31-Oct-2018

NACCO Industries, Inc. (NC)

Q3 2018 Earnings Call

CORPORATE PARTICIPANTS

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

OTHER PARTICIPANTS

Mitchell Lolley
Analyst, Nixon Capital LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Marcela, and I will be your conference operator today. At this time, I'd like to welcome, everyone, to the NACCO Industries' Third Quarter 2018 Earnings Conference Call. [Operator Instructions] Thank you. Christina Kmetko, you may begin your conference.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

Good morning, everyone, and welcome to our 2018 third quarter earnings call. I am Christina Kmetko, and I am responsible for Investor Relations at NACCO Industries. I will be providing a brief overview of our quarterly results and business outlook, and then, I will open up the call for your questions.

Joining me today are J.C. Butler, President and Chief Executive Officer of both, NACCO and North American Coal; and Elizabeth Loveman, NACCO's Vice President and Controller. Yesterday, we published our third quarter 2018 results and filed our 10-Q. Copies of our earnings release and 10-Q are available on our website at nacco.com. For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.

As we begin, I would like to remind participants that this conference call may contain certain forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements made here today in either our prepared remarks or during the following question-and-answer session.

We disclaim any obligation to update these forward-looking statements, which may not be updated until our next quarterly conference call, if at all. Additional information regarding these risks and uncertainties were set forth in our earnings release and in our 10-Q.

Now that I have the formalities done, let me provide the highlights for this quarter.

Our revenues increased 43.3%, $31.4 million from $21.9 million in last year's third quarter. Our consolidated income from continuing operations before tax increased 78.9% to $10.7 million, up from $6 million in 2017. And, finally, our consolidated income from continuing operations increased $9.2 million or $1.33 per share for the third quarter of 2018, compared with $3.3 million or $0.49 per share last year.

Our year-to-date effective income tax rate was 12.7%, just above the range we provided previously. As the majority of our consolidated results and all of our revenues are derived from our North American Coal business, I'll explain the reasons for these increases by explaining what happened to that business.

At North American Coal, coal deliveries increased to 10.5 million tons in the third quarter of 2018 from 9.9 million tons last year. Limestone deliveries at our North American Coal – North American Mining division also increased to 8.8 million yards from 6.4 million yards in the third quarter of 2017. Increased tons delivered at Mississippi Lignite Mining Company, our consolidated coal operation, was the primary driver of the revenue increase.

During the third quarter, North America Coal's pre-tax income increased to $12 million from $8.2 million in the prior-year third quarter. This increase was also primarily attributable to an improvement in Mississippi Lignite Mining Company's results due to the increase in tons sold.

Higher royalty income as well as an increase in earnings of the unconsolidated operation and reduced interest expense also contributed to the higher pre-tax income, but were partially offset by an increase in employee-related costs.

Looking forward in the fourth quarter of 2018, we expect our consolidated pre-tax income to increase substantially compared with the prior-year fourth quarter even though the 2017 fourth quarter included $1.6 million of gains on sales of assets that are not expected to be repeated in 2018.

We expect improvement as a result of anticipated lower employee-related costs and modest improvements in our consolidated operations, excluding Centennial. These improvements are expected to be partially offset by a decrease in royalty income and an increase in Centennial's pre-tax loss.

At our consolidated operations, Mississippi Lignite Mining Company's pre-tax income in the 2018 fourth quarter is expected to improve over the prior-year fourth quarter, but be significantly lower than this quarter. The fourth quarter year-over-year improvement is primarily because of anticipated increased volume as customer demand in the 2018 fourth quarter is expected to be higher than in the prior year. Also as a result of Mississippi Lignite Mining Company's strong third quarter, and additional improvements expected in the fourth quarter, provided customer demand is at expected levels, full year 2018 pre-tax income at Mississippi Lignite Mining Company is expected to increase compared with 2017. We also anticipate results at our North American Mining consolidated operations to increase in the fourth quarter, mainly due to an anticipated increase in customer requirements.

In the prior year fourth quarter, Centennial had a $2.4 million favorable reduction in its mine reclamation liability, partially offset by an unfavorable $1 million asset impairment charge. Including these items, Centennial's pre-tax loss increases year-over-year. But excluding them, Centennial's pre-tax loss is expected to be comparable to the 2017 fourth quarter.

Earnings at our unconsolidated operations are also expected to be comparable in the 2018 fourth quarter, compared with the prior year.

The expected decrease in royalty income is the result of the absence of a $1.2 million lease bonus payment that was received in the prior year fourth quarter. Excluding this item, we expect fourth quarter royalty income to be comparable to 2017.

The combination of these factors are expected to result in an overall increase in our 2018 full year consolidated pre-tax income from continuing operations when compared with 2017. We are anticipating an overall effective income tax rate in the range of 11% to 14% for the full year. This compares with the very low effective income tax rate of 2.2% last year as results in the 2017 fourth quarter and full year included tax benefits of $4.5 million and $3.1 million, respectively, related to U.S. tax reform.

As a result of the increase in the effective income tax rate and the absence of tax reform benefits, we expected consolidated income from continuing operations in the fourth quarter of 2018 to decrease substantially from the fourth quarter of 2017, but increase modestly for the 2018 full year compared with the prior year.

To wrap up 2018, we expect consolidated cash flow before financing activities to be lower in the fourth quarter and full year compared with prior year periods, primarily due to an increase in capital expenditures.

Now let me provide a high level look at what we expect for 2019. While we are providing this first look at next year, I'd like to remind you that we are currently going through our detailed annual operating planning process and we will provide more color on 2019 with our year-end earnings once we have finalized our annual operating plans.

Pre-tax income in 2019 is expected to increase primarily as a result of anticipated higher royalty income and improved results at our consolidated coal mining operations. Similar to our full year 2018 expectations, the 2019 effective income tax rate is expected to be in the 11% to 14% range.

We generate revenue from royalty-based leases, under which the lessees make payments to us based on the sale of oil, natural gas and to a lesser extent, coal, extracted primarily by third parties. We are expecting an increase in this revenue stream in 2019 based on the likelihood of a significant increase in the number of gas wells being developed and operated to extract the company's oil and gas assets, specifically in Ohio, and the expected continuing development of infrastructure.

In the past, we have not gotten this detailed about royalty, because of the uncertainty of this revenue stream. Whether or not this increase occurs depends on a number of factors outside of our control, which we have outlined in more detail in our earnings release.

In addition to the increase in royalty, we also expect improvement at our consolidated coal mining operations. These improvements are primarily from an anticipated increase in customer demand and volumes in 2019 at Mississippi Lignite Mining Company compared with this year.

Cash flow before financing activities is also expected to increase in 2019, compared with this year and capital expenditures are expected to be approximately $19 million next year.

Lastly, regarding our balance sheet, we ended the third quarter with consolidated cash on hand of $83.1 million and debt of $17.5 million. This compares with consolidated cash on hand of $101.6 million and debt of $58.1 million at the end of 2017. The decrease in cash was tied to the reduction in debt.

Also during the third quarter, we repurchased approximately 8,700 shares of our Class A common stock for an aggregate purchase price of approximately $200,000 under our $25 million stock repurchase program. Since the beginning of our program in February 2018, we have repurchased a total of approximately 10,400 shares for an aggregate purchase price of $300,000.

That concludes my prepared remarks. I will now open up the call for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Mitchell Lolley from Nixon Capital. Your line is open.

Mitchell Lolley
Analyst, Nixon Capital LLC
Q

Hi there.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.
A

Good morning, Mitchell.

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Good morning.

Mitchell Lolley
Analyst, Nixon Capital LLC
Q

It looks like you'll spend just north of about $40 million on SG&A this year. And I was wondering, is that a reasonable run rate looking into 2019, or are there still some maybe spend-related or employee-related costs that could roll off next year and cause SG&A to come down slightly?

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

No. It's – I mean, there is – looking at the LTM numbers, there is a little bit of noise in there, but there's kind of both sides of it. There's some noise from additional expenses, but we also collected some transition service fees while we were helping Hamilton Beach get up and running as an independent public company. So, that's probably close to a wash, maybe even slightly negative in a net basis. But it's not an off base run rate if you think about it.

Mitchell Lolley
Analyst, Nixon Capital LLC
Q

Okay. And then if I just think about SG&A a little more broadly, something I've been wondering about is, are there any costs related to the unconsolidated mining operations that get included in your SG&A for legal, accounting, or other reasons?

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Well there's no direct cost related to any of the mines that are in the SG&A number. Anything that's related to producing coal at the mines, and happens at a mine site, is included there. Every one of the mine sites has got a Mine President, it's got a Business Manager, it's got HR staff, IT people, all that's on-site at the mines and that's all included in their cost.

At a corporate level, I guess starting at the top, we've got public company costs, including Board of Directors, and public filings and all that sort of stuff. We also maintain sort of a centralized headquarters hub that's required for all these mines. It's part of the arrangement that we have in all these contracts. So, we maintain an IT hub, we maintain centralized HR and benefits. Oversight is what I'd call it.

It's really the folks that put the overall master programs in place. The cost of which, including health care and all that stuff, is billed to the mine sites and it's included in the reimbursable costs from the customers.

So it's really those headquarters kinds of expenses, IT, benefits, tax, because we file consolidated tax returns. Consolidated legal, business development, all those things are included in that number, but nothing that's related to producing coal at the mine sites.

Mitchell Lolley
Analyst, Nixon Capital LLC

Q

Okay. I appreciate the early commentary on 2019, including the CapEx figure that I think you threw out there, which was about $19 million of expected spending next year. And I was wondering if you could help us kind of unpack some of the things that you're thinking you'll be spending on in 2019? And are some of these related to growing the limestone business?

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well the places where we incur CapEx that's on our nickel, which is what's in that number for 2018, 2019, and every other year, are things that we spend at MLMC that are related to periodic equipment replacements, land acquisitions, things that we need for that one consolidated mine, anything that we might need at headquarters, if we end up swapping out computer systems that get capitalized, or things like that'll show up in there.

And then the other place is growing mostly North American mining, which is our primary growth platform right now. We, from time-to-time, have done things like we have acquired some drag lines that we've sort of put in inventory, because we know those are very helpful to have as we're negotiating contracts with new customers. They'll find themselves short on production, then maybe have a drag line that's too small, or it's in disrepair. And if we have a drag-line available we can bring it in pretty quickly and help them get up and running. And in doing so, really helps us get a new contract and help a customer in the process. So from time-to-time we do spend money on those sorts of things.

Mitchell Lolley
Analyst, Nixon Capital LLC

Q

All right. And then lastly, I've got to ask you, I mean you've got more than $9 a share of net cash on the balance sheet, and you pretty much continue to just generate cash every quarter. Would you ever consider paying a special dividend, even if only a modest one of like $1 a share?

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well, we talk about what we will do pretty regularly with our Board. I don't want to speculate on what decisions we might make in the future with respect to any of that. I guess I'd just go back to what we talked about with respect to capital allocation, both during the road show what we did at the NACCO level around the time of the Hamilton Beach spin a little over a year ago.

And as well as it's the same thing we've said in our recent investor presentations on our website, our priorities for cash are really to invest in strategic growth initiatives. We do think there's continued opportunities for us to grow in the coal space, and we're going to continue to spend money and resources in order to do so.

That's mostly with respect to business development. It's not so much with respect to me saying I'm looking for a coal mining company to buy, I don't know if anybody out there really fits our business model. The other place where we're – as you know we're growing pretty aggressively is in North American mining. I mentioned the expenditures that we're making with respect to drag lines, we're also investing pretty heavily in business development activities there as well.

Our second priority was to invest in complimentary ventures, really primarily focused on those that leverage our skills and strengths. Our primary focus right now is in the environmental area. I think we're going to talk more about that in the future as that business develops, but we see some opportunities to diversify into related activities that aren't necessarily directly tied to coal mining.

As you've seen the last quarter, we paid down a lot of debt. We think it's important to have a pretty conservative balance sheet since fundamentally we're a service business. Given the historical troubles in the industry, I want to make sure when we go talk to new customers that we can represent to them that we're in solid financial shape and they don't have to worry about our financial stability.

I know from experience that that's an important thing for us, so I both tell them that we are going to be conservatively leveraged and we're going to maintain that way and I'm not going to do anything to screw that up. So, having a conservative balance sheet is important.

And then as you know, we've paid a pretty consistent dividend over a very, very long period of time and we've had a number of share buyback programs in place and we currently have one that's active. I mean, that's just, I guess, what I'd say about capital allocation and how we think about using our resources.

Mitchell Lolley
Analyst, Nixon Capital LLC

Q

All right, well, thank you very much. I appreciate it.

John C. Butler
President, Chief Executive Officer & Director & President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Sure. Thanks for the question.

Operator: [Operator Instructions] There are no further questions. I turn the call back over to the presenters.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

Thank you very much. We appreciate your interest and if you do have any additional questions, you can reach me at 440-229-5130. That ends our part of the call.

Operator: The recording for this call will available at 11:30 Eastern Standard Time. Please dial in at 800-585-8367 or 855-859-2056 and enter conference ID 7797851 to listen. This recording will be available until November 7th. This concludes today's conference call. You may now disconnect.