Hallador Energy Company

Q1 2018 Earnings Conference Call

May 8, 2018 at 2:00 PM Eastern

CORPORATE PARTICIPANTS

Brent Bilsland – *Chairman of the Board, Chief Executive Officer, and President*

Larry Martin – *Chief Financial Officer*

Becky Palumbo – *Investor Relations*

PRESENTATION

Operator
Hello everyone and welcome to the Hallador Energy First Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation there will be an opportunity to ask questions. To ask a question you may press star (*), then one (1) on your telephone keypad. To withdraw your question please press star (*), then two (2). Please note this event is being recorded.

I now would like to turn the conference over to Becky Palumbo. Please go ahead

Becky Palumbo
Thank you, Steven. Thank you all for joining us today to discuss our first quarter 2018 results. This event is being webcast live, and you will be able to access a replay of this call on our website. We filed our first quarter form 10-Q yesterday afternoon. It can be viewed on our website.

Participating on the call today are Brent Bilsland, our President and CEO; and Larry Martin, our CFO. Larry will begin with a brief financial overview of the quarter followed by Brent with comments on operations. After management completes their opening remarks, we will open the line for Q&A. 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.

Now, I will turn the call over to Larry.

Larry Martin
Thank you, Becky. Good afternoon everyone. I need to get a few definitions out of the way before I start. So we define free cash flow as net income plus deferred income taxes, plus depreciation and amortization, plus ARO accretion and stock compensation, less maintenance CapEx. We define adjusted EBITDA as EBITDA plus stock compensation plus ARO accretion.

For the quarter ended in 2018, the first quarter, we had net income of $2.1 million, or $0.07 a share. Our free cash flow was $10.7 million. Our adjusted EBITDA totaled $18.9 million for the quarter and we reduced our debt by $11.3 million as of March 31st. We paid dividends of $1.2 million, or $0.04 a share. Our bank debt at the end of March was $190.7 million. Our net debt with marketable securities and cash was $173 million. We target our total bank debt to be $175 million at the end of the year. And our debt-to-EBITDA leverage ratio was 2.37 times at March 30th, and that is a Sunrise-only bank covenant, that's who our money is borrowed is our subsidiary Sunrise Coal.

I will now turn the phone call over to our CEO Brent Bilsland to talk about results and growth opportunities.

Brent Bilsland
Hello, everyone and thank you for joining the call. Overall, Hallador had good results with yet another quarter of positive free cash flow and meaningful debt reduction. The highlights are a

little hard to see at first glance as we are comparing this quarter's good results to year-over-year great results. Still, we are pleased with where we ended up and we are very optimistic about the future of Hallador.

Looking at our average price, you know, as we said on prior calls that we were expecting an $0.80 drop in the average sales price for the year, but the decrease in price this quarter of $1.10 per ton was slightly more, just due to the seasonal mix of our contracts. This is expected to even out as higher priced contracts get shipped later in the year. Our average price per ton for the quarter was $39.13 compared to first quarter of '17 of $40.23. On the average cost per ton, we had all in for all the mines $27.32 versus year-over-year at $25.53. This was $1.78 increase. Management guided Oaktown's operating costs at $28 to $30 a ton, and actual costs were $25.93. So, we beat our guidance. Just comparing year over year, first quarter of 2017 was a remarkable number.

After our last investor call, there was some concern over our cost structure as costs were higher in the fourth quarter, due to temporary adverse geological conditions, and perhaps we didn't do a good enough job explaining that. So, I want to spend a little time pointing out how consistent our cost structure has been. If we look back four quarters, our average cost structure for all the mines has averaged $29.30 a ton. If we look back eight quarters, again, the average cost for all of our mines has averaged just under $29.30 a ton. So I think that's been fairly consistent. When we look back to when we purchased Vectren Fuels, which is the Oaktown mine, that's roughly 14 quarters ago, and we have actually lowered Oaktown's mining costs a little more than $4.00 a ton, which I think is a remarkable feat. It has been our continued focus on creating a low-cost company that has led to quarter after quarter of positive free cash flow, which has allowed us to methodically reduce our debt.

So as we look at debt reduction for the quarter, as Larry stated it was $11.3 million. If we compare year over year, our debt has been reduced by $41 million, $41.3 million. If we look clear back to the Vectren Fuels acquisition, roughly three-and-a-half years ago, total debt reduction has been an impressive $159 million. All of this has helped us lower our leverage to 2.37 times debt to adjusted EBITDA, well within our bank covenant of 4.25 times. Our liquidity is now $82 million versus $84 million in 2017 first quarter as we have been paying down term debt and making significant capital improvements to our company. Term debt payments reduce debt, but they do not improve our liquidity.

So as I turn now to marketing, I'm excited to announce the Princeton Loop loaded and shipped its first unit train of coal last night and is loading its second train today. I'm very impressed with our operations group as they broke ground on this project just a little under nine months ago, had a tremendous amount of rain and cold weather to deal with, and yet we have the Loop operational as of last night. As I've said previously, the addition of the Loop has fundamentally changed our marketing ability in that before we were just on the CSX and with some mining rights through the Indiana Railroad, and now we're also a direct shipper on the NS railroads.

That's allowed us to add, or helped us add two new customers in 2018, one of which is being fully serviced via the Princeton Loop as well as an existing customer is being serviced via the Princeton Loop. Due to new sales since the beginning of the year, we are raising our sales guidance from 6.8 million tons to 7 million tons for the full year. Increases in sales volumes and the addition of new coal stockpiles at the Princeton Loop has required us to hold an increased amount of coal inventory. This is expected and we expect that to continue in future quarters. Coal inventory was $20.9 million at the end of the quarter versus $19.9 million year over year.

Now we previously discussed consistency of our low-cost structure. I think it's also important to point out the strength of our contracted sales position. We have 20.9 million tons contracted for the next five years, which at a 7 million-ton-a-year pace, which is where we're currently forecasting for this year, that sales position represents 60% of our total sales for the next five years are contracted today. 60% of our, at a 7 million-ton pace, are contracted for the next five years. Now, that's obviously a little more heavily weighted in the first years, but I still think it's about as good a book as anybody you'll see out there. I would also like to point out that none of our customers, none of our current customers, have announced plans to close plants in the next five years. Thus, when you look at our consistently low-cost structure, coupled with great sales book, add in our ability with the new Princeton Loop, and top it off with the five years of plants that are forecasted to be operational, that equates to the opportunity for many years of continued positive free cash flow.

So we spent some time talking about consistency. Now let's talk a little bit about growth opportunities. Any sizeable sale over 7 million tons, of which 6.9 is currently sold, we will give serious consideration to reopen our Carlisle mine. Carlisle has the capacity of 2.5 million tons annually and is currently costing us $5 million annually to hold it in hot idle status. So we are looking for opportunities to turn a $5 million annual drag on earnings into a positive free cash flow-generating asset. Stay tuned.

Looking to Hourglass Sands, in February of 2018 Hallador invested $4 million in Hourglass Sands, a frac sand mining company in the state of Colorado. Hourglass Sands currently controls a permitted sand reserve near Colorado Springs. We expect it to truck test shipments to customers in the DJ Basin this summer. To our knowledge, this is the only permitted frac sand mine in the state of Colorado. We hope to be part of the industry trend of switching to locally produced sand versus frac sand produced somewhere between 900 and 1000 miles away, outside the basin. We feel that frac sand mining is well within our core competency, exceeds our investment criteria, and though we do not expect it to be profitable in 2018, we believe Hourglass can meaningfully contribute to Hallador earnings in future years.

So with that said, I would like to open up the call to questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question you may press star (*), then one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question please press star (*), then two (2).

And our first question comes from Lucas Pipes with B. Riley FBR. Please go ahead.

Ted Beachley
Hi, guys. Ted Beachley here for Lucas Pipes, actually. And first thing, good job on the quarter everyone, it was very good. Um, so my first question is: Are you guys still considering bringing on a third-party operator at Hourglass? If so, really how's the search process going? And would you say this is a priority for you guys or just a possibility?

Brent Bilsland
Well, I think that we are using a fair amount of contractors out there on that project. The mining itself is extremely simple. You know, we're going to use contractors to haul the sand to an

existing wash plant and we've signed contracts with a third party to, we purchased their dryer and then we've agreed to a throughput agreement, where they'll process the sand through a wet plant and we're in the stages now of building a warehouse, so once that's ready to go, which should be a couple months away, we'll start shipping sand to customers. I hope that answers your question.

Ted Beachley
Yes. No, perfect. And then just kind of shifting, so congrats also on new customer through the Princeton Loop. I was hoping for some insight maybe on how customers with Norfolk Southern access are responding to you guys now being able to reach them, and can we expect more contracts in the near future from customers that you could only reach through the Princeton Loop similar to the one you inked this first quarter?

Brent Bilsland
Well I think the Loop does a couple different things for us. One is it gives existing customers that have plants on both the CSX and the NS flexibility, so that if they buy coal from us to a CSX served plant and have a problem there, they know that they can come back to us and figure out a way to move that coal to their NS plant while they solve their problem at their CSX plant. So it gives a lot of flexibility to our customer and makes them feel comfortable that they can then buy bigger volumes from us because they have optionality on where they can go with it. Secondly, yeah, there's just customers that we could never bid to before because we just didn't have a way of getting the coal there, so will we see more customers? We certainly hope so. We have bids out today to plants that we've never been able to bid to in the past, so we'll see how successful we are through those solicitations.

Ted Beachley
Okay. Sounds good. And good job on the quarter again. Thanks, guys.

Brent Bilsland
All right. Thank you, Ted.

Operator
Our next question comes from Mat Klody with MCN Capital. Please go ahead.

Mat Klody
Hi guys. How are you?

Brent Bilsland
Good. How are you, Mat?

Mat Klody
Good thanks. Congrats on the new sales and the cost profile in 1Q. I was just wondering if we could touch a little bit more on the Hourglass Sands project? There was a lot of headlines about growing shortages of sands and it sounds like an interesting opportunity. Could you just maybe dig a little deeper or provide some sort of range in terms of what we were talking about the cost to develop it, any volume price or margin profile, and I understand it's early, but I'm just trying to get a perspective, a better handle on the opportunity here.

Brent Bilsland
Sure. Well, I mean, I think in general, the trend that we're seeing in the industry is, you know, if you look at the fracking several years ago, ten years ago, a lot of these guys were using

ceramic sand because they were doing two-stage fracs. They were trying to get 1500 barrels a day of production through two-stage frac, so that was 750 barrels a day per stage. And from there we, then you migrated from two fracs to 50 fracs to 100 fracs, to now you've got wells that have 500 stages in them. And so what's changed in the industry is, when you have two stages and you're trying to get 750 barrels of production per stage versus 500 stages where you're trying to get three barrels per stage, we've gone from where you know, connectivity was extremely important to now coverage is probably the bigger focus. So people are using more sand but lower grades of sand and so that's allowed, but as you use more sand, how do you keep your cost structure low? And that's kind of forcing people, they went from ceramic to northern white to now you're seeing a lot of sands in Texas come into the market, and this is just kind of an extension of that.

This mine was originally a filtration mine and the sand was too fine to be filtration sand, but it's what customers are using now is where the industry has trended. So we like the project and we're ahead of the curve, because the permits are materially in place. So, we've kind of stepped into this into maybe a phase 1, phase 2. Phase 1 is we're going at this by a low capital exposure way to get sand out the door quickly and meet customer's needs as early as late summer. And then, we're kind of looking at, and through that capacity, we're going to be somewhere in the 800,000 to 1 million ton a year range starting sometime late third quarter, we hope. So that's our thinking today.

Phase 2 would be if the market can handle a lot more of this capacity, then we'll look to maybe build another plant and try to lower our cost curve, so get the volumes up and lower yet in the cost curve, so that's kind of our thinking. So for now, this is a startup year. It's tough to make money in a startup year. We hope to enter next year at an 800,000 to 1 million ton-a-year pace. And we think the mining is much simpler than what we're doing in coal, and we think the margins will be better than what we're currently doing in coal. So when you add all that up I think it's, I think it can be meaningful to Hallador's earnings stream.

Mat Klody
Got it. Thank you. And your ownership percentage again?

Brent Bilsland
Ah, well we, it's kind of a unique structure but we own 100% of the Class A stock and we capitalized this with some of our money and some of another company's money. They have a royalty interest in the deal. But we control 100% of the Class A stock. Once our capital is returned and a certain hurdle rate is met, then there's some Class B shareholders that would have rights to 10% of the earnings thereafter. So that's kind of the structure. But we control the company.

Mat Klody
Thank you. Congrats again.

Brent Bilsland
All right. Thank you, Mat.

Operator
And as a reminder, if you have a question please press star (*), then one (1) on your telephone keypad. And showing no further questions, this concludes our question-and-answer session.

I would like to turn the conference back over to Brent Bilsland for any closing remarks.

CONCLUSION

Brent Bilsland
Well, I want to thank everyone for joining our call, and we'll get back to work. Thank you very much.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.