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HNRG - Q4 2016 Hallador Energy Co Earnings Call

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CORPORATE PARTICIPANTS

Becky Palumbo *Hallador Energy Company - Director of IR*

Larry Martin *Sunrise Coal, LLC - CFO*

Brent Bilsland *Hallador Energy Company - CEO, President*

CONFERENCE CALL PARTICIPANTS

Lucas Pipes *FBR & Co - Analyst*

PRESENTATION

Operator

Good day and welcome to the Hallador Energy fourth quarter 2016 earnings conference call. All participants will be in listen-only mode. (Operator Instructions). Please note this event is being recorded.

I would now like to turn the conference over to Becky Palumbo, Director of Investor Relations. Please go ahead.

Becky Palumbo - *Hallador Energy Company - Director of IR*

Thank you, [Chad], and thank you all for participating in today's call. On Friday afternoon, March 10, we filed our Form 10-K with the SEC. It is available during this call on our website under the SEC Filings tab. This call is being webcast live on our website and will be available for replay and a transcript of this call will be posted on our website later this week. With me on today's call are Brent Bilsland, our CEO and President, and Larry Martin, our CFO.

Our remarks will include forward-looking statements that are subject to certain risks and uncertainties that could cause actual results to differ materially -- for example, our estimates of mining costs, future coal sales and regulations relating to the Clean Air Act and other environmental initiatives. We do not undertake to update our forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by law.

Following our prepared remarks today, we will open the call for Q&A. With that I will turn the call over to Larry.

Larry Martin - *Sunrise Coal, LLC - CFO*

Thank you, Becky. Good afternoon, everyone. I'm going to go over the operating results for the quarter and year.

For the fourth quarter 2016 we had a net loss of $3.8 million or $0.13 a share. For the full year, net income of $12.5 million or $0.42 a share. Included in those numbers is a $16.6 million impairment that we incurred in the fourth quarter that Brent will describe more in detail later in the call.

Our free cash flow for the quarter was $12.3 million. For the year, $58.3 million. We define free cash flow as pretax income plus depreciation and amortization plus amortization of stock comp plus impairment charge less CapEx.

Our adjusted EBITDA was $19.9 million for the quarter, $80.7 million for the year. Our adjusted EBITDA we define as EBITDA plus stock compensation amortization plus impairment charge.

We incurred debt in the fourth quarter of $9 million. Total debt incurred for the year was $24 million. We reduced debt by $8.4 million in the quarter, a total reduction of $34.9 million for the year, for a net $11 million reduction in debt.

We paid dividends of $1.2 million for the quarter, $0.04 a share. Total for the year was $4.8 million or $0.16 a share.

As described before, we had a $16.6 million impairment related to the Carlisle Mine. At the end of the year we had $238.6 million of debt. With our cash and our cash equivalents, marketable securities, we had a net debt of $219.8 million. Our debt target for the end of 2017 is $210 million to $215 million and that's bank debt. Then our debt to EBITDA for our bank covenant, which is Sunrise-only EBITDA divided -- or debt-to-EBITDA, Sunrise-only, was 2.95X, which was well under our covenant of 4.5X required.

I'm now going to turn over the call to Brent Bilsland, our CEO, to talk about our general statements and operations for the quarter.

Brent Bilsland - *Hallador Energy Company - CEO, President*

Thank you, Larry. Well, we continue to be pleased with the financial results of Hallador Energy, especially when you consider the challenging coal markets of 2016. Last year we began the December-February timeframe with the warmest on history. This led to 700 Bcf of additional natural gas at the end of March, forcing the natural gas price to go down to unsustainably low pricing. Coal inventory levels at customers rose, and in response we slowed our shipments in the second and third quarter of 2016. By the fourth quarter, coal inventories were more balanced and our shipments increased yet despite operating at only 60% of capacity, Hallador generated strong free cash flow of $58 million and adjusted EBITDA of $81 million. This allowed us to continue to pay down debt, maintain our dividend and invest in our business. We attribute the success to the men and women of Hallador who choose to work here and their dedication to maintaining our low-cost culture.

Just as shipments sped up at the end of 2016, the December-February heating season this year set yet another new record for its warmth. But despite this fact, our market remains much stronger than in 2016. Excess gas at the end of March is predicted to be half what it was last year. Natural gas shipments to Mexico, increased LNG exports and heightened industrial demand for natural gas have all worked to increase the natural gas pricing, pricing which is anticipated to be in excess of $3 this year versus a 2016 average price of $2.49.

All of this is a long way of saying we expect our customers to burn more coal in 2017 than in 2016. Our customers' approach for purchasing their fuel needs has changed, due to the natural gas pricing being so tightly interlinked with coal pricing in the past couple of years. Several of our customers are implementing a strategy of purchasing 80% of their needs at the beginning of the year and relying on spot purchases to fill the balance of their needs. We currently have 6 million tons sold of our 2.6 million to 2.5 million --

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Larry Martin - *Sunrise Coal, LLC - CFO*

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Brent Bilsland - *Hallador Energy Company - CEO, President*

Excuse me, of our 6.2 million to 6.5 million ton 2017 forecast.

Looking at the fourth quarter of 2016, we are very pleased with Oaktown's cash cost of $26.61. This is well below our forecast of the $28 to $30 that we had forecasted in prior quarters. We attribute the decline in costs to the uptick in production in the fourth quarter and our continued investment in the mines.

For 2017, our CapEx budget is $30 million. That includes $17 million for maintenance CapEx. For the remainder of 2017, we continue to forecast an Oaktown cash cost of $28 to $30 a ton. Going forward, we expect our SG&A to be $11 million annually and costs associated with Prosperity and Carlisle should drop to $7 million annually.

While on the subject of Carlisle, the deterioration of the north end of the Carlisle Mine, coupled with lower coal pricing, led us to determine that the northern end of the Carlisle Mine no longer could safely and be profitably mined, thus the decision was made to seal off the northern end of the mine. Sealing it will be completed in the first quarter of 2017. As a function of this process, we identified specific assets that needed to be written off, leading to a noncash charge of $16.6 million in the fourth quarter. After the impairment, we conducted a review of the Carlisle Mine assets and determined that no further impairment charges were necessary.

Part of the reduction in costs associated with Carlisle are due to sealing the north end of the mine. Prior to idling the mine in 2015, Carlisle maintained 88,000 feet of mains. Post idling, 35% of those mains were sealed. We will be sealing off an additional 45% of those mains in the first quarter. When Carlisle reopens, it will be much lower cost, with only 20% of the outbuy maintenance it had prior to idling the mine in 2015. Carlisle will remain in hot idle status with 2.5 million tons of annual capacity, well-positioned to respond to the market demands.

Looking at our balance sheet, at the end of 2016 we had healthy liquidity of $82 million. Our debt-to-EBITDA ratio of less than 3X was well within our loan covenants and despite purchasing $22 million worth of competitor assets in 2016, we were able to reduce our bank debt by $11 million.

From an administrative point of view, we are encouraged by the early progress of the Trump administration on improving the regulatory environment for coal. We are hopeful that coal will become one of the cornerstones for this administration's desire to create jobs. Long term, we believe this administration's policies will stop the closure of coal-fired power plants and create an environment that will be very beneficial to Hallador and its shareholders.

We continue to be pleased with the financial results of Hallador as we continue to generate positive cash flow, allowing us to further reduce our bank debt, pay dividends, make investments in our business and fund our capital expenditures.

This ends our prepared remarks and I will turn it back over to Becky Palumbo.

Operator

Pardon me. This is the operator. Are you ready for questions at this time?

Brent Bilsland - *Hallador Energy Company - CEO, President*

Yes, we are.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Lucas Pipes, FBR & Co.

Lucas Pipes - *FBR & Co - Analyst*

Good afternoon, everybody. So Brent, I wanted to ask a little bit more about the market. Obviously it's been a very mild February. Good to see the snow today. But when I look at the Illinois Basin coal price indexes, a lot of them show the product changing hands somewhere in the low 30s. I wondered if you could maybe give us a sense of where do you see the market for 2018 coal? How liquid is that market? Then even further out, are you contracting for 2019 at this point? If you could give me and investors a sense on the pricing and then also the depths of the market, especially with those different terms that I mentioned, I would appreciate that. Thank you.

Brent Bilsland - *Hallador Energy Company - CEO, President*

Yes, well, we touched briefly on -- utilities are trying to stay on the short side. In the past couple of years, gas has definitely been interlinked with coal pricing and has displaced coal at times. We're going to be -- the utilities are still, I think, playing this from the short side. The benefit that we see is that there's a lot less gas to compete against than in years past. The rate -- like I said, we expect the gas inventories to be half what they were -- or half above the norm of what they were last year and this is going to create a lot more coal to be burnt.

But in general, utilities are taking a wait-and-see approach and I think as the summer goes, they're going to wait now and see what the summer heat brings and layer in spot purchases as they get there. This has led to ours and everybody else's open book to be -- our contract positions are shorter than historically of what they have been. You asked about 2018; you asked about 2019. I don't think there's any utilities out there that are currently that focused in buying coal in those markets that are focused on 2017. Later this fall I think they'll start turning their attention on 2018.

The short approach has worked because we've had two of the warmest December-January-February timeframes back to back. Coming out of 2015 going into 2016, that was the warmest on record. This year, December was cool but if you add up December, January and February, it was the warmest -- going back 30 years, it was the warmest one on records. If you look historically, going back 30 years, we typically have two to three warm weather winters followed by two to three cold weather winters.

We think that a lot of capacity to produce coal has come out of our market. In fact, we know it has because in the last 30 months, we've been involved in either multiple mines that have closed, idled or we've bought the majority of their assets. So a significant production decline in our market. It hasn't been felt by our customers because we've had two of the warmest, most mild weather winters back to back. The odds of that happening in the future -- we know eventually that weather is going to flip and we're going to start having cold winters. When that happens, we question whether there's enough supply to meet those needs.

So in general, I think that we're going to continue to see pricing go sideways here for a little while and then at some point in time, there's going to be a weather event, and we're going to see a hockey stick to more robust pricing, because we just question whether the production is there to meet our customers' needs in a full-load environment.

Lucas Pipes - *FBR & Co - Analyst*

Yes, I appreciate all of those comments, Brent. I would agree with that, that if there's a stronger demand backdrop, of course, a lot of those events are positively correlated; i.e., if it's cold winter, gas prices are probably also significantly higher than where they are today. So it kind of -- if it goes well, it all goes well together.

Maybe just to follow up really quickly on the pricing side, it seems like utilities are mostly focused on 2017. You have a decent contract position there but I think you still have some tons to put to bed. What would you expect for prices here near term and any strategy around those sales? Thank you.

Brent Bilsland - *Hallador Energy Company - CEO, President*

Well, I think that again, I think it's going to come down to what does the summer look like? I think the stage was set coming out of the December timeframe of this year. We saw inventory levels become more imbalanced. December was cool. The export market kind of surprised everyone and took some tons out of the market. It was really telling to see our utilities -- they all started getting a little panicky because they know that we're in a market that isn't as liquid as it once was and playing it from the short side works until you run out of fuel. Then I think we would have had really robust increases in pricing, but then January and February turned off just extremely warm, a lot of 70-degree weather here in Indiana, so that kind of took the wind out of the sails.

We still think our customers are short. They're still telling us they're short. They're just not so short that they need to panic and I think that they're going to wait and see what the weather of May and June and July brings and then as their needs change, we anticipate they'll be buying. That's why we've said we've got 6 million tons sold, but we think we're going to sell another 200,000 to 500,000 tons yet this year, because that's what our customers are telling us. Pricing -- we expect it's going to be weather-dependent.

I think when the market moves, it's going to move very quickly. So if buyers need to fill 10% of their needs, pricing is going to be pretty flat. If buyers all of a sudden have to buy 30% of what they forecasted, on a 30% hole versus a 20% hole, I think that you're going to see pricing move dramatically because the capacity is just not there. The miners have been let go. A lot of the equipment has been -- I mean just look at it from a capital reinvestment standpoint. You've had so much of the industry not reinvesting in their mines and we attribute a lot of the success to our cost structure, in that we have continued to buy battery cars and put elevators and things like that in our mine, which helps lower our cost structure.

Lucas Pipes - *FBR & Co - Analyst*

I have maybe one other quick question. I could probably go on, but just one for now. As it relates to cost, production cost per ton, and also sustaining capital, what's your latest view on that as it relates to 2017 and then maybe also longer term? Thank you.

Brent Bilsland - *Hallador Energy Company - CEO, President*

I'm not sure I understand your question, Lucas.

Lucas Pipes - *FBR & Co - Analyst*

If you could give us a sense on cost per ton for 2017 and frame that up a little bit. I know that you also have still some idling costs. So kind of with and without idling costs, what is your cost guidance for 2017 and beyond? Then on the maintenance capital side, what should we expect for 2017 and also longer term? Thank you.

Brent Bilsland - *Hallador Energy Company - CEO, President*

Well, I think on the cost guidance we've stated that we expect our cash costs at Oaktown to be $28 to $30 a ton. We saw in the fourth quarter that shipments rose slightly and we ran the mine a little harder and our cost structure dropped to in the $26 range.

We're putting more investment into the mine this year. Sometime in the third quarter we'll have an elevator installed at the mine. We've added two more sets of battery cars for the mine, first set of battery cars. When we bought the mine, it had cable cars; now we're moving to battery cars. We see a significant productivity gain.

So we believe our assets are capable of running in the mid-20s but again, we're running at about 60% of capacity. So when you run these mines at a slower pace, we're trying to be conservative. But when we do that, it's higher cost. If we run harder, it's a lower cost. But the market's not telling us to run hard right now so we're not.

Lucas Pipes - *FBR & Co - Analyst*

Yes, and Brent, I'd --

Larry Martin - *Sunrise Coal, LLC - CFO*

Brent also mentioned, Lucas, that we expect Prosperity/Carlisle to be about $7 million this year in costs and our maintenance CapEx to be about $17 million.

Lucas Pipes - *FBR & Co - Analyst*

Perfect. Okay.

Brent Bilsland - *Hallador Energy Company - CEO, President*

The reason we're showing a lower cost at Carlisle from a maintenance CapEx is we've sealed off 80% of that mine. 35% of that was done immediately after we idled but another 45% here in the first quarter. So a lot less mine to inspect requires fewer people, less pumping, less power needs, less ventilation needs. The northern end of the mine was by far our highest cost portion of the mine to mine in. So we think that when we do bring Carlisle back online, the cost structure there is going to look a lot better. It's going to look something more along the lines of what it was in 2013/2014, when the mine was smaller.

Lucas Pipes - *FBR & Co - Analyst*

That's fantastic. Well, I appreciate all those comments and good luck. I'll jump back in the queue.

Operator

(Operator Instructions). At this time I'm showing no further questions so I'd like to turn the conference back over to Brent Bilsland for any closing remarks.

Brent Bilsland - *Hallador Energy Company - CEO, President*

Well, again, we'll keep our head down here and keep implementing the plan that we discussed. We appreciate you all taking the time today to call in and take interest in Hallador. With that, we'll wrap up the meeting. Thank you.

Operator

Thank you, sir. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.