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NACCO Industries, Inc. (NC)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the NACCO Industries Third Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I now like to turn the call over to Ms. Christina Kmetko. Please go ahead.

Christina Kmetko

Investor Relations & Media Contact, NACCO Industries, Inc.

Thank you. Good morning, everyone, and welcome to our 2020 third quarter earnings call. I am Christina Kmetko, and I'm responsible for Investor Relations at NACCO Industries. Thank you for joining us this morning. I'll 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 2020 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 For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.

Our remarks that follow, including answers to your questions, 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-Q 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.

Now let me discuss our 2020 third quarter. I will cover our consolidated results first and then provide the highlights for each segment.

On a consolidated basis, our third quarter consolidated operating profit improved 8.5% to $9.4 million, up from $8.7 million in 2019. This improvement was driven by a number of factors, the largest being a reduction in our unallocated employee-related costs. Higher earnings at both our Coal Mining and North American Mining segments also contributed to this improvement, but those segments earnings were more than offset by a significant reduction in the earnings of the Minerals Management segment.

Despite the improvement in our operating profit, our consolidated net income decreased to $8 million, or $1.14 per share from $10.3 million, or $1.47 per share last year. In the third quarter of 2019, we received an initial $2.7 million settlement award associated with a former India venture. In 2020, we received this final settlement of $1 million. The $1.7 million difference in these award amounts combined with a higher effective income tax rate more than offset the improved operating profit discussed previously.

Turning to the – turning to our segments, the Coal Mining segment's operating profit increased moderately over the prior year, driven by improved earnings at Mississippi Lignite Mining Company and lower employee-related costs, partially offset by reduced earnings of unconsolidated Coal Mining operations from lower customer demand and the termination of the Camino Real Fuels contract on July 1, 2020 that we discussed last quarter. At North American Mining, revenues and operating profit improved due to more tons delivered and favorable changes in the mix of customer requirements.

At our Minerals Management segment, similar to the first half of the year, earnings were down substantially, as the prior year benefited from a large number of new gas wells put into commission during 2018 and early 2019. This decrease was expected because of the natural decline wells go through before settling into relatively stable long-term production. Lower commodity prices this year have also contributed to the reduction in the Minerals Management operating profit.

Those are the significant factors affecting the third quarter results. Now, let me turn to our outlook. I'll provide some insight on our expectations for the fourth quarter and full year 2020, as well as provide a high-level overview of our current expectations for 2021. While we are providing this first look at 2021, more color will be provided with the fourth quarter and full year 2020 earnings release once we have finalized our 2020 annual operating plan.

At our Coal Mining segment, we expect the fourth quarter 2020 coal deliveries to become comparable to the prior year fourth quarter. [ph] Our profit (00:04:51) on the other hand is expected to decrease mainly due to an anticipated reduction in results at Mississippi Lignite Mining Company from an expected increase in the cost per ton delivered and a reduction in earnings at the unconsolidated mining operations. For the full year, coal deliveries and operating profit are expected to be lower than 2019, mainly because earnings at our unconsolidated mining operations are expected to decline as a result of the termination of the Camino Real Fuels contract agreement and reduced customer requirements.

Changes in power plant dispatch contributed to the reduction in customer requirements. The power plants served by our Sabine Mine has been dispatched at a much lower rate this year than in 2019. During the third quarter, Sabine Mine's customer reduced its lignite coal requirements to be between 1.4 million and 1.7 million tons annually, compared with 2.6 million tons delivered in 2019.

Also, on September 30, 2020, our Caddo Creek Resources' customer entered into an agreement for the sale of their activated carbon manufacturing business, including the Marshall Mine, which is operated by Caddo Creek. The buyer announced its intent to close the mine, which delivered 200,000 tons in 2019. Caddo Creek has been contracted to perform the mine reclamation.

Looking into 2021, we expect coal deliveries to be comparable to 2020 based on current expectations of customer requirements. But despite this, operating profit for this segment is expected to decrease compared with 2020. An expected increase in operating expenses and an anticipated reduction in earnings at the unconsolidated coal mining operations are the primary drivers of this decrease. The lower earnings at the unconsolidated operations are mainly because of a reduction in fee-based earnings at the closed Liberty Mine as our mine reclamation activities have been reduced.

At our consolidated mining operations, 2021 results are expected to be comparable between years and anticipate a decrease in earnings at Mississippi Lignite Mining Company due to an increase in the cost per ton of coal delivered versus – in 2021 versus 2020 is expected to be offset by a lower operating loss at Centennial.

In our North American Mining segment, we expect fourth quarter 2020 limestone deliveries to increase moderately over the fourth quarter of 2019, resulting in an overall modest increase in tons delivered for the full year compared to last year. Fourth quarter operating profit is expected to improve substantially over last year's fourth quarter as a result of favorable changes in the mix of customer requirements. But this improvement is expected to be less significant than what we saw in the first three quarters of this year.

As a result of the significant increases already realized in the first part of the year compared with last year, full year 2020 operating profit is expected to increase significantly over 2019. In 2021, we expect North American Mining's operating profit to be comparable to this year with its existing customer contract. However, we are pursuing a number of growth initiatives that, if successful, would be accretive to future earnings.

As I noted previously, last year's Minerals Management results included significant royalty income, particularly in the first half of the year, generated by a large number of new gas wells put into commission during 2018 and early in 2019. Given expected lower natural gas prices, fewer expected new wells, low commodity prices, and the natural production decline that occurs early in the life of a well, we expect fourth quarter and full-year 2020 royalty income to be substantially lower than 2019 levels.

Given these factors, royalty income from existing assets is also expected to be down substantially in 2021 compared with this year. While you can get the capital expenditure numbers from our 10-Q for the other two segments, let me spend a minute talking about our investment plans for Minerals Management. We are targeting investments in mineral and royalty interest of approximately $15 million in the fourth quarter of 2020 and approximately $10 million next year, although the timing of the fourth quarter investments could slip into 2021.

While we expect these investments to be accretive to earnings, each investment's contribution will be dependent on the timing, size, and stage of mineral development of the reserves acquired. To summarize, overall, we expect both consolidated operating profit and consolidated net income in the fourth quarter of 2020 to decrease significantly compared with prior-year period, once you exclude the impact of a $2 million unfavorable mine reclamation adjustment taken in last year's fourth quarter. Lower results in our Coal Mining Segment and an increase in income tax expense, partially offset by lower unallocated employee-related costs are driving this decrease.

We also expect a significant decrease in the full-year 2020 consolidated operating profit and net income, primarily due to the substantial decrease in operating profit at Minerals Management in the first nine months of this year and the anticipated reduction in full-year earnings at the Coal Mining segment. We are forecasting an effective income tax rate in the range of 5% to 7%.

Finally, we expect 2021 consolidated net income to decrease significantly from this year, because of the decrease in the Coal Mining segment's operating profit and a reduction in earnings at the Minerals Management segment, excluding any benefit from future acquisitions of additional royalty or mineral interest. The full-year 2021 effective income tax rate is expected to be negative 5% to negative 7% based on the current forecasted mix of earnings.

Moving away from results expectations, let me briefly provide some cash flow information. We ended the third quarter with consolidated cash of $97.6 million and debt of $23.1 million compared with consolidated cash of $95.5 million and debt of $28.4 million at the end of the second quarter. In addition, at the end of this quarter, we had availability of $138 million under our $150 million revolving credit facility. We believe that a conservative capital structure and liquidity are important, given our strategic initiatives to grow and diversify, as well as the changing trends occurring in energy markets.

We expect cash flow before financing activities to be significant use of cash due to substantial capital expenditures and payments made in the first half of 2020 related to deferred compensation and other payroll liabilities. However, in 2021, we expect cash flow before financing activities to improve and provide a solid generation of cash versus the use of cash this year. In 2021, it's still not expected to reach the levels realized in 2019.

That concludes my specific outlook remarks. But before I open up the call for questions, let me mention a couple of other items that could affect the company going forward. As we mentioned in our earnings release, we commenced the voluntary retirement program for certain corporate employees in the fourth quarter. We expect the program to be substantially completed by December 31, 2020. But until the program is complete and we understand the level of participation, the amount of savings and related one-time separation costs cannot be determined.

Lastly, let me take a minute to discuss the pandemic. It is still very much a part of our daily lives and may become more so as we see cases increasing again in the United States. While our mining operations have not been directly affected by the pandemic to date, the extent to which we are impacted going forward will depend on numerous factors and future developments, which are highly uncertain and unpredictable and could cause a significant and rapid deterioration in our results, our supply chain channels, and customer demand. Until proven treatments and vaccines for COVID-19 are available, we will work diligently to limit the exposure of our employees to COVID-19. We would also like to thank our workforce for their commitment to supporting our customers, while also working diligently to keep one another safe.

Now, let me open up the call for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] First question comes from Andrew Kuhn with Focused Compounding.

Andrew M. Kuhn
Partner, Focused Compounding Capital Management
Q

Hi, everyone. Thank you for taking my call. I want to start with the voluntary retirement program. I was wondering if you could talk a little bit about that. How long have you been considering a program like this, and were there any specific events that led to this decision, or is it more of a response to the shift in public opinion towards coal? Is it changes in the economics of wind versus coal? Is it future regulations, you think, or might be expecting? Maybe if you could talk a little bit about that, that would be great.

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

Sure. Thanks. Thanks for calling in. Thanks for the question. I guess, I would say that we're always paying a lot of attention to our overhead costs. I generally think it's a good rule to live by, whether it's a business or your personal life, anybody's personal life. So it's something that we watch pretty carefully. We measure it. We look at it. We study it, think about it. And I would say that it certainly is partly related to challenges that we see in the Coal segment.

We, earlier in the year, lost Camino Real, because of a termination event between our customer and their customer, and to a much lesser extent, Caddo has now gone into reclamation, but that's kind of immaterial and we've got lower production levels at Sabine. I mean, there's no question that there's – there are challenges in the Coal segment.

But I'd also point out there's – I'm sure you've noticed the changing nature of our business, right? We've had a lot of growth over the last several years in our newer businesses. North American Mining is growing very rapidly. We've got – we're seeing initial growth in our Minerals Management business. We certainly anticipate more of that and we've started this new Minerals Management business called – I'm sorry, mitigation business called Mitigation Resources of North America. The growth in those businesses will change the needs that we have from an overhead G&A kind of standpoint. And so as we think about those dynamics, we also look at the investments that we've made over the last several years in new tools and seeing the better utilization that we get out of these new software platforms and its providing us with an opportunity to see that we can operate from an overhead standpoint more efficiently, lower cost. I always think that's a good thing to do.

So, I would say, your question started with, have we been thinking about it for a long time? I'd say, we're sort of always thinking about our overhead structure and so this seem like now was a confluence of factors that said now is probably a pretty good time to think about doing them.

Andrew M. Kuhn
Partner, Focused Compounding Capital Management
Q

Got it. Great. My next question would be you're planning to invest $25 million in mineral and royalty interests during 2020 and 2021. Are these most likely to be US oil rights as opposed to anything foreign or anything that's mainly natural gas? And is your reason for making these kinds of investments purely about diversifying away from being just [ph] kind of (00:17:32) natural gas, or would you say the price decline in oil over the last year played a part in where you've chosen to focus your investments?

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

A

Yeah. So it's – I mean, it is – this is one of our core growth platforms, our Minerals Management business. We, as you know, have a vast majority of our legacy investments are – were made decades ago really in the Marcellus and Utica. It's largely natural gas. And I think as we've stated publicly, but I certainly have said, we're looking to diversify what we own in the mineral space. So that will – we're heavily weighted towards natural gas now. So that means we will probably be investing in oil as opposed to natural gas. I will tell you that we're focused in the United States, not offshore at all. And we view this as a core part of diversification.

I wouldn't say – I think one of the things you mentioned was diversification away from coal. I wouldn't say it's away from coal. I just look at our company and say, gosh, any business does better when it's got a diversified portfolio of customers and suppliers and business models and skill sets and sources of income. And so the activities that we've been pursuing pretty aggressively over the last several years, and we intend to continue to pursue, reflect that desire to grow and diversify, create additional platforms that we think can be successful contributors to our business.

Andrew M. Kuhn
Partner, Focused Compounding Capital Management

Q

Got it. And then, finally, I guess maybe the question is, how do you want investors to think of NACCO? Are you a mining services company, are you an energy stock, are you a coal company? Basically, what industry would you tell an investor they are buying into when they purchase NACCO shares? And I'll jump back in the queue. Thank you so much.

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

A

Yeah. Thank you for the question. I will tell you it's a question that we are spending some time on right now thinking about how to do a better job of describing who and what we are. I mean, historically, we've said NACCO Industries is a – well, we all know, historically, NACCO Industries was the parent company for North American Coal and Hyster-Yale and Hamilton Beach. Hyster-Yale and Hamilton Beach are now separate companies. So today, North – NACCO Industries is the parent – public parent of North American Coal, and North American Coal has a group of growing businesses inside it including its legacy coal operations.

Those businesses that we're growing are becoming more like siblings than children, if you think of typical org chart kind of structure, and we're thinking about what all that means with respect to how to think about NACCO. The way I – I mean, short of an eloquent way to describe it, it will – hopefully, we'll be able to produce here in the next several months. The way I describe it is we're a very strong legacy coal business. We're really in the mining services business, because the nature of our management fee contracts were – which are all, but one of our coal mining contracts really are structured in a way where we're providing mining services.

We only have one mine where we're actually in the business of selling coal and making our profits off the margin. The lime rock business started as a very small business, helping people with their maintenance and operation of draglines. It's now turned into a very sizable business. We're now the largest operator of draglines for any purpose in the United States. And it's turned into a kind of a really nice growth platform where we're providing mining services, not only in aggregates, but we're doing some sand work and as you know, we're going to be developing a lithium mine with a management fee approach, so, again, in mining services.

And then we have our other two businesses that are the Minerals Management space, which is really a royalty business, invest in minerals, collect royalties. It's a very low overhead investment kind of business. And we've got our mitigation business that grew out of our strength in our reclamation work and environmental work and our coal mining operations, but we've turned that into a business.

So, I'd say, in some ways, we're headed back towards having a portfolio of businesses and the natural resources of mining services industries, but how exactly to describe that in a succinct eloquent way, I mean that's something we're trying to figure out. And Andrew, that's going to include rethinking everything from how we think about marketing materials when we go talk about potential new partners to how our websites are designed. But it's a very topical question that you've identified and hopefully, I've helped describe, at least, what our thinking is at the moment.

Operator: [Operator Instructions] And we have a question from Trey Henninger with DIY Investing.

Trey Henninger
Author, DIY Investing

Q

Hi. Thank you for the opportunity to ask a question.

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

A

Yeah. [indiscernible] (00:23:49)

Trey Henninger
Author, DIY Investing

Q

I want to – my first question about North American Mining. Now that the North American Mining Division has positive operating earnings, do you expect to see operating leverage from the future revenue growth opportunities that you're pursuing, or do you expect earnings to grow linearly with future revenue growth?

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

A

Well, of course, the answer is always it depends, depends on the mix of new business that we bring in and the profit growth profile of any new project. But I would say, in general, we believe that we have made the investments that we need to make in the administrative platform kind of the backbone of the North American Mining business. I think the largest of those investments have probably already been made and we have the infrastructure that we need to continue to drive that business forward.

So I would expect that we are going to see, in general, probably pretty good operating leverage as we continue to grow that business. We think we can add quite a bit without meaningful additional overhead costs. And I will say, we've got a headquarters in the Miami area. We have a secondary warehouse and service center in Central Florida. I mean, if we find that we're establishing another pocket of business somewhere in the United States, we may end up putting another satellite facility to serve a number of customers. But that really would be that would be – that would probably come after we were establishing a toehold in another part of the US. It wouldn't be investment that we'd make ahead of time. So I think, yeah, I think there's pretty – I think there are good opportunities for the operating leverage that you mentioned in that business, albeit there may be some stair steps along the way.

Trey Henninger
Author, DIY Investing

Q

Understood. Thank you. My next question is about the minerals mining – or Minerals Management investments that you're talking about making. So you mentioned making somewhere in the range of $25 million in investments over the next year. Can you speak at all to those types of return on investments that you're seeking from those sorts of investments, either in terms of ROI or payback period?

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

A

I mean, we haven't – I mean, we have not disclosed our specific targets. And each – as we look at each type of mineral that we might acquire, and that's with regards to whether it's gas or oil, which basin is it in, but it would also what stage of development. We may invest in some undeveloped mineral reserves that we think have reasonable likelihood of future development. We may invest in some recently drilled wells that are yet to be completed. We may invest in some that were drilled and completed several years ago and they're lower and they're further out of their decline curve.

So each of those is going to have its own return profile. But I would say that the business model that we are trying to build and we think that we're going to be successful in building is one that's going to deliver returns on returns on capital that'll be certainly in the teens. And that's – but that's going to take some time to build. We have our legacy operations. We have very, very little invested in them, because the investments were made a long time ago. We've recently added – we now have three people in this business that are really driving us forward. And we've made some investments in some technology and software tools to help them. And it's really now building out the platform that eventually will get us to a business where we've got we think very nice returns.

Trey Henninger
Author, DIY Investing

Q

So, are those direct investments in minerals, or is this more similar to the $2 million investment where you've purchased public securities?

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

A

Yeah. The $2 million purchase of public securities was a unique point in time when, certainly, public company stocks in the royalty space had been beaten up. So we feel that we were able to get a jump-start in our diversification efforts by making that investment. But that is not our primary interest. Our intent is to buy mineral interests or royalty interests, which is really very similar to a mineral interest. It's just one step removed. We intend to do that directly as opposed to doing that through investments in public companies that are doing exactly the same thing that we're thinking about doing that. That first investment was really an opportunistic jump-start as we saw it.

Trey Henninger
Author, DIY Investing

Q

Okay. And so, just to be clear, the Minerals Management segment, if you were to invest in say, oil reserves, you don't have any plans to develop those reserves yourself, but simply to earn the royalties on them when partnering with another developer?

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

Correct.

Trey Henninger
Author, DIY Investing
Q

...Are you becoming an oil company, or is it just the reserves?

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

I'm sorry. Can you just say that last part again?

Trey Henninger
Author, DIY Investing
Q

So the question is more structured like are you becoming like an oil E&P company, or you're just holding the reserves to seek the royalties basically?

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

We are owning the reserves to seek the royalties.

Trey Henninger
Author, DIY Investing
Q

Okay. Thank you.

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

In some instances, those will already be leased. In some instances, they're already partly being leased and developed. In some instances, they might not be leased yet.

Trey Henninger
Author, DIY Investing
Q

Understood. Thank you.

J.C. Butler, Jr.
President and Chief Executive Officer, NACCO Industries, Inc.
A

Yeah. Thank you for the questions.

Operator: [Operator Instructions] And we do not have any telephone questions at this time. I will turn the call over to the presenters.

Christina Kmetko
Investor Relations & Media Contact, NACCO Industries, Inc.

Thank you very much for joining us. J.C., did you have any follow-up concluding remarks you wanted to make?

J.C. Butler, Jr.

President and Chief Executive Officer, NACCO Industries, Inc.

No, Christy. I just want to thank the callers for their questions.

Christina Kmetko

Investor Relations & Media Contact, NACCO Industries, Inc.

Great. Thank you, again, for joining us today. We do appreciate your interest. And if you have any follow-up questions, my information is available on our earnings release. Please feel free to give me a call. Thanks so much and have a great day.

Operator: Thank you for participating in today's conference call. This call will be available for replay beginning at 11:30 AM Eastern Time today November 3 through 11:59 Eastern Time, November 10, 2020. The conference ID for the replay is 1574089. Once, again, the conference ID for the replay is 1574089. The number to dial for the replay is 800-585-8367. Once, again, the number is 800-585-8367. This concludes today's conference call. You may now disconnect.