

31-Oct-2019

# NACCO Industries, Inc. (NC)

Q3 2019 Earnings Call

## CORPORATE PARTICIPANTS

Christina Kmetko

*Investor Relations Consultant, NACCO Industries, Inc.*

John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

---

## OTHER PARTICIPANTS

Andrew M. Kuhn

*Analyst, Focused Compounding Capital Management*

---

## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning. My name is Brandy and I will be your conference operator today. At this time, I would like to welcome everyone to the NACCO Industries Third Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. [Operator Instructions]

Thank you. Ms. Christina Kmetko. You may begin your conference.

---

Christina Kmetko

*Investor Relations Consultant, NACCO Industries, Inc.*

Thank you. Good morning, everyone, and welcome to our 2019 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 2019 results and filed our 10-Q. Copies of our earnings release and 10-Q are available on our website. For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.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 let me discuss our 2019 third quarter. I will cover our consolidated results first and then provide the highlights for each segment. On a consolidated basis, although revenues increased to \$32.6 million from \$31.4 million in the

prior-year third quarter, our third quarter 2019 operating profit decreased to \$8.7 million from \$10.5 million a year ago.

Despite the decrease in operating profit, consolidated net income increased to \$10.3 million or \$1.47 per share, up from \$9.2 million or \$1.33 per share last year. The improvement in net income was mainly due to the receipt of a \$2.7 million pre-tax payment associated with a prior India venture. This payment was reported on the income statement below operating profit within other income. For the year-to-date period, our effective income tax rate was 14.1% compared with 12.7% in 2018.

Reduced operating profit at both our Coal Mining and North American Mining segments contributed to the operating profit decline. This decline was partly offset by higher earnings at our Minerals Management segment, as lessees operated more wells on our Ohio mineral reserves resulting in an increase in the amount of royalty income received.

At our Coal Mining segment, the operating profit decrease was mainly due to a reduction in the earnings of our unconsolidated operations and higher employee-related costs including an increase of \$700,000 to the estimated noncash equity component of incentive compensation, which was driven by the significant increase in our stock price during the third quarter. The decrease in the unconsolidated operations earnings was primarily because of fewer coal tons delivered as a result of customer plant outages.

At our North American Mining segment, we reported an operating loss this quarter compared with modest operating profit in last year's third quarter. The third quarter loss was primarily driven by higher employee-related and business development costs. Those are the significant factors affecting the third quarter results.

Now, let me turn to our outlook. I will provide some insight on our expectations for the fourth quarter and full-year 2019, as well as provide a high-level overview of our current expectations for 2020. While we are providing this first look at 2020, more color on 2020 will be provided as part of the fourth quarter and full-year 2019 earnings release as we are still finalizing our 2020 annual operating plan.

At the Coal Mining segment, we expect overall deliveries to decrease in the fourth quarter and for the 2019 full-year from prior-year periods. This decrease is the result of anticipated changes in customer requirements, including the timing and duration of power plant outages, as well as comparisons to historically high delivery levels experienced last year at certain of the unconsolidated operations.

As mentioned in previous quarters, in the fourth quarter of 2018, we received a \$3 million contractual settlement and recognized \$1.8 million in favorable adjustments to mine reclamation liabilities. Excluding these favorable prior-year items, we expect fourth quarter 2019 operating profit to increase modestly because of a reduction in operating expenses and improved results at our consolidated operations. However, lower income at the unconsolidated Coal Mining operations resulting from the reduction in tons delivered is expected to partially offset these improvements.

For the 2019 full-year and excluding the favorable 2018 items, operating profit at the Coal Mining segment is expected to decrease as anticipated lower income at the unconsolidated operations from reduced customer requirements and higher operating expenses are expected to be only partially offset by improved results at the consolidated operations.

Looking into 2020, we expect coal delivery to increase compared with 2019 primarily at the unconsolidated operations because of an expected increase in customer requirements. Our customers are forecasting a

reduction in planned power plant outage days in 2020. We expect 2020 Coal Mining operating profit to increase substantially over 2019, predominantly in the first half of the year. This anticipated increase is mainly because of an expected significant increase in income at the consolidated operations in the first half of the year and an improved earnings at the unconsolidated Coal Mining operations throughout 2020.

To provide more clarity, we have disclosed capital expenditures by segment. In the Coal Mining segment, we expect capital expenditures to be \$7.4 million in the fourth quarter and \$13.9 million for the full-year. In 2020, we expect capital expenditures to be approximately \$30 million. Elevated levels of capital expenditures are expected through 2021 primarily as a result of spending at Mississippi Lignite Mining Company associated with the development of the new mine area.

At our North American Mining segment, we expect operating profit in the 2019 fourth quarter to be significantly lower than the prior-year quarter primarily due to the absence of a \$600,000 gain on the sale of assets recognized in the 2018 fourth quarter. While down from the prior year, fourth quarter operating profit is expected to improve over the results in each of the first three quarters of 2019. That said, we expect North American Mining's full-year results to decrease compared with last year as the improved fourth quarter results will not offset the cumulative losses incurred in the first nine months of this year. We expect 2020 full-year operating results in North American Mining to improve significantly over this year as the results are expected to benefit from earnings associated with new limestone mining contracts.

With regard to business development, we are pleased to report that North American Mining, through a new subsidiary, Sawtooth Mining, entered into an agreement to serve as the exclusive contract miner for the Thacker Pass lithium project in Northern Nevada. Thacker Pass, which is 100% owned by Lithium Nevada Corp., is believed to be the largest known lithium deposit in the United States.

Sawtooth will design, construct, operate, and maintain the Thacker Pass surface mine, which will supply Lithium Nevada's lithium-bearing claystone ore requirements. The mining agreement provides that Lithium Nevada will reimburse Sawtooth for its operating and mine reclamation costs and pay Sawtooth a management fee per metric ton of lithium delivered during the 20-year contract term. Lithium Nevada estimates that it will secure all major permits by the end of 2020, commence plant construction in 2021, and commence production of lithium products in 2023. More details are available in our earnings release, but at this time, we are limited in the information we can provide as this project is still in its early stages.

We expect capital expenditures at North American Mining to be \$6.7 million in the fourth quarter and approximately \$13 million for the full year. In 2020, we expect capital expenditures of \$10 million. These expenditures are primarily for the acquisition, relocation, and refurbishment of draglines.

Our Minerals Management segment's operating profit increased significantly during the first nine months of the year. In the fourth quarter and in the full year, we expect operating profit to decrease from the prior-year periods. The 2020 decrease is expected to occur primarily in the first half of the year as comparisons are made to historically high earnings levels in the first half of 2019.

These decreases are based on natural gas price expectations and the natural production decline that occurs during the life of a well. New wells have high initial production rates and follow a natural decline before settling into a relatively stable long-term production. Decline rates can vary due to factors like well depth, well length, formation pressure, and faculty design. Also, as we mentioned in the earnings release, it is important to note these expectations for royalty income are dependent on a number of factors outside of our control.

To summarize, overall, we expect both consolidated operating profit and consolidated net income in the fourth quarter to decrease significantly compared with the prior year mainly because of the favorable prior-year items I've already discussed. Excluding these favorable items, operating profit is expected to decrease. However, despite this decrease, net income is expected to increase primarily due to an anticipated lower effective income tax rate in the 2019 fourth quarter compared with last year.

As a result of the strong favorable results in the first nine months of 2019, we expect the full-year consolidated net income to increase significantly compared with last year. We are also forecasting an effective income tax rate excluding discrete items of approximately 15%.

Finally, we expect 2020 consolidated net income to decrease moderately compared with this year primarily in the first half of 2020. The full-year effective income tax rate for 2020 is expected to be between 10% and 12% excluding discrete items.

Before I open up the call for questions, let me quickly provide some balance sheet and cash flow information. We ended the third quarter with consolidated cash on hand of \$115.1 million and debt of \$7.7 million. With regard to cash flow, we expect our fourth quarter 2019 consolidated cash flow before financing activities to be substantially lower than in the prior-year quarter. However, despite the fourth quarter decline, we expect full-year 2019 cash flow before financing activities to increase over 2018. In 2020, we expect cash flow before financing activities to result in a modest use of cash as a result of anticipated increased capital expenditures and payment of deferred compensation and other payroll liabilities.

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

## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] And your first question comes from the line of Andrew Kuhn with Focused Compounding.

Andrew M. Kuhn  
*Analyst, Focused Compounding Capital Management*

Q

Hey, guys. Thanks for taking my call.

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

A

No problem.

Andrew M. Kuhn  
*Analyst, Focused Compounding Capital Management*

Q

So – yeah. So, 2020 is going to be a year of higher-than-normal CapEx. So, I'm kind of curious, what does a normal CapEx year look like? Looking past the next two years of higher CapEx, would you expect most years from 2022 on to be the same dollar amount of CapEx,? Would you expect 25% less CapEx, 50% less CapEx? I'm kind of curious for some clarity on that.

John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

A

So, this is J.C. Butler. The – and thanks your question. So, CapEx is driven really by what's going on at our consolidated Coal Mining operations and North American Mining, at least as it – as we're organized today. Any CapEx that happens in our unconsolidated mines doesn't show up in our CapEx line because it's funded by the customers.

So, when you think of those groups, what's driving higher CapEx right now is moving into a new mine area at MLMC, our main consolidated mining operation. That's going to go on, I think we say in there, for a couple of years. Started in 2019, it's going on in 2020 and 2021, and then it's going to drop back to levels that are more consistent, at least at that operation with what we'd seen in prior years.

Now, I've got to caution you that the equipment that you use at a mine site is big stuff, and it periodically has to be replaced. So, you can go along at a "normal level" and then come up on a year when it's time to replace a couple haul trucks, and that can cost \$8 million, \$9 million, \$10 million to replace that equipment.

Andrew M. Kuhn

*Analyst, Focused Compounding Capital Management*

Q

[ph] Sure (14:15).

John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

A

So, I don't know that you can really say what's a normal level because I would consider when the trucks reach the ends of their life and it's time to replace them, that's normal, although it is going to cost bumpiness in the cash flows.

At North American Mining, I'd say given the growth trajectory in that business, it's a little harder to predict. We do, from time to time, acquire draglines that we put into inventory. We may, in the future, acquire other pieces of equipment that we would put into inventory that we can use with new projects. We do that so that when we come upon a potential customer, or even an existing customer who could benefit by having different equipment in their quarry, that we can come operate for them and allows us to more quickly get in and provide them with a solution.

And the really – the future CapEx in that business is going to be dependent on what happens with our growth. So, if you want to go out as far as 2024 or 2025, I can't tell you with confidence what that business is going to look like at that point. I hope it's going to be quite a bit bigger than it is now. So, the CapEx requirements could be higher. So, I don't know that I can really predict where it's going to be at that point.

I guess the other – one other point I'd point out at North American Mining aside from the aggregates business is we announced our lithium – new lithium contract. We – as part of that arrangement, we are obligated to fund the first fleet of equipment that will be used at the mine, and that's up to \$50 million. So, that will be coming 2023, 2024, 2022, just depends on the timing of that project.

Andrew M. Kuhn

*Analyst, Focused Compounding Capital Management*

Q

Got it. Thanks for answering that question. And then if I could ask a couple more, in last year's proxy statement, some bonus payments were tied to Mississippi Lignite Mining adjusted return on tangible capital employed. And you say you don't disclose MLMC's return on tangible capital employed because the number is competitively

sensitive. So, without disclosing the actual number, can you explain why MLMC's adjusted return on tangible capital employed is important for shareholders, and why you use it as a performance metric for management?

John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

A

Well, I mean, the reason it's – I mean, return on total capital employed is essentially the money that we make off of the business measured on sort of a cash flow basis compared to the capital that we have employed. As managers of the business, we invest money and we're expected to earn an acceptable return on the capital it's employed.

And return on total capital employed has been used for – gosh, I mean, I've been around for 25 years and it's been – almost 25 years, and it's been in use in one way, shape, or form in our incentive plans about as long as I can remember. It's a pretty standard measurement of, are you being good, responsible stewards of the capital that we have put to use? It also provides a lot of people in the company that are participants in the incentive comp programs to focus on that.

Mining is a capital-intensive business. And so having the people that are making decisions about the capital investments that will be made at MLMC, have them think about how do you defer capital, how do we minimize capital, how do we think about ways to do mine development with less cost that gets capitalized, all those are good things because it's reducing the amount of shareholder capital that we've got employed. And then the trick is, how do we maximize the returns that come from that. Does that answer your question?

Andrew M. Kuhn

*Analyst, Focused Compounding Capital Management*

Q

Yeah. No, that does answer my question. And then if could ask one more, since the value of lithium per ton is many multiples of the value of lignite per ton, will your management fee per ton at [ph] their (18:44) capacity many multiples of the management fee per ton that you now charge at your lignite mines?

John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

A

So, if you study kind of how we talk about ourselves in our annual report letter and on our website, we are really a service business. We provide mining as a service for people, and I don't mean that like airplane engine manufacturers are providing engines as a service. I mean, we do this business as a service. We get paid a fee for providing the expertise to come run a mine for somebody.

So, the value of the product that's produced I don't think really has a big influence over the services that we're providing. The service that we're going to provide to Lithium Americas at the Thacker Pass project is very similar to the services that we provide at one of our coal mines where we're managing the whole mine from permitting to initial pre-strip, do all the mining, do all the reclamation, take care of all of that. So, it's a service that's very, very similar to what we're doing at a mining – at a coal mining operation, and the fees will be calculated in a similar way.

Andrew M. Kuhn

*Analyst, Focused Compounding Capital Management*

Q

Got it. Thanks a lot for answering my questions.



John C. Butler

*President, Chief Executive Officer & Director and President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.*

A

Yes. Thank you.

**Operator:** [Operator Instructions] And there are no further questions at this time. I would now turn the call back over to the speakers for any closing remarks.

Christina Kmetko

*Investor Relations Consultant, NACCO Industries, Inc.*

Thank you again for joining us today. We do appreciate your interest. If you do have any follow-up questions, please reach out to me. My number is available on the earnings release. Thanks so much and have a wonderful day.

**Operator:** Thank you for participating in today's NACCO Industries third quarter earnings conference call. This call will be available for replay beginning at 11:30 AM Eastern today through 11:59 PM Eastern on November 7, 2019. The conference ID number for the replay is 3849307. Again, the – our conference ID number for the replay is 3849307. The number to dial for the replay is 1-800-585-8367. Again, that is 1-800-585-8367.

Thank you. And this does conclude today's conference. You may now disconnect.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2019 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.