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NACCO Industries, Inc. (NC)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

Christina Kmetko
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J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

OTHER PARTICIPANTS

Andrew Kuhn
Director, Focused Compounding Fund LP

Nachy Kanfer
Analyst, Donovan Energy

MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to the NACCO Industries Q4 2022 Earnings Conference Call. My name is Lauren, and I'll be coordinating your call today. [Operator Instructions]

I'll now hand you over to host, Christina Kmetko. Christina, please go ahead.

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Thank you. Good morning, everyone, and welcome to our 2022 fourth quarter and full year earnings call. Thank you for joining us this morning. I am Christina Kmetko and I am responsible for Investor Relations at NACCO Industries.

Joining me today are J.C. Butler, President and Chief Executive Officer; and Elizabeth Loveman, Vice President and Controller. Yesterday, we published our 2022 fourth quarter and full year results and filed our 10-K. This information is available on our website. Today's call is also being webcast. The webcast will be on our website later this afternoon and available for approximately 12 months.

Our remarks that follow, including answers to your questions, could contain 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. These risks include, among others, matters that we have described in our earnings release issued last night and in our 10-K and other filings with the SEC. We disclaim any obligation to update these forward-looking statements, which may not be updated until our next quarterly earnings conference call, if at all.

In addition, we will be discussing non-GAAP information that we believe is useful in evaluating the company's operating performance. Reconciliations for these non-GAAP measures can be found in our earnings release and on our website.

In a moment, I will discuss our results for the quarter. But first, let me turn the call over to our President and CEO, J.C. Butler for some opening remarks. J.C.?

J.C. Butler, Jr.

President, Chief Executive Officer & Director, NACCO Industries, Inc.

Thank you, Christy, and good morning, everyone. I'm very pleased to report that our company once again delivered strong results, generating much higher operating profit, net income and adjusted EBITDA in the 2022 fourth quarter and full year than in the 2021 fourth quarter and full year. Christy will go into more detail about our fourth quarter earnings and provide an overview of our outlook in a minute. But first, let me provide some highlights for the year.

Our strong full year operating results were led by our Minerals Management segment, which more than doubled its operating profit and adjusted EBITDA from 2021. These improvements were driven by substantially higher natural gas and oil prices, as well as production by and from more recently acquired mineral interest and increased production from legacy mineral interest. Our team at Catapult Mineral Partners continues to look for opportunities to expand our portfolio of mineral and royalty interests through acquisitions, while also promoting development of our existing interest.

The team acquired approximately $12 million of additional mineral and royalty interests in 2022 and is targeting additional investments of up to $20 million in 2023.

Our 2023 forecast for the Minerals Management segment assumes oil and gas prices, market prices moderate to levels in line with 2021 averages. However, as we witnessed in 2022, commodity prices are inherently volatile and changes in natural gas and oil prices could result in adjustments to our current forecast. On the upside, the development of additional wells on existing reserves beyond our forecast or future acquisitions could be accretive to our future results.

At our Coal Mining segment, a big highlight of 2022 was Rainbow Energy's purchasing Coal Creek Station from Great River Energy. We are very enthusiastic about our new relationship with Rainbow. With this transaction, our Falkirk Mine gained a new customer and we recognized $30.9 million of pre-tax contract termination settlement income. This settlement included a cash payment of $14 million, the transfer of ownership of an office building, and the conveyance of membership units in Midwest AgEnergy Group.

Midwest AgEnergy was acquired by a third-party in December and we received a cash payment of $18.6 million on our ownership position.

While the transfer of Coal Creek Station was very positive for our Coal Mining segment, a decision made by another customer is not so encouraging. The owner of the power plant served by our Sabine Mine in East Texas plans to retire the fleet – retire the plant. If that happens, we'll start delivering coal as of April 1, just a few short weeks away, and final mine reclamation will commence.

Sabine will receive compensation for providing final mine reclamation services, but that annual income will be less than our income during active mining. Despite the planned closure of Sabine's power plant and the ongoing political and regulatory challenges the coal mining industry faces, we continue to believe the use of coal as a fuel source for reliable electricity in the United States will continue for the foreseeable future.

Shifting to our North American Mining segment, our full year operating profit did not meet our expectations. We're working on initiatives designed to support the return to profitability. During 2022, we conducted a thorough review of each North American Mining quarry operation to identify areas that are not meeting expectations. We are implementing changes that should drive future improvements in financial results. Until profit improves, North American Mining has narrowed its business development efforts.

On a positive note, Lithium Americas continues to make progress on the Thacker Pass project. Our Sawtooth Mining subsidiary is exclusive contract miner for this major US lithium project and Sawtooth is part of our North American Mining segment. In January, General Motors announced that they will invest $650 million in the Thacker Pass project. It's our understanding that this agreement with GM is a major milestone in moving Thacker Pass towards production. And in fact, on March 2, Lithium Americas announced that construction has started. Phase 1 production is projected to begin in the second half of 2026. We plan to begin acquiring equipment for this project in 2023. While this project isn't expected to result in significant income generation until production commences, this is an important step forward in what is expected to be a key project for domestic lithium production.

The Mitigation Resources of North America team continues to advance work on existing mitigation projects and build on the substantial foundation as established over the past several years. Mitigation Resources established two new stream mitigation banks near Dallas and Nashville in 2022 and was recently named a designated provider of abandoned mine-less land restoration by the State of Texas. Mitigation Resources is making strong progress towards its goal of becoming a top 10 provider of stream and wetland mitigation services in the southeastern United States. Overall, I'm very pleased with the way all of these businesses are advancing their strategies, including efforts to protect our coal – our coal mining business.

Before I turn the call back to Christy, I'd like to recognize that our strong 2022 results were made possible by our great team of employees. Their hard work and tremendous passion for our business continues to propel us forward, and I'm very grateful to be working with such a fantastic team.

With that, I'll turn the call back over to Christy to cover our results for the quarter in more detail. Christy?

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Thank you, J.C. As J.C. mentioned, we had a strong fourth quarter. I'll start with some high-level comments on our consolidated fourth quarter financial results and then add detail on our individual segments.

On a consolidated basis, our 2022 fourth quarter operating profit increased to $15.5 million, up almost 44% versus 2021. Consolidated net income increased to $13.8 million or $1.84 per diluted share, up from $7.8 million or $1.07 per diluted share last year.

Consolidated adjusted EBITDA increased 33% to $23.6 million. These improvements were driven by Minerals Management, which more than doubled its operating profit and adjusted EBITDA over the prior year quarter due to both increased production and substantially higher natural gas and oil prices.

Significantly lower earnings in the Coal Mining segment partly offset the impact of the higher Minerals Management earnings. Coal Mining's fourth quarter revenues increased 30% over 2021 due to a significant increase in customer demand from higher power plant dispatch and a higher per ton sales price at Mississippi Lignite Mining Company.

Conversely, operating profit and adjusted EBITDA in the Coal Mining segment decreased significantly. This decrease was due to a substantial increase in the cost per ton of coal delivered at Mississippi Lignite Mining Company and lower earnings at the unconsolidated operations. The decrease in earnings of unconsolidated operations was mainly due to a temporary reduction in the per ton management fee at the Falkirk Mine from May 2022 through May 2024. This was partly offset by an increase in earnings at Coteau as a result of contractual price escalation.

North American Mining's fourth quarter results improved from the prior year. The year-over-year improvement was primarily due to lower employee-related costs that stemmed from a voluntary retirement program the company implemented in the third quarter of 2022. The increase in segment adjusted EBITDA outpaced the improvement in the operating loss because of an increase in depreciation expense.

Looking forward in 2023, the Coal Mining segment's operating profit and segment adjusted EBITDA are expected to decrease significantly year-over-year, including and excluding the $14 million GRE termination payment received in 2022. The decline is primarily the result of an expected significant reduction in earnings at Mississippi Lignite Mining Company, driven by a reduction in the profit per ton of coal delivered. We expect a moderate decrease in earnings of unconsolidated operations to also contribute to the decrease in operating profit. The expected lower earnings are due to the reduction in the per ton management fee at Falkirk for a full 12 months in 2023, compared with eight months in 2022 and the cessation of deliveries at Sabine as of April 1.

In 2023, we expect North American Mining's full year operating profit to decrease significantly versus the prior year because final mine reclamation activities at Caddo Creek were substantially completed in 2022. Conversely, we expect segment adjusted EBITDA to increase from 2022 because improvements at the underlying operations are being masked by a significant increase in depreciation expense in 2023 versus 2022.

Finally, at our Minerals Management segment, we expect 2023 operating profit and segment adjusted EBITDA to decrease significantly from 2022. This anticipated decrease is primarily driven by current market expectations for natural gas and oil prices and anticipated reduction in volumes as existing wells follow their natural production decline and limited forecasted development of additional new wells by third-party exploration and production companies. As J.C. mentioned, changes in natural gas and oil prices from current expectations could affect 2023 results.

To summarize, on a consolidated basis, we expect full year 2023 consolidated net income to increase significantly, largely due to the $30.9 million of pre-tax contract termination income recognized during 2022. Excluding this settlement income, net income is expected to decrease substantially from significantly reduced royalty income in the Minerals Management segment and lower earnings in the Coal Mining segment. These reductions are expected to be partially offset by lower income tax expense.

Looking beyond 2023, we continue to remain optimistic about our long-term outlook. The Coal Mining segment expects increased profitability due in part to improvements at Falkirk and Mississippi Lignite Mining Company and we continue to pursue activities which can strengthen the resiliency of our coal mining operations.

As J.C. previously mentioned, opportunities for growth remain strong in the Minerals Management and Mitigation Resources businesses. In addition, we remain committed to North American Mining and are encouraged by recent developments at Thacker Pass.

Lastly, from a liquidity standpoint, we ended the quarter with consolidated cash of $110.7 million and debt of $19.7 million. In addition, we had availability of $116.3 million under our revolving credit facility. For the 2023 full year, we expect cash flow before financing activities to remain positive but be significantly lower than 2022 because of the anticipated high capital expenditures primarily for Sawtooth. We will now turn to any questions you may have.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Andrew Kuhn from Focused Compounding. Andrew, please go ahead.

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

Good morning, everyone.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Good morning.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

A

Good morning.

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

So for North American Mining, the results didn't meet your expectations this year. Can you talk about what type of factors has driven the difference between your return on capital expectations when you first started growing this business and the results you've had so far? Like, are these issues with expense management, is it capital intensity, is it the contract economics, any way that you can expand on that would be great?

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Thanks for the question. I think what I do is point to the – talk about the initiatives that we're working on with respect to getting that business where we want it to be. We mentioned in the release that we've done a review of the operations at each one of the quarries. I would say that, at a majority of the quarries, things are going very well. We're generating the profits we've expected out of those. There are some quarries where we're not meeting our expectations, which gets thrown into the mix of the whole business.

So we're looking at productivity and efficiency improvements. We're working on how we coordinate our work with our customer. The quarries in the North American Mining business, where we operate at the quarries, we're not running the entire quarry. So it's really a coordinated sort of effort between our work and our customers work. So we're trying to get that better in sync so that both sides are more efficient. And as we've described in our earnings releases as well, we're focusing on some administrative areas where we think we can be more efficient. So, in that whole collection of things, we think we can make some meaningful progress towards getting this business where we'd like it to be.

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

Got it. And then, I think this is the first 10-K where you've mentioned one day possibly developing utility scale solar power, reclaim [indiscernible] (00:16:18). Is that an idea you've been exploring internally for a while or is there some other reason that it's included in this year's 10-K?

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

It's an idea we've been exploring for a while. I think it's not a unique idea. You're seeing a number of companies doing this, and we've been working on it as well. We think that it's got enough potential that we decided that we should start talking about it in our public disclosures.

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

That's great to hear. And then in your 10-K, you use a standard disclosure that cash and cash equivalents consist of cash advance and highly liquid investments with original maturities of three months or less. And given that would be a large and uninsured depositor at any bank you do business with, I'm just curious if there's been any discussion about being more in three months and under investment and what's been actual bank deposit?

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

So, I mean, I'm sure like lots of people, right, we just double checked, where all of our investments were, where are they placed and we don't have very much that's exposed with respect to just regular deposits. A lot of this is in three-month types of paper, things like that. Does that answer your question?

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

Yeah.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

That's fine.

Andrew Kuhn
Director, Focused Compounding Fund LP

Q

All right. That's all I have for today. Thank you so much. I'll hop back in the queue.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Great. Thanks for calling.

Operator: Thank you. [Operator Instructions] Our next question comes from Nachy Kanfer from Donovan Energy, please go ahead.

Nachy Kanfer
Analyst, Donovan Energy

Q

Hi. Nachy actually like knocking on the door. Thanks. Appreciate all the insight this morning. Just a couple of questions, actually follow-ups from conversations we've had in previous earnings calls. First about Mississippi Lignite, while back, maybe about a year ago, I'd asked this to management team, has any concern about the credit worthiness of your customer out there, Choctaw Generation? And your answer was no. I'm wondering if that's still the case.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

I think ultimately the customer is TVA, right, which essentially is a government entity. So I think when you look at TVA's interest in this plant from a resiliency and reliability standpoint and the way they've described the plant publicly, I think it's pretty safe to say that they intend to operate – intend to take electricity from this plant for the foreseeable future. So if you work your way back through the value chain, I think that's how we feel pretty comfortable with the way this is all put together.

Nachy Kanfer
Analyst, Donovan Energy

Q

Got it.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

We do acknowledge, however, that Southern Company and the bondholders are trying to work out some situations between them, but that's really between them. But ultimately, TVA is really the end customer here.

Nachy Kanfer
Analyst, Donovan Energy

Q

Got it. Thanks. That's helpful. So from NACCO's perspective, a default at Choctaw Generation, there's no material risk to coal sales or coal revenue – coal sales revenue at that customer.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Well, I think, it's – I mean, I'll go back to TVA, right? Everybody's got a chain of contracts that work themselves from us supplying coal all the way through TVA, taking energy. And I think the only way anybody gets any recovery on their own investments is by operating the plant. And you can't operate the plant without coal coming out of our mine. So it's in everybody's best interests to continue to operate.

Nachy Kanfer
Analyst, Donovan Energy

Q

Got it. Thanks. And then at Rainbow, I wanted to ask about EPA's proposed action on Coal Creek's Part B application under the Coal Residuals – Coal Combustion Residuals rule. My understanding is EPA is proposing to deny Coal Creek's Part B application, which would result in a significant capital expense to upgrade ash handling and other things. Don't have a handle on what that capital expense is. I'm wondering if you do and if you can give me a sense of kind of what does that contract work in terms of EPS or anything else? How are we thinking about that?

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Yeah. Good question. I'm going to give you, unfortunately, two answers that aren't going to be very helpful to you. But one is that, Coal Creek's negotiations or discussions with the EPA between them, I don't think it's right for me to comment on those and we have never disclosed our individual profits that we make at any of these mines for obvious competitive reasons.

Nachy Kanfer
Analyst, Donovan Energy

Q

Understood. I guess, can you describe – so, is there a risk that Coal Creek declares force majeure on your, like brandly renegotiated contract there and how are you thinking about that risk? Well, maybe, not force majeure. I'm not an attorney, but...

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Yeah, well, that's what threw me. Unlike, well, how does force majeure come into this?

Nachy Kanfer
Analyst, Donovan Energy

Q

No. Is there a risk that there is – there is a termination and early termination of some sort to that coal sales agreement?

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Not that we see. I mean, look, is there a remote possibility that anything could happen? I mean, it could get hit by an asteroid, right?

Nachy Kanfer
Analyst, Donovan Energy

Q

Sure.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Things can happen, but we don't view that as a significant risk.

Nachy Kanfer
Analyst, Donovan Energy

Q

Okay. Thanks. Appreciate it.

J.C. Butler, Jr.
President, Chief Executive Officer & Director, NACCO Industries, Inc.

A

Great. Thanks for the question.

Operator: Thank you. We have no further questions. I'll now hand you back over to Christina Kmetko for closing remarks.

Christina Kmetko

Investor Relations Consultant, NACCO Industries, Inc.

Thank you. We'll close with just a few final reminders. A replay of our call will be available online later this morning. We'll also post a transcript on the Investor Relations website when it becomes available. If you have any questions, please reach out to me. You can reach me at the phone number on the press release. I hope you enjoy the rest of your day. And now back to our operator to conclude the call.

Operator: This concludes today's call. Thank you for joining us. You may now disconnect your lines.