

# Rockwood Capitalizes on Recovery

Returning demand and careful cost control are lifting the 2010 outlook.

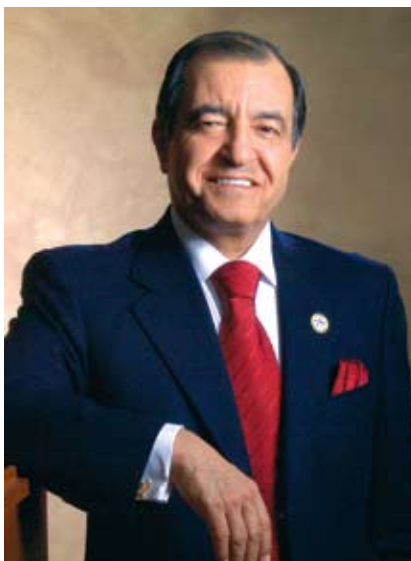
**R**ockwood Holdings says it is well-positioned to capitalize on its strengths and outperform in the economic recovery. The Princeton, NJ-based producer of specialty chemicals, advanced ceramics, and pigments and additives has managed to grow during one of the most severe economic downturns in history. In fourth quarter 2009, Rockwood posted a 18% increase in adjusted Ebitda, to \$155 million, on sales up 7%, to \$786 million, compared with the year-ago quarter. The company also managed to generate \$299 million in free cash in 2009.

Rockwood was built through a series of acquisitions since 2000. Sales have grown from \$750 million in 2002, to about \$3 billion in 2009. The businesses acquired are largely self contained with leading market positions and limited exposure to raw material and energy price changes. Rockwood has leading positions in lithium compounds, fiber anatase titanium dioxide, color pigments, advanced ceramic components used in hip-joint prostheses, and wood protection products.

Rockwood does not provide an earnings guidance for 2010, but says it managed to achieve adjusted Ebitda margins above 18% despite plummeting volumes in 2009. Chairman and CEO Seifi Ghasemi attributes this to careful cost control. "If you just cut variable costs, your margins will drop significantly" as spending creeps higher in recovery, he says. "But we were able to flex on all of our costs. You can only do that if you have a very good understanding of the people in your organization."

In addition to production cuts and spending curbs, the company put many employees on furlough, working four days a week for 20% less pay, he says. The company managed to save about \$150 million in 2009 through restructuring efforts and cost cuts and expects to retain \$60 million of those cuts in future annual savings.

Anticipating the economy's weaknesses was also key to Rockwood's successful navigation of last year's economic crisis while simultaneously boosting margins and generating cash, Ghasemi says. The company began cutting costs and restructuring its businesses when the construction market started to slow down in late 2007. By the



**GHASEMI:** Rockwood's top line has the potential to grow 9%-10%.

time the recession entered full force in late 2008, Rockwood was a year ahead of its peers in taking action, he says.

"And now that the volumes are going up, we expect to get significant leverage because not all of those costs are going to come back," Ghasemi says. If sales return to 2008 levels, he expects the firm's adjusted Ebitda margins to reach 20%. "A company that cannot maintain these kinds of margins should not be called special."

The company's fourth quarter titanium dioxide (TiO<sub>2</sub>) pigments sales increased 21%, to \$186 million, and adjusted Ebitda rose 38%, to \$32 million. Higher demand for TiO<sub>2</sub> and functional additives, as well as productivity improvements and lower raw material costs, boosted the segments' performance, Rockwood says. The company uses the sulfate-process for TiO<sub>2</sub> production, with a focus on higher-margin fiber anatase product grades that do not face competition from chloride-process TiO<sub>2</sub>, which dominates global TiO<sub>2</sub> production. "A lot of people were very surprised by our fourth-quarter margins of 17% for TiO<sub>2</sub>," Ghasemi says. In September 2008, the company entered into a TiO<sub>2</sub> JV with Kemira that produces specialty titanium dioxide pigments. The JV, named Sachtleben, has given Rockwood the ability to focus on gaining a leading position in the higher-margin segments of fiber

manufacturing and special inks, Ghasemi says.

Pigment volumes are currently down 25%-30% from normal, but the company is still maintaining double-digit margins, Ghasemi says. "So in terms of potential upside, if construction comes back those businesses can do very well," he says. "We believe very strongly that all our pigment businesses have potential Ebitda margins of 18%-20%." Rockwood has no plans to expand its commodity pigments business, especially not in commodity TiO<sub>2</sub> sectors, Ghasemi says. Instead, the company will work to develop new products, including biodiesel catalysts, and to use existing capacity to produce specialty grades.

The company managed to expand margins in other businesses as well. Performance additives sales decreased 3.1%, while adjusted Ebitda gained 215% on lower raw material costs and cost-cutting measures. Results were negatively impacted by lower selling prices for Rockwood's Viance (Charlotte, NC) timber treatment chemicals JV with Dow Chemical. The wood treatment business remains depressed due to the weak construction market, but the JV is a very small part of Rockwood, accounting for total 2009 sales of less than \$150 million and adjusted Ebitda of less than \$10 million, Ghasemi says. Created in 2007 by combining the wood biocides business of Rohm and Haas, acquired by Dow last year, and the wood protection chemicals business of Rockwood subsidiary Chemical Specialties, Rockwood is working with its new JV partner to develop a longer-term strategy for the business, Ghasemi says.

The specialty chemicals unit was negatively affected by lower selling prices for potash, partially offset by higher selling prices for surface treatment chemicals. Sales increased 3%, to \$274 million, while adjusted Ebitda fell 3%, to \$70 million.

The company currently trades above \$26/share, up from lows of nearly \$4/share last March. Despite the gains, Ghasemi says the company's stock is below mid-summer 2008 levels of \$40/share. "We obviously think that Rockwood is worth a lot more than 6.5-7 times Ebitda. It's frustrating for us because we have not been able to

fully position ourselves with investors as a company positioned for very good organic growth," Ghasemi says. One problem is the company's debt-to-Ebitda ratio, which during the recession inched higher, toward 4, he says.

Rockwood, which was formed through the buyout from Laporte by Kohlberg Kravis Roberts (KKR) in 2000, has been comfortable with that amount of debt but acknowledges that public investors are skittish about debt, which has likely caused the stock to trade at a discount. "I personally think Rockwood has a significant amount of liquidity and free cash," Ghasemi says. "But I have learned that, as a public company, the ratio needs to be around three. Anything more than that and your stock will consistently be undervalued." Rockwood's goal is to get its debt-to-Ebitda ratio back to three by the end of 2011, he says.

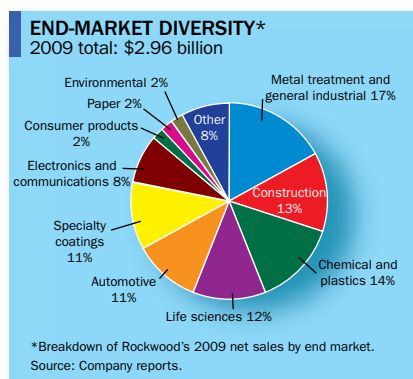
Investor attention has been focused on the potential growth of lithium in car battery applications but the organic growth potential of Rockwood's other businesses is also strong, Ghasemi says. "So far, car battery lithium volumes are minuscule. The \$299 million we generated in cash in 2009 has nothing to do with car batteries. It will be 2013 or 2014 before lithium demand for car batteries has a noticeable impact on Rockwood's bottom line," Ghasemi says. The company has the potential for significant organic growth with lithium sales for other battery applications and pharmaceuticals, and also has a leading market share in the profitable and growing medical ceramics business, Ghasemi says.

The company also has the cash on hand to seize bolt-on acquisition opportunities. "There is room to grow in surface treatment," Ghasemi says. "It is a business that is not fully consolidated, and there are still a lot of small players." Rockwood is number two behind Henkel, with about 20% of global market share. Acquisitions in specialty pigments and ceramics could also be attractive, he adds.

"All together, the top line of Rockwood has the potential to grow 9%-10%, and I don't think we've yet fully convinced the market of this," Ghasemi says. That may change, however, now that the market knows Rockwood can maintain margins and even generate more cash than ever during a recession, he says.

Analysts recently raised their 2010 earnings outlook for Rockwood, citing

improvement in demand for  $\text{TiO}_2$ , functional additives, ceramics, and lithium products, as well as the company's ability to maintain steady lithium pricing despite cost-cutting by a key competitor.



David Begleiter, analyst at Deutsche Bank (New York), raised its forecast for Rockwood's 2010 EPS 5 cts/share, to \$1/share, to "reflect improving demand for titanium dioxide and functional additives as well as advanced ceramics." Cost savings and improving demand will continue to boost Ebitda margins, which are expected to exceed 20% even without materialization of lithium sales for hybrid and electric cars, Begleiter says.

J.P. Morgan (New York) also upgraded Rockwood's 2010 earnings outlook, from \$1/share to \$1.10/share. "We increase our 2010 forecast for adjusted Ebitda from \$599 million to \$635 million, reflecting margin leverage from a rebound in end market demand for  $\text{TiO}_2$ , coatings, advanced ceramics, and lithium products in addition to margin improvement from cost-saving initiatives," says J.P. Morgan analyst Jeffrey Zekauskas. "We expect a period of healthy margin expansion when demand returns in these markets."

Investments in the fast-growing Chinese market are notably absent from Rockwood's growth plan. Ghasemi attributes this break from the industry norm to Rockwood's mix of low-volume, value-added products. The company can still compete in China and India without taking the political risk of investing in infrastructure there, he says. "I don't think having exposure to the growth in China necessarily means you have to have plants in China," Ghasemi says. "The important thing is to have products that an expanding economy needs. Commodity chemical makers need to be there. Fortunately, we are not in that kind of business." China is already one of

Rockwood's biggest markets for  $\text{TiO}_2$  fibers and ceramics, and the company also sells lithium to Chinese battery makers.

Rockwood is on the short list of producers poised to cash in on lithium demand for electric and hybrid car batteries. Analysts forecast that car batteries will comprise a quarter of overall lithium demand by 2015, up from less than 1% in 2007. Along with Sociedad Quimica y Minera de Chile (SQM) and FMC, Rockwood extracts lithium from the "lithium triangle," a series of salt flats located along the borders of Argentina, Bolivia, and Chile with a large cost and purity advantage over other lithium sources.

Rockwood is also the only domestic source of lithium at Silver Peak, NV. The company's Chemetall Foote lithium subsidiary was the only lithium supplier to receive Department of Energy (DOE) funds under a \$2.4 billion Recovery and Reinvestment Act program to advance battery technology for hybrid and electric-drive vehicles. The \$28.4 million in DOE funds will be used to expand and upgrade the production of lithium carbonate at Silver Peak and add the production of very high purity lithium hydroxide to the company's Kings Mountain, NC, facility. "For strategic reasons and long-term security of supply it makes sense for U.S. battery makers to have a domestic source of lithium," Ghasemi says.

Lithium's commercial potential has prompted new entrants to the market, but Rockwood says it is well-positioned to maintain its market share. The quality of reserves outside the lithium triangle and the time it takes to develop the technology to produce lithium in a form the market can use are both considerable barriers to entry, Ghasemi says. "Lithium extraction and production is not something we

**If sales return to 2008 levels, Rockwood expects Ebitda margins to reach 20%.**

just did," he says. "It takes a long time to develop the know-how and technology to produce lithium in a way that customers can use." Many new entrants produce low-quality lithium that would never be of high enough quality for use in a car battery, he adds. "I think people investing in these projects need to be cautious," Ghasemi says. "Lithium sources can be like oil shale in that way—it's there, but it's not practical or economical." —REBECCA COONS