



FINAL TRANSCRIPT

EcoSynthetix Inc.

2018 Second Quarter Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the EcoSynthetix 2018 Second Quarter Results Conference Call. At this time, all participants are in a listen-only mode.

Following the presentation, we will conduct a question-and-answer session. Instructions will be provided for you at that time for questions.

If anyone has any difficulty hearing the conference, you may press *, 0 for Operator assistance at any time.

Listeners are reminded that portions of today's discussion may contain forward-looking statements that reflect current views with respect to future events. Any such statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements.

For more information on EcoSynthetix's risks and uncertainties related to these forward-looking statements, please refer to the Company's Annual Information Form dated March 6, 2018, posted on SEDAR.

This morning's call is being recorded on Tuesday, August 7, 2018, at 8:30 a.m. Eastern Time.

I would now like to turn the call over to Mr. Jeff MacDonald, Chief Executive Officer of EcoSynthetix. Please go ahead, sir.

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Jeff MacDonald — Chief Executive Officer, EcoSynthetix Inc.

Good morning, and thank you for joining us today. Friday afternoon we released our 2018 second quarter results, which you can find on our website at ecosynthetix.com.

You can also download a copy of the slides that accompany today's call from our website, or alternatively access them on the webcast.

It was a great quarter. Net sales were up 22 percent to 5.8 million, driven by higher volume and higher pricing. We improved our adjusted EBITDA loss by 63 percent to \$480,000.

Our commitment to achieve profitability in the near term is now clearly within sight. We are delivering on this commitment through top-line growth and by executing on items that are fully within our control, specifically disciplined cost management.

In the past eight quarters, we have doubled quarterly revenue. The top-line growth has been primarily driven by the paper and paperboard business to date, which I'll address in a moment.

At the same time, we've dramatically reduced our cost base with a 70 percent improvement in adjusted EBITDA loss. What is more difficult for us to directly control is the pace of change in the wood composites sector.

Speaking frankly, I anticipated that change would happen more quickly than it has at this stage. However, paper and paperboard has grown more than we anticipated. Taking the two items together, the growth in paper and paperboard and the slower growth in wood composites, we are on track to achieve profitability.

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The primary reason for the pace of change in wood composites remains the pricing dynamics related to PMDI, the co-binder that DuraBind works with as a replacement for incumbent low-cost formaldehyde resins.

PMDI pricing has regressed from its peak in 2017 to a level in and around US \$2,500 a tonne and €22.50 in the European market. The supply constraints we heard from prospects earlier this year that they could not even obtain PMDI for trials have subsided. Top manufacturers of PMDI have also recently announced plans to expand supply.

At these price levels, our near-term opportunities remain primarily in the oriented strand board segment. PMDI has approximately 50 percent market share in the OSB market. DuraBind offers OSB manufacturers that use PMDI an opportunity to lower their input costs by reducing the amount of PMDI used.

We believe there are significant opportunities within the OSB segment for DuraBind, and we are actively engaged in industrial trials with many of the top OSB manufacturers.

We also continue to engage with prospects in both particle board and MDF, which are the larger segments of the wood composites market. Those manufacturers with a conviction to drive change and offer a no-added formaldehyde solution to their customers are building their plans on today's PMDI pricing dynamics.

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At the current levels, products that use PMDI and DuraBind would not be priced at parity with products that use formaldehyde-based binders. We expect the NAF products would be priced at a slight premium. However, thought leaders in the market continue to support NAF alternatives.

As an example, in June, IKEA publically committed to use only renewable and recycled materials in its products by 2030. During their presentation, IKEA's CEO referenced using a greener glue in its particle board as one of its initiatives.

IKEA holds a unique position in the market as the major retailer of particle board, as well as a manufacturer through its ownership in IKEA Swedspan, which manufactures particle board and MDF. No one is more committed to the change agenda than IKEA, and we remain engaged with them at both the corporate level and with their supply chain partners to support their green agenda.

On the paper and paperboard business, we continue to benefit from recent pricing dynamics in the SB latex market. The value proposition of our EcoSphere binder continues to improve with SB latex prices moving up and continued tightness and pricing strength in butadiene, and more recently, styrene, the two key components of latex.

SB latex prices were in the range of \$1.10 in June, as the price of crude oil increased and butadiene remained in short supply. These pricing dynamics have led to higher volumes within our existing accounts, as well as higher average pricing.

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In addition to trials focused on expanded use at existing customers, we are seeing an acceleration in trial activity with new prospects in all regions. These are accounts that do not use EcoSphere today, but are attracted by the stability of our pricing relative to SB latex.

What we know from experience is that converting an account to EcoSphere is the primary challenge. Once we have secured an account, they become very sticky, given the cost savings of our solution.

Economics remain the primary driver in this market, but green is becoming increasingly important to key players in this space, given growing consumer preference for more renewable, safer, and nonpolluting materials, particularly in packaging. Several of our customers are actively pursuing 100 percent bio-based products to satisfy this drive from their packaged goods customers.

The opportunities in the paper and paperboard market are stronger today than at any time since I joined the Company. Based on SB latex pricing dynamics, we are confident there are additional opportunities in paper. It's a good environment for new business.

However, the opportunity for DuraBind in the wood composites market remains our number one priority, given the scale of that market and the demand for NAF alternatives that are cost effective and offer comparable performance. While the pace of change in wood composites has not moved as quickly as we would like, we remain confident that our DuraBind offering is the NAF alternative with the product profile to attract large-scale manufacturers.

With that, I'll turn the call over to Rob to review the financial highlights.

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Rob?

Rob Haire — Chief Financial Officer, EcoSynthetix Inc.

Thanks, Jeff, and good morning. From a top-line perspective, net sales were 5.8 million in Q2 2018, an increase of 22 percent compared to the same period in 2017. This increase was primarily due to higher sales volume of 800,000, or 17 percent, and higher average selling prices which improved sales 200,000, or 5 percent.

Gross profit was 1.2 million in the quarter, up 14 percent compared to 1 million during the same period in 2017. Net of manufacturing depreciation, gross profit as a percentage of sales was 23.9 percent in the quarter compared to 25.8 percent for the same period in 2017.

As Jeff mentioned, the pricing dynamics of SB latex in the paper and paperboard market are providing us with a reasonable level of pricing power. However, while the cost of corn inputs have been steady, there has been pressure on cash margins related to the cost of freight and our processing aids.

Adjusted EBITDA loss was 480,000 in the quarter compared to 1.3 million in the same period in 2017. The 63 percent improvement in the quarter was due to lower operating expenses and increased gross profit.

We continue to be disciplined in our approach to cost management. SG&A expenses adjusted for depreciation and share-based compensation were unchanged at 1.3 million in the quarter compared to the same period in 2017.

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R&D expenses adjusted for depreciation and share-based compensation was 400,000 in the quarter compared to 1.2 million in the same period in 2017. This change was primarily due to lower mill trial-related costs, people-related expenses, and third-party development costs.

Our R&D efforts continue to focus on further enhancing value for our existing product lines and expanding our addressable opportunities.

Overall, R&D expense was 9 percent of revenue in Q2 2018. We are confident that our current investment level is appropriate to deliver significant growth for our business.

As of June 30, 2018, we had 46.7 million in cash and term deposits. We used 327,000 of cash in operations during the quarter. In general, we expect our cash utilization to track closely to our adjusted quarterly EBITDA loss.

We have more than sufficient cash reserves to execute our growth strategy, and we'll remain disciplined and manage our cash responsibly while continuing to invest in our long-term growth strategy.

With that, I'll turn it back to Jeff for closing comments.

Jeff MacDonald

Thanks, Rob. We are executing on our plan to achieve profitability on an adjusted EBITDA basis in the near term. We've delivered cost discipline to the business and grown the top line consistently over the past eight quarters.

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We are engaged with OSB manufacturers to deliver cost savings versus using PMDI alone.

We remain engaged with the right strategic accounts in particle board and medium-density fiberboard: accounts that have a conviction and the retail pull to deliver on an agenda of change.

Our pipeline of paper and paperboard prospects conducting mill trials is robust, providing us confidence that it remains a growth vertical.

The combination of these factors has positioned us to achieve our goal of profitability in the very near future.

With that in mind, we have been active in the market making use of our normal course issuer bid. We have purchased both larger blocks when available and consistently been at our daily limit when the trading window is open.

During May and June, we purchased and cancelled nearly 490,000 shares for total consideration of \$650,000. This initiative underscores our confidence in the trajectory of the business. Our commitment to deliver profitability is within sight.

We appreciate the trust and the patience that our investors have shown, and I look forward to updating you on our progress again very soon.

And with that, I'll turn it back to the Operator to open up the call for any questions. Thank you.

Q&A

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Operator

If you'd like to ask a question at this time, press *, then the number 1 on your telephone keypad. If you would like to withdraw your question, press the # key. We will pause for just a moment to compile the Q&A roster.

Your first quarter comes from Steve Arthur, RBC Capital Markets. Your line is open.

Steve Arthur — RBC Capital Markets

Great. Thank you. Just a few questions here. I guess first on the paper and paperboard market, stronger than expected, which is, I guess, quite a positive surprise. Just wondering about the sustainability of that and what your expectations are looking ahead? Obviously, that depends somewhat on SB latex pricing, but is it positive enough that you're in need of deploying more resources, sales support resources to target that growth?

Jeff MacDonald

Good morning, Steve. Thanks for joining us. So we see it as being quite positive in the foreseeable future based on where crude oil is—it continues up even today—and where styrene-butadiene, both the styrene and the butadiene components are in lockstep with oil, and where they're in short supply relative to oil in some cases, so we think the dynamics are really good.

We said on this call several times that when crude oil crosses back over \$60, we become very interesting in this space again. And we've been there now for a while, and we're starting to see the results of it.

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Second part of your question, do we need to add more? No, we're really well positioned with the right people in front of customers with the technical skills to help them make conversions. And our product is now pretty well known in the industry by many of the leaders. So when they're pushing the limits of use of our products, they're doing it with greater confidence. And that gives us the opportunity then to deploy our resources in looking for additional opportunities. And we're starting to see some customers that we've struggled with below that \$60 oil mark start to get a little bit more interested.

So it looks good. I think, as I said, the opportunity in wood composites just because of the scale of the market and the demands for change it's definitely the bigger opportunity. But paper is showing that it can be a nice growth business for us as well.

Steve Arthur

Okay. No, it sounds good. I guess in, yeah, in the wood composite, I understand some of the pricing dynamics there. Just one question with the existing DuraBind customers, how are those implementations going generally? And have you seen any growth at all in their orders? Or would you expect to see that in the coming year?

Jeff MacDonald

So I think the best way to describe it is steady. Our first customer's been working with us for coming on two years now. They have during the course of their time with us increased the usage of our product, and I would say they're at a steady-state level of confidence in using our product today

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to the point where they are a large customer and they're a large player in the wood composite market, and they're looking—not only looking, but working hard with us to see where else we could help them in their operations.

The second customer has only been with us for a short time and things look sort of normal course; basically, the same kind of profile that we saw in getting started with Swiss Krono when they became our first customer.

Steve Arthur

Just a couple on the numbers. R&D, Rob, you mentioned sustainable, I guess, in here I think was something like the word you used, but down sharply over the past year and even from last quarter. So just wondering how much, if anything, we should read into that? Is it that the product set is pretty stable now to go to market and then develop more later? Or are you forgoing anything now just in the cost-containment mode?

Rob Haire

Yeah. Thanks, Steve. No, we look at—so R&D has been—was steadily increased a year ago. I think that was close to where our peak was from an R&D perspective. There was a significant investment getting DuraBind ready for the marketplace where we were also utilizing a lot of third parties to help us. A lot of those contracts have come to the end. The product is ready and obviously being used by two of the top 10 players in the marketplace now.

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We look at our current R&D investment being in this, call it, 9 percent of revenue range, plus or minus a couple percent to be steady for the foreseeable future. We don't see a big spike.

I know this is a big drop from what we saw a year ago, but there was a lot of items in there of just getting the product ready for the wood composite market.

Jeff MacDonald

I think the other point we should make, Steve, is that in the comparative period we were very active in both particleboard and MDF. That's where most of our trial activity was. And those trials are much more intensive in terms of equipment and people requirements because you're typically dealing with customers that are running UF today, and the changeover is fairly complex for them.

Today, the majority of trial activity is in OSB with customers that are used to using PMDI. The infrastructure's in place, the capabilities are there to do it, and it's a lighter trial from our side as well. So that's had a pretty significant on trial costs, which are booked to R&D.

Steve Arthur

Okay. No, that makes sense. Just final one kind of putting this together, G&A has been pretty steady for almost a couple of years now in this 1 million, 1.3 million kind of range. So if we put all that together, the R&D expense, the G&A, gross margins somewhere in the low 20s, that points to breakeven somewhere on the order of 8 million a quarter of revenues. Is that thought process and math kind of the right way to think about things?

Rob Haire

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Yeah. Steve, it is. I mean, if you kind of take our current cash base as OpEx, it's \$1.7 million in the quarter. We kind of—we look at it—we still see a little bit of optimization from a run rate perspective there I'm going to say in, call it, the \$1.5 million range on a quarter would be what I would say closer to being a normalized of where we're at today.

Steve Arthur

Okay.

Rob Haire

Extrapolate that out, \$6 million would be our OpEx a year and our margin can—we do see some upside from a margin perspective right now, especially if SB latex prices stay similar to the range that we saw in June; had another increase in July. So if you even use, let's say, a 25 percent margin, you're talking we can be at breakeven at a \$24 million would be the lower end of the range and then depending on some sensitivity on the margin side, somewhere closer to the number that you're at.

But that's why we're highly confident this stage that we do see near-term profitability in sight based on kind of where the business is at.

Steve Arthur

Good stuff. Thanks very much.

Rob Haire

That make sense?

Steve Arthur

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Yeah. No, that's great. That's the rough math I was working through and, yeah, it doesn't look too, too far away.

Rob Haire

Yeah. Thanks, Steve.

Steve Arthur

Thank you.

Operator

Once again, if you would like to ask a question, press *, then the number 1 on your telephone keypad.

Next question comes from Raveel Afzaal with Canaccord. Your line is open.

Raveel Afzaal — Canaccord

Morning. Thank you for hosting the call. Another question on R&D. Can you tell us, if you have these numbers handy, what percentage of R&D is mill trials now versus, say, Q2 '17, just as a percentage of total R&D expense?

Rob Haire

Yeah. So, Raveel—and good morning. Sorry, I'm just going to give you a proxy here, but I believe in the quarter, so year over year, it was approximately \$300,000 of savings came specifically from mill trials.

Raveel Afzaal

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Perfect. That's very helpful. Thank you. And then you mentioned new MDI supply should be coming online too. Do you know the timing of that? Is it coming online in 2019? Or are we thinking 2020?

Jeff MacDonald

Kind of staged, Raveel, and we're picking it up from what some of the public MDI suppliers have been saying in the last quarter. And the reason why it's staged, if you recall, building an MDI plant is quite an undertaking, and can take up to five years to bring capacity fully online. But there are de-bottlenecking opportunities within existing operations, and those can be from months to a year to a couple of years. So it's not a kind of binary you must wait for five years. And part of what the public MDI suppliers were announcing were some of those de-bottlenecking opportunities.

So it's staged. We do have some more detail that we can share with you from the public statements of the MDI suppliers, if that's helpful.

Raveel Afzaal

Yeah. I'll take that

Rob Haire

Just—sorry, Raveel, just I'll add on to that. I mean, we watch closely a couple of the very large public MDI suppliers, and effectively at the end of last year they were reporting sold-out capacity. By Q1, they were reporting the mid-90 operating percent rates. The last quarter, which just

came out about a week ago, they were reporting approximately 90 percent operating rates was the terminology that they were using.

So we are seeing a significant drop. And that has ... a 10 percent from an operating perspective in that industry has a huge impact on pricing and they move in a much tighter range, so we are seeing a big change over the last few quarters.

Jeff MacDonald

They continued to show charts that showed demand outpacing supply, and that's why they're announcing some of these supply additions.

Raveel Afzaal

Perfect. And just two more quick questions. Just from a strategy perspective then, if MDI prices come down going into 2020, then how do you allocate your resources between whether to focus more on the OSB market versus particle board market? How do you strategize which market to focus on?

Jeff MacDonald

I think we'll strategize based on where we see the opportunities pulling us. When MDI was in the 1,200 to €1,500 per tonne range, definitely the opportunities were more robust than MDF and particle board. And that's by far the bigger opportunity for us and where change is being demanded. So I would expect as we come down below 2,000, assuming it goes there, we're going to see more of that switch on.

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We did have, I'll say, a bit of a restart from an MDF supplier that's anticipating some change. And they've gotten back into a development agenda for NAF products that was essentially dormant for the last year. So we're starting to see it with some of the early movers, but I think it's probably got a crossover below the €2,000 per tonne mark before you see that in earnest.

Raveel Afzaal

Very good. And do you see—can you speak a little bit about the butadiene supply? It's in short supply right now. Do you guys see more supply coming online?

Jeff MacDonald

Well, part of what's caused the short supply, there have been a couple of force majeure events. And so those will be corrected. But at the same time, I think the more important factor over the last few years is just discipline in the supply of SB latex from the major players. They've taken capacity offline, given that paper has been a shrinking market for them. And they've managed pricing accordingly to the benefit of their bottom lines for any of them that you might follow; they've done quite well.

We've also seen one of the major players in the North American market basically withdraw from the paper market, and so that's obviously going to give some continued pricing strength to the other two major incumbents in that space.

So that's part of what gives us some of the optimism that this could continue for a bit.

Raveel Afzaal

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Perfect. Very helpful. Thank you so much.

Rob Haire

Thanks, Raveel.

Jeff MacDonald

Thank you, Raveel.

Operator

Once again, if you would like to ask a question, press *, then the number 1 on your telephone keypad.

We do not have any questions at this time. I will turn the call over to Mr. Jeff MacDonald.

Jeff MacDonald

Thanks again for joining us this morning, and look forward to checking in with you all again soon.

Operator

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

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