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CORPORATE PARTICIPANTS

David Scott Martin *Harsco Corporation - Director of IR*

F. Nicholas Grasberger *Harsco Corporation - Chairman President & CEO*

Peter Francis Minan *Harsco Corporation - Senior VP & CFO*

CONFERENCE CALL PARTICIPANTS

Huang Howe *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

Jeffrey David Hammond *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Robert Duncan Brown *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good morning. My name is Stephanie, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Harsco Corporation fourth quarter release conference call. (Operator Instructions) Also, this teleconference presentation and accompanying webcast made on behalf of Harsco Corporation are subject to copyright by Harsco Corporation, and all rights are reserved.

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I would now like to introduce Dave Martin of the Harsco Corporation. Mr. Martin, you may begin your conference.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you, Stephanie, and good morning, everyone, joining us. I'm Dave Martin, Vice President of IR for Harsco. With me today is Nick Grasberger, our Chairman and Chief Executive Officer; and Pete Minan, Harsco's Senior Vice President and CFO. This morning, we will discuss our results for the fourth quarter and the full year as well as our outlook for 2020. We'll then take your questions.

Before our presentation, however, let me mention a few items. First, our quarterly earnings release as well as the slide presentation for this call are available on our website. Second, we will make statements today that are considered forward-looking within the meaning of the federal securities laws. These statements are based on our current knowledge and expectations and are subject to certain risks and uncertainties that may cause actual results to differ materially from those forward-looking statements.

For a discussion of such risk factors and uncertainties, see the Risk Factors section in our 10-K. The company undertakes no obligation to revise or update any forward-looking statements. Lastly, on this call, we will refer to adjusted financial results that are considered non-GAAP for SEC reporting purposes. A reconciliation to GAAP results is included in our earnings release today as well as the slide presentation.

Now I'll turn the call over to Nick to begin his remarks.

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Thank you, Dave, and good morning, everyone. Our results for the fourth quarter were consistent with our previous guidance, and Pete will provide additional color in a few minutes.

My comments will focus primarily on our outlook for this year, and I will also reinforce a few of the key messages related to our planned acquisition of the Environmental Solutions business or ESOL from Stericycle.

For 2020, on a consolidated basis, we expect revenue and EBITDA to grow by mid- to high single digits, with the strongest growth in rail, followed by Clean Earth and Harsco Environmental or HE. Our guidance does reflect a cautious stance on the potential effect of the coronavirus outbreak on our HE and rail businesses. Even though we have yet to experience any meaningful direct impact.

I'll make a few comments on each segment. First, Harsco Environmental. Our Q4 results reflected the weakest conditions across our steel industry customers in the last 4 years. Volume was down nearly 10% year-over-year, and capacity utilization declined to 72.5%, the lowest figure since Q4 of 2015. Nevertheless, on a full year basis, the impact of new contracts and cost reduction measures enabled HE to hold revenues and profits about equal to 2018 and once again delivered double-digit profit margins.

We anticipate the weak market conditions to persist through at least the first half of this year with perhaps modest LST growth in the second half. Our growth drivers this year will again be new contracts, further cost reduction as well as gains from Innovation and Applied Products. While new contract growth opportunities in HE remained at a high level, our allocation of capital will become more balanced between HE, our Clean Earth segments and debt reduction.

So we will become even more selective on growth investments in HE. Finally, we have recently made several organizational changes in HE. I'm very excited to see what the team can accomplish this year.

Turning to Clean Earth. We expect the business to perform in line with our assumptions when we acquired the business last summer. If anything, internal growth opportunities are greater than we expected across all business lines. Those being hazardous waste, contaminated soil and dredge material. The integration of Clean Earth is also on track and should be completed later this year when the final IT systems are migrated to the Harsco systems.

Perhaps most importantly, the Clean Earth team is highly enthusiastic about both the strategic and financial merits of the pending combination with ESOL.

Concerning Harsco Rail, we anticipate a 30-plus percent increase in revenue, based heavily on our existing backlog and the expected boost in manufacturing capacity and productivity by the middle of the year. Since the revenue growth is weighted more towards the second half of the year, it's critical that we achieve these midyear milestones.

Let me provide a few more specifics. We have developed a robust plan we call SCOR or Supply Chain Operational Recovery. It incorporates the key elements required to fix our problems. These elements include top grading our operational leadership, which has been completed, reconfiguring the plant to expand the equipment slots from 18 to 34, outsourcing additional lower-value work to existing partners and implementing a manufacturing system to optimize material flow and reduce lead times.

All of these elements and others are currently being measured and tracked against the SCOR program, not simply to achieve the midyear milestones, but also to ensure that fixes are sustained. The entire Rail leadership team, together with Pete and myself are heavily engaged in this program. And at this point, I'm very confident in its successful execution.

Moving on to the ESOL acquisition. As you might imagine, there is a significant amount of work underway by both our internal team and our external partners to advance our planning to integrate the business and improve its financial performance. We have about 20 functional operational teams in place and reporting into our integration management office.

As stated, our goal is to double ESOL EBITDA to $70 million in 3 years and move the margins closer to those of Clean Earth over time. Recall that the ESOL margins today are around 6%, whereas the comparable Clean Earth margins are about 20%.

The primary value drivers in the near term will be returning visibility and accountability to the sites, quicker responses to bid requests, improved billing processes, optimize logistics and better vendor management. Both the Clean Earth team and our outside partners have tremendous expertise in these areas and are eager to get started, in partnership with our new ESOL colleagues.

So I'll now turn the call over to Pete.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Thanks, Nick, and good morning, everyone. So let's start with Slide 4 and our consolidated financial summary for the fourth quarter. Harsco's revenues totaled $400 million and adjusted operating income in the fourth quarter was $31 million. Both these figures are the same as the preliminary financial results we provided in January. This adjusted operating income figure compares with adjusted operating income of $27 million in the prior year quarter after excluding the Industrial businesses that we've now sold.

The majority of the variance against the original guidance in the quarter was attributable to our Rail segment, where we encountered shipment delays and higher operating costs as a result of manufacturing and capacity challenges following the consolidation of our manufacturing facilities in North America.

The remainder of the variance was due to the environmental segment were softer-than-expected services and product demand from our customers impacted the results. Steel output in our customer sites was roughly 6% lower than anticipated and declined approximately 9% compared with the fourth quarter of 2018. Furthermore, steel market pressures intensified late in the quarter, essentially a continuation of what was overall a challenging year for the industry. Against this challenging backdrop, we are encouraged that the business was able to maintain a 10% adjusted operating margin in the quarter, which is comparable with the prior year quarter.

Overall, we again believe that our performance, particularly later in 2019, illustrates the improvements we've made within this business in recent years, and it reflects positively on the growth investments we've made in environmental.

Meanwhile, Clean Earth had another strong quarter, consistent with our expectations. Revenues grew 20-plus percent year-on-year or 17% organically, and we delivered a 17% adjusted operating margin in Q4. Harsco's adjusted earnings per share from continuing operations for the fourth quarter was $0.12. This figure is adjusted for strategic costs related to our pending ESOL acquisition and a few other unusual items in the quarter.

Lastly, we generated $28 million of free cash flow in Q4, and we spent nearly $6 million to repurchase 349,000 shares of our stock in the quarter.

Now please turn to Slide 5 in our Environmental segment. Revenues totaled $243 million and adjusted operating income was $25 million, translating to a margin of just over 10%. Revenues and profitability were largely impacted by lower services demand, including the impact of exited sites.

Customer steel output was down meaningfully year-on-year, as I indicated earlier, with capacity utilization at our customer sites at roughly 72%. As Nick mentioned, this represents the lowest utilization level at our customer sites in 4 years and reflects that there was likely a meaningful amount of inventory destocking going on throughout the steel supply chain, while underlying demand was far more stable.

Steel producers decided to trim production as a result. These actions appear to have stabilized the markets, and we're hopeful will lead to a recovery in the coming quarters. The impact of exits is principally related to 2 sites in the Southern Hemisphere. One was a joint venture with a customer who exercised its option to exit the contract and purchase our equipment. The other exit was a site where the renewal metrics didn't meet our standards. The Applied Products impact was principally driven by a few businesses in North America, where lower volumes and commodity prices weighed on our performance.

These factors were offset by lower administrative expenses and other spending as we recognize the need to control costs given the external market conditions in the quarter.

Next, please turn to Slide 6 for Clean Earth. As noted, Clean Earth delivered another strong quarter with revenues up 22% and profitability nearly tripled. Clean Earth's organic growth rate in the quarter was 17% year-on-year, with volume growth most pronounced for contaminated and dredged materials. Business mix also favorably impacted Clean Earth's Q4.

The segment's adjusted operating margin in the quarter was 17%, as mentioned earlier, the highest among our 3 segments. Lastly, Clean Earth's free cash flow totaled $29 million in the second half of the year, with free cash flow conversion at approximately 80% of EBITDA. We believe this ratio illustrates an important and attractive financial characteristic of this business and the industry.

Now please turn to Slide 7 regarding our Rail business. Rail revenues were $75 million, up 8% over the prior year period due to higher equipment sales in North America and additional revenue on long-term contracts. Lower aftermarket and Protran volumes and a less favorable mix weighed heavily on earnings in the quarter.

These impacts also reflect the manufacturing issues we experienced, which delayed shipments and led to higher operating costs and lower cash flow in the quarter. The manufacturing or cost impact is included in the other category in the bridge on the slide. Also, contributions from our rail contracting business, which can be lumpy at times were modestly lower.

Very importantly, on Rail, let me comment on backlog, which illustrates the positive strategic and commercial momentum we're seeing in this business. Rail backlog totaled $447 million at the end of the year, which is another record for us. This total is up approximately 20% quarter-on-quarter and 50% year-on-year, with the sequential increase attributable to equipment orders in Europe, India, Brazil and Japan.

Our rail backlog has now more than doubled since the beginning of 2018 and has steadily climbed over time as a result of product innovation and penetration in new markets and new customers. This backlog provides us with significant visibility for 2020 and 2021 and provides confidence in our growth plans for this business.

Now, as Nick mentioned, we are very disappointed with the recent operational developments within Rail, so against the background of strong and growing demand, our manufacturing footprint and expanded workforce in South Carolina did not execute up to our standards after the facilities consolidation. But we've moved quickly and are taking decisive action to improve the situation. Our biggest challenge is physical space or capacity, and Rail is focused on reorganizing its manufacturing workflows, strengthening its shop for leadership and incentives and improving processes with a goal of optimizing production later in the year. And as Nick mentioned, we are confident the plans we have in place will drive improvement in the coming quarters.

Turning to Slide 8, which is the high-level summary of our full year 2019 results. The data on this slide is presented on a continuing business basis, that as it excludes our now divested Industrial businesses. If you were to include Industrial for the first half of the year, our adjusted earnings were down only modestly. Strong results for Clean Earth offset a large portion of the steel market and foreign exchange rate pressures on Environmental and the Rail operating challenges.

As a result, our operating -- adjusted operating margin was stable at approximately 11% for the year.

So now let me discuss our segment outlook for 2020 on Slide 9. First, the high-level point is that each business is expected to show improvement compared with 2019. And please note that we'll now be guiding to EBITDA as opposed to operating income, consistent with many of our peers.

So starting with Harsco Environmental, revenue and EBITDA is projected to increase low single digits as a result of new contracts and products growth. We also expect to benefit from some improvement on restructuring savings during the year. We are not anticipating much tailwind from the steel industry. Although market fundamentals likely touch bottom a couple of months ago, and one of our major customers is pointing to a more normalized growth rate for the industry in 2020.

Next, for Clean Earth, we are guiding to EBITDA of $50 million to $55 million for the year. However, we are actually planning to do better than the midpoint of this range. The high end of this range is up low teens year-on-year versus pro forma 2019 with underlying organic volume growth in permit modifications to process more medical and consumer waste being the primary drivers. Note that our Clean Earth outlook does incorporate a corporate cost allocation of $5 million for 2020, but this growth rate I mentioned is on a like-for-like basis.

For Rail, we are expecting 30% top line and 30% earnings growth, reflecting our strong backlog and some shipment delays from Q4. For the year, higher equipment and technology sales will offset the impact of weaker parts mix and investments in research and development. We expect to resolve our operating or capacity challenges in Columbia, South Carolina by the end of the first half. And lastly, corporate costs are anticipated to be within a range of $26 million to $29 million.

So turning to our consolidated 2020 outlook on Slide 10. Our adjusted EBITDA is expected to be within a range of $280 million to $310 million. This compares with pro forma EBITDA in 2019 of $283 million, which includes the effects of Clean Earth for the full year and excludes Industrial for the full year. This range also reflects some consideration for recent external developments such as the coronavirus and foreign exchange fluctuations, primarily against the euro. This EBITDA guidance translates to earnings per share of $0.84 to $1.12 per share.

The EPS range contemplates nonoperating pension income of $7 million, interest expense of $49 million to $51 million and effective tax rate of 28% to 30%. Lastly, free cash flow is projected to be between $10 million and $40 million, including growth capital spending of roughly $70 million and total CapEx within a range of $170 million to $180 million.

I should point out here that we are continuing to exercise strict discipline over capital spend this year. Despite our pipeline of opportunities growing significantly, particularly in Environmental, we are keeping gross CapEx spending to the same level as last year, selecting those projects which best meet our strategic and financial standards.

The improvement in free cash flow during the year will principally be driven by working capital in Environmental and Rail, where some of the pressures on Q4 free cash flow are expected to ease and/or reverse as well as higher cash earnings.

So let me conclude on Slide 11 with our first quarter guidance. Q1 adjusted EBITDA is expected to range from $43 million to $48 million. The range contemplates that Environmental results will be lower year-on-year as a result of lower services demand, foreign exchange translation and site exits. Rail results are also expected to be lower year-on-year, given the lumpy nature of this business and a less favorable mix compared to the prior year quarter. Though the results should improve on a sequential basis compared with Q4. And Clean Earth is projected to show strong double-digit growth in revenues and EBITDA as a result of underlying volume growth and a more favorable mix. Clean Earth's results will be lower on a sequential basis compared with Q4, given the normal seasonality of this business.

Lastly, let me comment on phasing. As you'll likely conclude, we expect our results to strengthen as the year progresses. The factors to consider regarding the phasing, include the seasonality of both Clean Earth and Environmental, the impact of growth investments in the maturing of new sites in Environmental and that Rail's manufacturing efficiency will continue to be constrained until the second half.

So that concludes our prepared remarks, and I'll now turn the call back to the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Chris Howe with Barrington Research.

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

Just moving through some of my questions here. If we look at the time period since you released preliminary Q4 results until now you had mentioned the different buckets and the different operational improvements that are happening at the facility in South Carolina. Is the conservative assumption to assume that, that facility is back up and running and running to your expectations by midyear? In other words, could this be back up and running sooner? Or is it right to think about midyear only?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Chris, I believe that the midyear assumption is appropriate. There's an awful lot to do, again, indicate and express my confidence that we will, in fact, get it done. But I think to assume anything earlier than midyear is inappropriate.

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

Okay. So yes, given the improvements being made there in combination with your expectations for rail, it seems like that could line up for a good 2021, not to be too forward-looking. But going more on Rail, my next question, can you talk more about what you're seeing in regard to the aftermarket mix? You had mentioned that the aftermarket mix was part of some of the weakness. But I assume aftermarket is still expected to grow positively in fiscal year '20 and beyond. Can you talk more about that?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Yes, that's right. The backlog commentary that Pete provided, the growth in the backlog is primarily driven by equipment. Now we still do expect the aftermarket business to grow about 10% top line this year. So still very good growth, whereas the growth in equipment is 40%, 50%. So that's driving the mix.

Huang Howe - *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*

Okay. Okay. And then as far as Protran, that's still going to continue to be a substantial growth driver moving forward. What are your expectations for Protran as far as how it winds up as a portion of the mix in 2020?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Again, I think the Protran top line growth should be well over 10% as well. A few of the large orders that were expected in Q4 that have been pushed out are in the guidance for this year.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes. So Chris, this is Pete. The Protran revenues in '19 are about $12-or-so million. We're probably going to do twice that in 2020 at the top line, it's obviously a very small base, but it will grow substantially.

Operator

Your next question comes from the line of Jeff Hammond with KeyBanc Capital Markets.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Just on Clean Earth, can you just talk about the mix dynamic that's holding back the margin drop through? And then I'm just wondering why corp ex, corporate expense and overall is going up if you're shifting, $5 million to Clean Earth?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes, let me take the second question first, Jeff, it's Pete. So in terms of corporate, it's really a combination of a couple of things. There's some growth investment that we're making in corporate. There's also some additional compensation in the comp comparison to last year that's driving most of it. There's a very little amount of other stuff, but it's a combination of new positions, some comp increases compared to last year and growth investments. In the case of Clean Earth, the mix really is a combination of the 3 business lines. So we've got contaminated dredge and hazardous. And in '19, the mix in hazardous had a couple of operations with respect to mobile units that were very, very good margins. They're going to be online in this year as well, but they're going to be at a slightly lower margin. So the composition between -- or among the 3 business lines is really what's driving it. Dredges increasing a bit. And as you know, dredge has a lower margin than Haz. and the contaminated business will grow as well. It's just a combination of those.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay. And then free cash flow, can you just talk about what you think working capital is going to be because it was a pretty big drag in '19? And it looks like you're keeping your growth CapEx flat. Is there any expectation that, that ends up being a high number and you pull back some of the growth CapEx?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes. So the working capital, we had some challenges in working capital really in Q4 and really in the last month of Q4, really in 2 areas. One, the biggest, by far, was related to the operational challenges we had in Rail, which affected our inventory levels that were -- ended up being higher than we wanted them to be. It kind of delayed some of the sales into later in the month, so we didn't get some of the billings out that we wanted to. So the combination of that had a very significant effect on our working capital, which we think we've got under control and intended to see that reverse itself in 2020.

In the case of HE, we also struggled with working capital. But in that case, it was largely related to receivables that our customers held back on the last couple of days of the year, and we ended up receiving a good portion of the -- these deferred collections, if you will, in early January. Nice level to continue for the year, but we've got strategies in place to kind of manage that as well as manage the vendor payments to help.

In terms of CapEx, the expectation, just as you laid it out. Right now, we're targeting to keep gross CapEx spend flat including -- well, that's not just HE -- HEs, the bulk of it, but there's a little bit in Rail as well. But by and large, there's really no intention to move that even though the pipeline of opportunities is greater. We're going to be selective to identify those that best achieve our desired metrics.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay. And then just one on ESOL. I was kind of going through some of the conference calls, et cetera. And it seems like their Industrial business, which I think flows through hazardous still had been pretty cyclical, and there were some large projects. And I think you characterized your hazardous business is less cyclical. So I'm just trying to understand maybe what's different there? And then they also talk about direct disposal costs. And I think Clean Earth doesn't really do any direct disposal. So can you just kind of address those 2 dynamics on the ESOL business?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Yes. So I'll take the second question first. Actually, ESOL and Clean Earth, have a very similar dynamic with respect to disposal, right? They -- neither business owns final disposal assets. So they both need to contract with them for the ultimate disposal of what's processed through their TSDFs. So there's not much of a difference there between the business model on the 2. With respect to the so-called M&I or Industrial component of hazardous waste. It is true that in Clean Earth, it's really not lumpy as we did our diligence on ESOL. There was a little bit more lumpiness. But again, I think that's something that we would hope to address in our operational improvement initiatives.

Operator

Your next question comes from the line of Rob Brown with Lake Street Capital.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Stick with ESOL, maybe you could just give a sense, Clean Earth has had very strong growth in the quarter, but I think ESOL is growing much more slowly. Could you kind of reconcile why the difference there? And can you get ESOL's growth improving? And what's sort of the plans there?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Sorry, Rob, can you repeat that? I didn't catch all of that for some.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Yes. Sorry. Just wanted to kind of get a sense of what you think the growth rate in ESOL can be and Clean Earth seem to have a pretty strong growth rate. Can you get ESOL's growth rate improving? And what's sort of your plans for growth in the Clean Earth business overall?

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

Yes. So as Nick mentioned, the ESOL business is very similar to the Clean Earth business that we own, as you know, in terms of their business dynamics. They've got some elements that are different and some expanding -- expanded markets that we don't have at Clean Earth but I think the expectation is that we should achieve similar organic growth rates in ESOL, maybe even slightly better than what we're currently experiencing in Clean Earth, which is roughly high single digits. Clean Earth has been consistently achieving those -- that type of organic growth rate over the last few years, and we think that there's clearly the opportunity to deliver that same degree of growth in the acquired ESOL business once we get it on board.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, great. And then switching to rail, thinking through the backlog growth there, what's sort of your expectation in 2020? Should you see a continued strong order flow there? And maybe comment on the capacity that you'll have, once you get the operations fixed and how that backlog growth sort of fits into that capacity?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Yes, we certainly do anticipate the backlog to continue to grow. In fact, I mentioned some key milestones from a capacity standpoint by midyear. We have other targets for the end of this year to accommodate the backlog going into 2021, which was pointed out earlier, should be another quite strong year for the rail business. So we need to continue to expand capacity really throughout the year to accommodate that backlog for '21.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. All right. And can you kind of mention what would your capacity be exiting '20? Do you have a number?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Well, we look at it primarily from equipment perspective and the number of slots available in the plant for machines. And I think we're at about 18 now, we need to try to get to around 30 by midyear and something closer to 40 by the end of calendar 2020.

Peter Francis Minan - *Harsco Corporation - Senior VP & CFO*

So if I may add, Rob, it's Pete, just in terms of kind of the financial equivalent, basically, when we're successful in addressing the matters that we described under Project SCOR, we feel confident that the capacity will be adequate -- more than adequate to deliver the long-term revenue targets that we put out.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. Great. That's helpful. And then on China, and I guess, the coronavirus, what -- you kind of mentioned that as some -- a bit of a headwind. What are you sort of expecting there? What's the risk points and exposure?

F. Nicholas Grasberger - *Harsco Corporation - Chairman President & CEO*

Well, of course, it's very difficult to say. We -- our revenue in China is really derived from 2 primary steelmaking facilities. At this point, they have not reduced their production. But my understanding is that we're seeing inventory levels -- steel inventory levels in China increase. And so it wouldn't surprise us if at some point this year, there are some production cutbacks, but they've not been discussed with us by our customers, and we're certainly not seeing any impact now. We just see the potential for that being the case.

Operator

Thank you. This concludes today's conference. You may now disconnect.

David Scott Martin - *Harsco Corporation - Director of IR*

Thank you. Have a good day.
