customer and product mix. During 2016, we expect to continue to benefit from the lower cost structure we created in 2015, and will focus keenly on our sustainable growth initiatives for 2016 and beyond.

Moving then to Slide 8 and our rest of the world segment, which is really about Latin America, we had strong performance across the board, excluding the impact of FX. We had foreign currency headwinds of 17%, which led to a slight decrease in Adjusted EBITDA, but on a currency neutral basis, our Adjusted EBITDA grew 25%. In Brazil, we continued to see benefits from the acquisition and integration of D'Altomare. Increased market penetration and site consolidations contributed to a 180-basis-point improvement in EBITDA margin. In Mexico, volume growth of 3% from market share gains was the primary driver of strong double-digit EBITDA growth on a currency neutral basis. We now have a larger, healthier business in both countries and expect that growth will continue. However, we remain cautious of the weak macroeconomic environment in Brazil and the impact it is having on slower industrial production there.

To sum up, our three segments outside the USA, in aggregate, grew Adjusted EBITDA 4% on a reported basis and 14% during the quarter on a currency neutral basis.

Moving then to Slide 9, as Erik mentioned, we generated strong cash flow in the first quarter. Adjusted operating cash flow was $112 million. That's Adjusted EBITDA less the change in net working capital, less cap ex. This equates with an 83% after cap ex cash conversion rate and a 6% operating cash margin. While last year's large Q1 inflow of cash from lower working capital did not repeat, we did hold our working capital productivity gains from year-end.

As we communicated to you three months ago, we spent less in other cash outflow items. Our cap ex of $24 million was down $8 million, or 26%, from last year. For the full year, we continue to expect cap ex to be about $100 million, down $45 million from last year.

Cash taxes were actually an inflow of $7 million in the quarter versus an $11 million outflow last year. For 2016, we expect our cash taxes to be about $10 million lower than the $38 million we paid in 2015, and we now expect our full-year 2016 effective tax rate to be approximately 30%. We will update these estimates quarterly.

For the quarter, our effective tax rate of 26.7% was 1 percentage point lower than last year and lower than the 35% guidance we provided, largely due to change in the mix of geographic earnings before taxes.

Cash interest expense of $44 million was down $15 million, or 25%, from last year. We continue to expect full-year cash interest to be about $150 million, which would be about $12 million down from last year.

Pension contributions of $8 million in the quarter were down 50% from last year. We continue to expect full-year contributions will be down about $30 million from the $60 million we paid into the fund last year.

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Lastly, our cash non-operating expenses of $3.7 million in the quarter were down about 50% from last year.

Our priorities for use of cash are to reinvest for growth in our asset-light business, including digital projects that will lower our transaction costs per unit, to make targeted, attractively priced, value-creating bolt-on acquisitions, and to pay down debt. Given the sluggish growth in demand from the global industrial markets that we are currently experiencing, we think it's prudent to allocate more cash to debt reduction. We have $40 million of scheduled debt amortization payments this year and we aim to more than double that amount.

Slide 10 details our debt profile. Net debt at quarter end was $3.0 billion, unchanged from year-end, but down 18 percent from a year ago. Our leverage ratio declined from 5.7 times a year ago to 5 times at March 31, 2016. Our current total liquidity is $761 million, unchanged from year-end, despite our two acquisitions in the quarter. Our cash interest coverage is 4.0 times. That's up from 2.7 times a year ago. Our return on assets deployed in the quarter was solid at 21%.

As we look forward to 2016, we have a close watch on industrial production by country and daily customer demand by vertical markets for signs of increases, especially in the US.

With that, I'll turn it back to Erik.

Erik Fyrwald:

Thanks, Carl. Overall, I'm pleased with our performance in the first quarter. However, given the market uncertainty, we are taking a cautious position on near-term market demand, even though year-over-year comparisons will get easier in the second half. As Carl and I both mentioned, we saw positive volume growth in Q1, excluding upstream oil and gas and our EMEA restructuring program. Although we are expecting an uptick with typical seasonality, we are seeing soft and inconsistent demand early in the second quarter. We are highly motivated to continue to better manage what we can control to strive for better performance in any economic scenario.

Our entire organization is aligned and focused on executing against our three strategic priorities: first, to grow organically in attractive end markets with chemistry products and value-added services; secondly, to improve operational excellence, including aggressively driving productivity gains; and three, continuing to make bolt-on acquisitions. To ensure that we have the right focus and resources to invest in these priorities to profitably grow, we are closely managing our costs by cutting discretionary spending and executing against the restructuring program we launched last December. Compared to 2015, we've reduced headcount in upstream oil and gas by more than 40% and we are moving forward with our previously announced global restructuring program that is reducing headcount in back office roles by 4% and resulting in the shutdown of several small facilities. Estimated annual savings from the program are at least $10 million per year and we expect to be at that run rate by the end of December 2016. We should start seeing the benefits of these initiatives in the second half of this year. We continue to strengthen our people, processes and execution to ensure we are in the position to drive profitable growth and productivity going forward.

Now, let's look at our outlook on Slide 11, which I'll have Carl address. Carl.

Carl Lukach:

On a reported basis, we expect second quarter 2016 Adjusted EBITDA to be moderately above the $134.1 million reported in the first quarter of 2016, reflecting sluggish industrial demand, continued but diminishing headwinds from upstream oil and gas markets, and continuing downward pressure on

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chemical prices, specifically in the USA market. We expect these headwinds will be partially offset by the benefit of our focused organic growth initiatives, incremental growth from the small acquisitions completed in 2015, and in the first quarter, and lower operating costs from our productivity initiatives. For the full year, we are reaffirming our full-year guidance for 2016 Adjusted EBITDA to be modestly below the $600.1 million reported in 2015.

With that, back to Erik.

Erik Fyrwald:

So, as I look back over the last four years as CEO of Univar, I am proud that we have made significant progress getting our Company positioned to grow, by strengthening our commercial capability and supply chain operations, our services businesses and productivity muscle. My intent was to continue to work with the team here, but was approached about a very unique opportunity to lead Syngenta, one of the world's leading agriculture chemistry and seed companies, something that strongly fits with my passions and previous experience.

I remain very excited about the future of Univar. David Jukes, who led the incredible turnaround of Univar EMEA over the last four years, is already stepping into his critically important USA leadership role and working with his team to drive improved performance. Steve Newlin is the best leader to take Univar forward as CEO. He has a proven track record of creating significant value for shareholders in the chemical distribution industry and will support the team here to accelerate Univar's profitable growth. Steve demonstrated the leadership and experience to drive greatness with what he did at PolyOne, and Steve knows Univar well, as a board member since October 2014, and he has played a key role helping guide the development of our Univar strategy. He will quickly transition into the CEO role. He has the right vision for driving the business forward and is a talented leader who brings people together to drive outstanding performance.

Now, I am a large shareholder in Univar and I have tremendous confidence in Steve Newlin and the strong team we now have leading Univar, and I have not sold a single share and do not have any intention of selling, as I look forward to what I expect will be significant value creation in the coming years. Univar is in good hands.

With that, the Operator will open the lines for your questions. Thank you.

Operator:

Thank you. At this time, if you would like to ask a question, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, you may press the pound key. Please hold while we compile the Q&A roster.

Your first question comes from the line of Bob Court from Goldman Sachs. Bob, your line is open.

Ryan Berney:

Good morning. This is Ryan Berney on for Bob. Despite the big beat with the acquisitions and the improving currency, you didn't raise the full-year guide, so I was hoping maybe you could help define some of the headwinds from the oil and gas market, the FX, and maybe just slower industrial macro that are included in that full-year guide.

Carl Lukach:

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Sure, Ryan, good morning. We think it's prudent to take a cautious stance here. As we said, April sales sequentially from March were flattish, and we normally expect an uptick from the industrial markets, particularly in the US. Pricing sequentially ticked up a little bit just slightly, volumes just slightly. We expected more, so we've taken a cautious stance on 2Q. We do expect that to tick back up here in May and June. Upstream, it's persistent but it's diminishing on a year-over-year basis, so we'll see less of the headwind compared to the results, the tapering down results of last year. Then, FX also should be diminishing, and based on today's spot rates, we're probably going to get a little better there than what we feared, but we'll see where we are in two months on the FX rates. I think the headline is more about this sort of sluggish, not perky demand on the industrial side.

Ryan Berney:

Thanks, that's helpful. Then, it looks like you completed two deals in the quarter. Could you give us a sense for how much you expect that to contribute to EBITDA in 2016?

Carl Lukach:

Just from those two, Ryan, because we've got—we have eight now, I guess, compared to the prior year. Well, I'll give it to you both ways. The two are on the team now and will start kicking in in the second quarter. We've said that the impact of acquisitions on our 2/16 results versus 2/15 will give us a 2 to 3-ish percent uplift versus the $600 million we earned last year, and we feel very comfortable with that track that we're on.

Ryan Berney:

Great. Thank you.

Operator:

Your next question comes from the line of Laurence Alexander from Jefferies. Lawrence, your line is open.

Laurence Alexander:

Good morning, guys, just a couple of questions. First, can you give us an update on your internal EVA metric, just how that's trended sequentially? Secondly, can you give a little bit more granularity around the softness in North America? Some of the larger chemical companies have flagged a late March/April acceleration in demand and I just want to get a feel for the degree to which your business is or isn't correlated or lagging theirs.

Carl Lukach:

Okay. Good morning, Laurence. Let's go to your first one. Our UVA, the Univar Value-Added metric, let me give you that answer by segment. We're seeing very remarkable improvement in the European UVA metric that we use, which, for those who aren't familiar with it, is our after-tax cash returns minus a capital charge applied to working capital and gross permanent investment that we have tied up in that segment. It's up in EMEA because of the improvement in EBITDA and reflecting the restructuring programs we put in place last year. Latin America up also remarkably, based on the smart acquisition we made of D'Altomare, the uplift in EBITDA, the cost synergies that we're getting there. Canada, flattish, but number one, our number one return on capital territory in the world, reflecting the lean model that we operate in up there in Canada and the high cash returns that we're getting.

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The downdraft, as you can imagine, is in the United States, reflecting the drop-off in our upstream oil and gas business. So, as we de-cost the upstream business, as we have, and also as we take assets out of that equation, we will be turning around that decline that we've experienced so far in UVA in the United States. Acquisitions of course are also helping and those are predominantly in the United States.

Then your second question around the industrial markets, yes, we too read a lot of that in late March and April. I can tell you from our results it wasn't tied to chemicals that we're shipping. We saw some railroad data that was up, it may have been plastics and things that we're not selling for our suppliers, but for the 30,000-plus chemicals that we're distributing in bulk and repackaged form, we're seeing that sluggish sort of environment.

I don't want to paint too, too dark of a picture here. We are expecting an uptick here as we move into May and June. and we think we'll get that.

Laurence Alexander:

Then I guess just a question for Erik. Can you speak a little bit about the coach role transformation you've been driving at Univar, where you're at in it, what problems you're leaving on the table for Steve, because when he came in at PolyOne, they clearly had very different cultural issues to fix.

Erik Fyrwald:

Yes. I would say that we've made very good progress over the last four years on both the culture, the strategy, the capability of our people, our processes, and beginning to execute much better. As you know, we've had tremendous headwinds with the oil and gas market, and the chemical price deflation and the foreign exchange, but I think as we really start to lap those—and in the second quarter will be our last significant headwind—Carl, I think you put it at about high single or low double-digit EBITDA headwind for the second quarter, and our upstream oil and gas headwind. As we lap those, I think you'll see the underlying performance benefits of the things that we've been doing, and what I would say is that we're driving a culture of accountability, we're driving a culture of more focus, both commercially and in supply chain, we're comparing ourselves to best practices of other distributors in the chemical industry and outside the chemical industry, and driving both the commercial, the growth, the improvement in profitability, as well as the productivity, and the bolt-on acquisitions. We're also working more closely with our suppliers, a greater customer focus, and watching very closely on how we're doing in improving customer satisfaction, supplier satisfaction and employee satisfaction, watching those metrics very closely and the things that drive the improvement, and we're seeing nice improvements across the board.

What I would say is Steve comes in with a great track record at PolyOne. He proved that they could take a company that was, I think, generally focused on commodity plastic distribution and, in addition to that, get better at that, but also add to that a more specialty, more services approach, and we're in the middle of doing that. He took them very far in that drive and I think he's the absolute perfect person to take us from where we are today and support the team to keep driving further to be more value-creating, continued aggressive productivity, but bring more value to customers and suppliers in a way that creates more value for our shareholders. So, I think we've made a lot of progress but very clear with our team and with our investors that we've got more to do, and I think Steve's the perfect person to take it from here to make that happen with the team.

Laurence Alexander:

Thank you.

Operator:

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Your next question comes from the line of Allison Poliniak from Wells Fargo. Allison, your line is open.

Allison Poliniak:

Hi, guys, good morning. Could you touch on—you know, gross margin is obviously holding in nicely, a lot of headwinds there, but as we look to the balance of 2016, just given some of those headwinds don't seem to be abating, just your thoughts on sustainability of that margin, risks or benefits either way, could you touch on that?

Carl Lukach:

Sure, Allison, good morning. Thanks for that question. Our margins are up very nicely, as you see, in all segments, both gross profit margin, and we measure that margin a number of different ways, raw GP, finished financial, and then also delivered, and they're all up. Most of that is reflecting product and customer mix change. So, I don't want to lock in on an actual margin percentage, because the way we run this business model is we manage those margins really to maximize EBITDA and cash flow, so I don't—we will, and likely will, those margins will come down as the economy starts to recover and we seek more growth and respond to more demand from the marketplace. So, sustainability, I think these go up and down with that wide diversity of product offering, a customer offering, and end market use offering that we've got.

Erik Fyrwald:

What I would add to that is in Europe, we're getting through the restructuring there, where we walked away from business that was not attractive, shut down facilities that were not profitable, that's enhanced our margin and that will stick. Secondly, we've put a lot of focus on driving aggressively our service businesses, which now are growing very nicely. In fact, in the second quarter, we had double-digit growth in our services businesses, which we've highlighted in past reviews as an area that we were putting more emphasis in, strengthening our leadership, putting more resources on and now are starting to really see the growth happen there, and it's where we're putting a lot of emphasis on for our M&A, our bolt-on M&A, and that will continue. So, yes, some of the bigger product volumes will go up and down a bit with the cycles, but we are taking actions that will have an ongoing positive impact on our margins.

Allison Poliniak:

That's great. Then Erik, you touched on the value-added services piece of it. Obviously, in a soft environment—you talked about it accelerating just because of the efforts that you're putting in, but from a customer standpoint, do you sense just given a soft environment that they're sort of seeking out these kinds of value-added services right now?

Erik Fyrwald:

Yes, I do. In fact, with the tough environment, there's challenges, because more customers want to bid business and looking for lower prices for existing things that they buy, but they're also looking for savings, and we can come in and offer them a broader portfolio of products. We've had some customers that are looking to lean out their logistics and their sourcing organizations, and looking to us to supply more of their products, so that they're consolidating their supplier base. That's bringing opportunity. On the ChemCare side, where we're seeing tremendous growth, we're seeing customers that are looking at all their waste, and if somebody can come in—that's us—come in and aggregate all that, take it from them in one step, simplify their operations, reduces their costs, simplifies their operations, gives them more confidence that their waste will be handled well, environmentally friendly, we can save them some money, and we have a great business with it. So, the answer is yes, that the challenging economic times provide more opportunity for our services.

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I'll give you one more example. With ChemPoint, we're seeing a number of suppliers who again are looking to simplify their distribution approach, who have shifted business from multiple other distributors to ChemPoint to simplify their distribution, and that's a nice trend and we hope to see more and more of that. So, the answer is yes. Our focus on services, to have strong leadership, to be better and better at these services, and the challenging economic conditions, are creating more opportunity for our services.

Allison Poliniak:

That's great. Thank you so much.

Operator:

Your next question comes from the line of Steve Byrne from BoA. Steve, your line is open.

Ian Bennett:

Thank you. Good morning. This is Ian Bennett on line for Steve. First, Erik, congratulations on the new opportunity. My question is for Steve. Where do you see the most opportunity for margin improvement in this business? Is it from product mix or productivity cost cuts, or acquisition to scale? Just how do you think about that opportunity?

Erik Fyrwald:

Steve won't be joining this call, but you'll have lots of opportunity going forward to interact with Steve, but I can tell you that Steve and I have talked a lot about it and I think he's extremely excited by what we're doing across the board in terms of our strategic direction, and if you've seen what he did at PolyOne, he got them very good at the commodity distribution piece, but added a lot on the specialty and services piece, and my guess is you'll talk to him about it, but he'll support the team to push even harder at more value-add as a way to enhance both the growth rates and the margins.

Carl Lukach:

Great. Your question goes back to, really back to last year June when we first brought out the stock to the investment community and talked about a rising margin profile for Univar. Really, the drivers of that upward direction are three. Number one is mix enrichment through added services that Erik talked about this morning, that becoming a larger portion of our Company and our business, at higher margins than the average. Number two is our specialties product offering, focusing in a different way and going to market there in a bit different way, that will help price. That's number one, mix enrichment. Number two is the overall productivity initiatives, lean Six Sigma launches that we've made throughout our Company that have taken hold and are producing results. Lastly, the acquisitions that Erik also mentioned are lean, and into to what is an attractive acquisition is more towards those specialty type companies that have higher business margins. Kind of a fourth that we've mentioned this morning, as well, is we have shed some low, no-profit business in Europe. That was a big piece of our European restructuring. We've seen margins there go from 3-ish percent EBITDA margins to 6% and 7% right now, as well as a very active margin management process here in the United States. So, a combination of all those things are giving us this trend line we hope for sustainable higher margins, subject of course to the active management that I mentioned to Allison a minute ago.

Ian Bennett:

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Okay, thank you. As a follow-up, just thinking about the outlook more in the near term, what items do you have a clear line of sight at for improvement in EBITDA in the second half of the year compared to the first half of the year?

Carl Lukach:

A couple that are crystal clear. Number one is our acquisitions that have already closed and we have a good fix on what they'll do. I mentioned 2% to 3% uplift from last year's earnings. Number two is our cost—I don't want to call them programs, but we have a lot of things going on in the cost area. Remember, we announced last quarter a resizing program that is underway as we adjust the Company to the absence of a large upstream oil and gas business. That's reducing our headcount globally by about 4%. Erik mentioned in the call we'll be at least at a $10 million annual run rate savings by the end of this year and I think we expect to beat that. Another program, the lean Six Sigma initiatives, particularly in our operations, transportation area, where we are getting much better at trucking logistics, our warehouse management and operations, where we're putting points on the board there, in the first quarter we delivered year-on-year cost savings there that were high single-digit, low double-digit millions in the quarter. So lots going on. That's where we have clear line of sight.

Not to get overlooked, the de-costing we did in the upstream oil and gas, we reacted quickly. We started last year in the first quarter to de-cost our business and that is clear sight, we know what that cost structure looks like right now and for the rest of '16.

A little more opacity would be around the customer demand in the various industrial markets of Europe and in America. Canada's a little clearer to us, we see we have a great ag season underway up there that we hope will last through the season, we think it will, butut in the industrial markets of the US, they're just not peppy, not perky at the moment, and we expect that to pick up here later in this quarter.

Ian Bennett:

Great. Thank you.

Operator:

Your next question comes from the line of Karen Lau from Deutsche Bank. Karen, your line is open.

Karen Lau:

Thank you. Good morning, everyone.

Erik Fyrwald:

Good morning, Karen.

Karen Lau:

Congrats to Erik and to Steve. So, first question, about the quarter, did you in any way benefit from customer restocking, maybe they started out with inventory too low and then in anticipation of higher prices down the road they did some restocking; and also were there any impact from more selling days year-over-year in the first quarter?

Carl Lukach:

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Good morning, Karen. It's Carl. The short answer is no. What we did see was a little pre-buying, we think, because of the warm weather in our Ag business in Canada that probably came out of the second quarter, but in terms of bulk and repackaged chemicals, we service 90-plus percent of the GDP on a one-day lead time here in the United States, and so our customers rely on us for that kind of delivery ability, so there's not a lot of stocking in the pipeline, so I'd say, generally, there could be some exceptions, but, generally speaking, we did not see that occurring in our supply chains.

Karen Lau:

Okay. Any impact on difference in selling days year-over-year?

Carl Lukach:

Yes. It's a leap year and I kept looking for when we were going to get that benefit, because is varies by region. It really isn't that significant in the first quarter, but we do watch it, we do watch it more on a monthly basis, and like I said, it's different each segment, but no impact there really on the first quarter results.

Karen Lau:

Okay, fair enough. Then, you mentioned you didn't see any typical seasonal pick-up from March to April, but you're expecting that to come through in May and June. I'm just curious what gives you the confidence in the industrial volume or volume in general will pick up sequentially? Is it based on just conversation with customers or kind of the logic that eventually customers would have to buy at some point? Just maybe give us a little bit more color on the expectations.

Carl Lukach:

Okay, sure. If you look at our—well, the first point would be around May results. We do actually look at our sales on a daily basis and we've had a couple of good days here. It's still quite early and not a trend line yet. But, if you look at the end markets, particularly in the US, industrial end markets, there's certain seasonality that it's hard to imagine wouldn't occur. Let's take the coatings market and the warmer weather paintings that go on, and you've heard that from the paint companies already talk about their outlooks for the second quarter.

Erik Fyrwald:

And as temperatures increase, the water treatment increases, the pool use and other things that occur every year.

Carl Lukach:

Occur every year. So, weather will drive some of it up, warmer weather, and so that gives us confidence that that's coming and those orders will pick up here. I think that's probably the extent of it, Karen.

Karen Lau:

Okay, that makes sense. Then, lastly, just thinking about oil and gas, and sensitivity to commodity prices, oil prices have improved a little bit, and then if the trend continues we might see more well completion and production down the road. I'm just curious, for your oil and gas business, would you benefit from those kind of activities, or it's more tied to drilling and rig counts because of the fracking exposure? So, even if we have some more production but still no drilling, you may not see benefit.

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Carl Lukach:

Our upstream is tied to the level of fracking activity, which, despite the increase in oil prices recently, has continued to decline with the rig count. Now, if the oil prices stay above $40, there is a chance that there could be some additional rig activity, some additional fracking activity in the second half, we're hearing some of that, but we're assuming that that doesn't happen in the outlook that we're providing. If it gets even worse, we have this significant still headwind in the second quarter, but in the third and fourth quarter that headwind becomes fairly insignificant regardless of how low the fracking goes, because we're pulling the cost lever so it can't get significantly lower in the third and fourth quarter. So, we'll bottom out in the third and fourth quarter, and what I would say is if the oil price stays in the mid-$40s or it goes up, there could be increased fracking activity in the second half, but it is not in our outlook or our forecast.

Karen Lau:

Okay, but it's more tied to fracking than to general production and well completion, right?

Carl Lukach:

Correct, yes. The second part of your question, the sensitivity of our products to oil price, you know, the hydrocarbon products and methanol, of course very sensitive and will move, those tend to be our bulk chemical product sales, and so we will see some, and have seen some, sequential increases, slight, as the spot oil prices have moved up a bit. We gauge it at about 20% to 25% of our total product offering would have high correlations to oil price, the price of those products.

Karen Lau:

Got it.

Carl Lukach:

But we're not assuming any significant and sustained oil price increase in our outlook, right?

Erik Fyrwald:

Right.

Karen Lau:

Got it, that makes sense. Thanks very much.

Carl Lukach:

Okay. Thanks, Karen.

Operator:

Your next question comes from the line of James Sheehan from SunTrust Robinson. James, your line is open.

James Sheehan:

Thank you. Could you guys quantify what you think the pull-forward was in ag from the second quarter into the first quarter?

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Erik Fyrwald:

I'll start and then Carl, you can put the numbers behind it. It's hard to tell, because the season has started off well, and it's hard to tell what's pulled forward versus what will be a strong ag season. So, what I would just say is that it was stronger than we expected, and Carl can estimate an impact on that, but we're hopeful that that means a stronger total ag season, but the first quarter was stronger than expected.

Carl Lukach:

Thanks, Jim. Good morning. It's not that material to the big picture. I'd say low to mid-single-digit millions was the size of that impact. We gauge it that way. Remember, we sell in our ag business seeds, protection chemicals and now fertilizer with our acquisition, so it's a very different—it's the whole tool kit for farmers and we've got leading market share there, so it's—but agronomically and weather-wise, it is a great start to the year and we're cheering for a continuation of that into the 2Q, so we may have to give back that early start, but we may not.

Erik Fyrwald:

Right.

James Sheehan:

Okay, great. Then, in USA, you talked about a mix upgrade. I'm just wondering about the sustainability of that. If you do see more macro tailwinds in the second quarter and third quarter, the sequential pick-up you're talking about, does that mix upgrade stay with you or does that dissipate?

Carl Lukach:

If you tie mix upgrade to our gross profit margins in the USA, really, I'd go to the customer and end market mix more so, and the decline in oil and gas, that fracking end market consumed a lot of bulk chemicals that are generally on our range of product gross profit margins, you know, towards the lower end, so the absence of that in the demand is giving us a mix kick up overall for the United States, so I don't think that would go away. I think it's down to pure volume here. I think the margin has kind of settled out right now and what we need is just pure demand to go up. Services—excluding from that comment, services is here to stay and growing so that would help us get through any cloudy skies ahead in the second quarter.

Erik Fyrwald:

And the business that we've either raised the prices on or walked away from because we weren't making money, that discipline process stays and we're not going to go back after bad business.

James Sheehan:

Great. You guys talked about deleveraging as a priority and paying down debt as a priority use for cash. What would you target your leverage ratio to be by year-end, and also further out in 2017?

Carl Lukach:

Great question, Jim. Okay, so, you notice we turned the volume up on paying down debt. We think that's a prudent thing to do in this economic situation. The debt paydown in this calendar year will be more

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back-end loaded towards the end of the year, as we see how things develop. At the end of the year, I'm just going to give you, Jim, 4.X versus 5.0 at the end of this first quarter, you know, see how that goes, how our cash flow goes, and then in '17, again, a lower number than the end of where we ended in 2016. So, we've got $40 million of committed debt payment reduction that we will and must make and we're aiming to more than double that this year, and I think you can see us at this point in time, as we look into 2017, to stay on that track, with our longer-term goal being 3 to 3.5-ish as a leverage ratio for this Company and this business model.

James Sheehan:

Thank you.

Operator:

We have no further questions at this time. I turn the call back over to the presenters.

David Lim:

With that, we'd like to wrap up our first quarter earnings call. Thank you all for your interest in our Company. My IR teammate, Carrie Wang and I will be available to answer any follow-up questions you may have. Our contact information is on our website and we look forward to meeting you all soon. Have a great day everyone.

Operator:

Thank you, ladies and gentlemen, for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.

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