Hallador Energy Company

First Quarter 2019 Earnings Conference Call

Tuesday, May 07, 2019, 2:00 PM Eastern

CORPORATE PARTICIPANTS

Brent Bilsland - *President, Chief Executive Officer*

Larry Martin - *Chief Financial Officer*

Becky Palumbo - *Director of Investor Relations*

PRESENTATION

Operator
Good day and welcome to the Hallador Energy First Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your touchtone phone, to withdraw your question, please press "*" then "2." 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
Thank you, Alison. Thank you everybody for taking the time to join us today to discuss our first quarter 2019 results. As a reminder, 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 and it is now posted on our website.

Participating on today's call 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 up 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 maybe required by law.

And with that, I will turn the call over to Larry.

Larry Martin
Thank you, Becky and good afternoon everybody. Before I get started, I'd like to explain a couple of definitions. We define free cash flow as net income plus deferred income taxes, depreciation, depletion and amortization, ARO accretion and stock compensation less maintenance CAPEX and the effects of our equity method investments. We define adjusted EBITDA as EBITDA plus stock compensation and ARO accretion less the effects of our equity method investments in Hourglass Sands.

We had for the first quarter of 2019 we had net income of $7 million, $0.23 a share. This resulted in our free cash flow of $14.7 million. We had adjusted EBITDA of $25.2 million. We paid down debt of $20 million and we paid dividends of $1.2 million or $0.4 a share.

Our bank debt as of 3/31/19 is now $168.5 million. Our net debt after cash, CDs and marketable securities was $157.2 million. We target our debt for the end of this year to be $150 million to $155 million and our leverage ratio for our bank covenant, on a credit agreement was 2.12 times.

Now, I'll turn over the call to our CEO, Brent Bilsland.

Brent Bilsland
Thank you, Larry. We had an excellent quarter, thanks to management team and operations team for executing our game plan perfectly. I think the numbers speak for themselves when comparing Q1 2019 results to Q1 2018 results.

Our net income increased by 228%, our adjusted EBITDA increased by 28%, our free cash flow was up 37% and cash provided by operations was up 58%. These results highlight the tremendous value that we believe Hallador represents. Our cash from operations was $20.8 million in Q1, 2019. This translated, you know, as Larry previously mentioned to $14.7 million of free cash flow in the first quarter.

So if we look at our trailing 12 months of free cash flow, it's just under $40 million, when you look at our market cap last night of a $153 million that equates to a free cash flow yield of 26% trailing 12 months or if you want to use an enterprise value of $310 million last night that would be a 13% yield. That again this is trailing 12 months.

If you look forward, here we just had a quarter of $14.7 million, and if we take out $2.5 million for a onetime event of selling off some oil wells, our forward free cash flow looks something in the neighborhood of $50 million, which would put our free cash flow based on market cap at 33% and on enterprise value at 16%, so I don't know other companies that are trading at those kind of yields.

And when some people say well, which is more indicative, you are trailing 12 months or your first quarter of 2019. Well, I'd point out that we are selling 850,000 more tons in 2019 than we did in 2018 or up 12%. And then the other thing to look at is our cost structure last year was elevated in the second half due to bringing on Carlisle. We ran that mine for most of the second half of the year with one unit. In the last couple weeks of '18, we brought on the second unit and here we see in the first quarter our operating costs companywide have dropped to $29.24, versus roughly $31 in the second half of 2018.

So now that we have great yield, I think we have great free cash flow visibility because ultimately we're…79% of our sales for four years and an 8 million-ton pace are contracted. Over that time period, 2019 to 2022, we have 25.3 million tons committed. So some will say, well, Hallador is trading at a high free cash flow yield due to concerns about a declining market, however, our customer base has been growing. As we've discussed in prior calls, we've nearly doubled the number of power plants we serve from 9 power plants in 2017 to 17 power plants today, located in eight different states. This growth in customers has led to our coal sales volume and sales revenue to increase by 25% and 28% respectively when comparing Q1, '19, to Q1, 18.

In addition to our customer growth, we've recently seen the State of Indiana which represents 72% of our sales, further embrace and defend coal. On April 24th, 2019, the Indiana Utility Regulatory Commission, IURC, approved 95 million in additional environmental controls in a coal-fired power plant that we exclusively serve. Additionally, in the same ruling, the IURC rejected the same utilities petition, closed three coal-fired units in 2023 and replaced them with combined-cycle natural gas. We believe the IURC's decision is a material statement that the testimony regarding the utilities petition proved that existing Indiana coal generation is lower costs than new natural gas-powered plants in the State of Indiana.

Additionally, the decisions show that cost is an important factor in future cases brought before the IURC. Furthermore, out of concern for the trend of increasing electricity rates in Indiana, the legislature created a committee to study Indiana energy's policy and release their findings by December of 2020. We're also pleased to see a recent announcement by another one of our largest customers that they consider their coal plant to be their "workhorse" and that the plant is both profitable and dispatching at 80% of availability. Coal is alive and well in Indiana, and so is Hallador.

So, we've established that we have a great free cash flow yield. Our sales position gives us superior future free cash flow visibility. Our customer base is growing, not shrinking. And so what will we do with this stream of future cash flow? Well, we see opportunities to continue to grow production at Sunrise Coal from 8 million tons annually to something greater. I'll remind everyone that in 2007, we only produced a million tons a year. And today 12 years later, we're 8.2 million tons projected for the 2019. Additionally, we will continue to work on developing frac sand mine…a frac sand mine in Colorado. Now I'll admit it's taken longer than I previously anticipated to bring this mine to production, but we are making progress and conversations are ongoing with customers.

In the meantime, we will continue to pay down debt. Looking at our balance sheet, in the first quarter we've reduced our debt by $20 million bringing our base debt owned…owed to $168.5 million. This further reduced our leverage ratio to 2.12 times, well within our 3.75 times covenant. Our liquidity also approved by $8 million in the quarter to a healthy $88 million.

So in conclusion, we strongly believe that Hallador or has a great free cash flow yield, superior contract visibility, a growing customer base and plenty of excellent opportunities to redeploy capital.

So with that said, I will open up the lines for questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press "*" and then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your question, please press "*" then "2." At this time, we will pause for a moment to assemble our roster.

Our first question will come from Lucas Pipes of B Riley. Please go ahead.

Lucas Pipes
Hey, good afternoon, everyone.

Brent Bilsland
Good afternoon, Lucas.

Lucas Pipes
Congratulations on the very solid performance, just a few quick questions. When I look at the 10-Q and I look at your commitments for this year and for next, very good job. The 84% for 2020 that are committed, are those all kind of priced at $41, or are there maybe some collars around that or are committed in un-priced tons, just wanted to double check that? Thank you.

Brent Bilsland
Well, Lucas, for the most part, we have one customer that we have to price here in the next 30 to 60 days. The rest of those tons are all…the average price for the year is the $40.

Lucas Pipes
Got it, and that additional customer, what sort of magnitude would we be…should we be thinking about.

Brent Bilsland
It is around 800,000 tons.

Lucas Pipes
Okay. Very helpful. And then of course, we have all seen the weakness in the seaborne market this year and I wondered what do you think of the implications for the Illinois basin market more broadly. I understand you don't export, but how could this weakness potentially ricochet through the domestic pricing landscape. I would appreciate your thoughts. Thank you.

Brent Bilsland
Certainly, a lot of conversation about concern over the export market pricing as of today. I think most people that are exporting and again we do not export any coal, but there certainly are significant tons in the Illinois Basin that are now…I would argue that most of those tons come from the state of Illinois and typically don't compete well with our primary markets. Again, 72% of our coal is sold in the state of Indiana.

So we certainly can see maybe some pressure on the River prices, but pricing in the Indiana typically doesn't see a stronger run up and it doesn't see a stronger rundown. It is more of a…little bit more of an isolated market. We did price coal during the quarter and we did not see any weakness in my mind on those prices, so it hasn't shown up yet. We have very little coal that we need to sell. We need to sell 2% for this year. There are 200,000 tons to hit our target and so…and then even looking at next year, you know to hit our current target, we need to sell 1.3 million tons. We see significant opportunities to do that, you know looking in the next year.

I think right now we are in the shoulder months, so everyone is focused on gas prices coming down but if buyers really aren't looking to do any buying, I think as we get into late summer and fall, you know those are the traditional buying periods to finish out the summer and get everyone's book in line for 2020. So by and large, we are not really concerned about it. And I think that kind of comes back to what we keep saying is we think we have got better cash flow visibility than anybody else because we think we have better hedges than most companies and we have been able to add so many customers here of late which gives us more opportunities to place those tons that we need to place versus in the past, so we are pretty happy.

Lucas Pipes
Yes, now it's a great job you have done especially on the contracting side. In terms of kind of the outlook for the year and the cadence of the quarters, can you point us to maybe second quarter, third quarter, fourth quarter things to be aware of just in terms of volume, cost, price perspective? I would appreciate the thoughts. Thank you.

Brent Bilsland
Well, I think that we have come out and so we are going to ship 8.2 million tons. We are a little ahead of that pace in the first quarter. Cost structure, especially at Carlisle has been coming down nicely, and I think there is still room for improvement on that. But I don't see any…again

we are pretty much sold for the year. We have got little work to do, you know probably in that July, August timeframe, but buyers are going to wait and see what kind of weather summer brings. So we just don't anticipate making a great deal of sales in the second quarter. That's just not traditionally when that happens. Now, certainly if they call, we are ready, willing and able. So I think it is going more of the same for us.

Lucas Pipes
Got it. Okay. That's helpful for now. I may ask some more but I will turn back in queue. Thank you.

Brent Bilsland
Alright, thank you.

Operator
Again, if you would like to ask a question, please press "*" and then "1." And as another reminder, if you would like to join the question queue, please press "*" and then "1." And we have a follow-up from Lucas Pipes from B. Riley. Please go ahead.

Lucas Pipes
Yes, thank you for taking my follow up question. So…?

Brent Bilsland
Yes, no problem Lucas, barely we have a lot of people on the call, they are all shy.

Lucas Pipes
Yes, there is something about that, right. So I just wanted to kind of ask higher level, how you commented in your prepared remarks about other state of Indiana is embracing coal good to hear. Where would you put kind of the break even of coal with natural gas kind of in your service markets, obviously in Indiana, but then also outside of Indiana, as topic received a lot of attention a few years back and just wanted to circle back on it, because obviously it's still important? Thank you.

Brent Bilsland
Well, I think that…I think that, when gas gets oversupplied, it tries to price down the final market to fill and the power market is a market that it can fill. And the markets that we have additional transportation to i.e., Florida, those markets obviously gas will complete at a higher price with coal than in our backyard where 72% of our sales are. Though you know, gas prices is down in the 250s…260s, the strip basically 260, I don't…to me so far it really hasn't had a material effect on how much coal will be considered in the State of Indiana, I think at the end of the day, this is just…we are in the shoulder season right, temperatures are mild, there is not a lot of focus on other than the gas injection numbers, so we are seeing gas prices come down. I think everyone is waiting to see what kind of weather event that we have. Gas up to $2 is a problem for coal in Indiana. Coal plants will struggle to dispatch and you will see coal back up, that being said we're contracted, so our customers are obligated to take those tons through 2022. And quite frankly, I think we have got a few sales out in 2023, we just report that far out.

But…so it's certainly if and when…if that event would happen we would certainly be in a position of strength to have discussions with customers about deferrals and that sort of thing. But, today, I mean, we have seen like I said, we just…there were some significant buying that just happened in the last 25 days. So we got a piece of that. And quite frankly, it is kind of a unique quality coal, so we got a piece of it. But I mean, we still are seeing significant buying going on, I don't think that would be happening when utility came out and bought a spot purchase of a 1.3 million, I think. I don't think it would be happening if people were overly concerned about gas prices.

Lucas Pipes
Got it.

Brent Bilsland
And this was a Southeast buyer, it wasn't even an Indiana buyer.

Lucas Pipes
That's very interesting. What do you think of the supply response here, it appears to have been somewhat elusive over the last few years. But I would appreciate your thoughts that, do you see some of your competitors maybe closing down some capacity over the coming years, any mines in particular if you feel so inclined to share…I don't know if you want to share specific names or not. But if possible any mines that might be near the end of their life, where you think that capacity could be rolling off?

Brent Bilsland
Well, I think in general we have seen Peabody last quarter came out and said that they are going to reduce their Illinois basin supply. We think that reduction is the State of Indiana, we don't know. We recently won business with a large utility in the State of Indiana, excuse me, a large industrial account in Indiana that…as part of that process they agreed to…they didn't agree, but they chose to close their own mine, which is 1.8 million tons coming out of the state of Indiana that's…that…I think that mine has ceased production as of today, if not it's got a few weeks left. And we see…I think in general, our number is about a third of Indiana production. It does not look long for this world just from the standpoint of it's either operating at negative cash flow or it's got a reserve base that just is going to mine out.

Now, we certainly don't control what our competitors do. But just from gazing across the fence, it just looks like some of these assets are not long for this world. So we've tried to get ourselves in a position of where we've added more customers, we brought on more volume, we're very comfortable with our sales position, if we needed to bring on more capacity, we could. But we would want to see a price response I think to do that. And when our hedges start to roll off out in 2023, we don't think there's going to be as much production still alive in the state of Indiana just due to the age of some of these assets and quite frankly to the lack of reinvestment by competitors in some of those assets.

Now there's certainly some good buys in the state of Indiana and I think most people know who those players are, but they're certainly we think about a 3rd…won't be here in 4 years.

Lucas Pipes
Very, very interesting. And maybe to hone in on your comment regarding Peabody, what do you have that they don't have, you obviously you are signing up more customers. You've been increasing production. What do you think some of the main drivers account for that different direction in the production outlook between you and Peabody in Indiana?

Brent Bilsland
Well. I think Peabody does a fine job. I think they just have a mine that is ending…reaching the end of their reserve life and that's just…he can't mine tons that don't exist. From our perspective, we've tried to focus on with our Princeton Loop making ourselves more flexible

from a transportation perspective, and allowing customers to hey, we can deliver you coal by truck, we can deliver you coal by the CSX, we can deliver you coal by the NS railroad. And so that's kind of led to some of the growth in our business.

And then additionally, a large industrial customer decided they would prefer to buy coal from us and others on long-term contracts versus produce their own coal. And so that's a very large customer for us. It's a long-term contract and it's a material shift in our business. So these are the things that are leading towards us, gaining new customers and more success, plus we have spent a lot of money, reinvesting in our assets to keep them low cost. We think that there's other competitors that have not done that as well. There's certainly some that have, but there is certainly that haven't. If you look at the CAPEX spent per ton in Illinois basin compared to the public companies and it'll show you who has reinvested in coal and who hasn't, who has sucked the money out to put it into something else. And we've continued to reinvest in our assets and I think we're having success because of that and I think we've got a lot of runway in front of us.

Lucas Pipes
Yes. That's great. Well, I really appreciate all the color on the follow-up questions, and best of luck. Thank you.

Brent Bilsland
Thank you, Lucas.

Operator
Again, to ask a question, it is "*" and then "1". Our next question will come from Ethan Park of Extract Capital. Please go ahead.

Ethan Park
Hi, Brent and Larry.

Brent Bilsland
Hi, Ethan.

Larry Martin
Hi, Ethan.

Ethan Park
Congrats on the Q1 number. I have two questions for you. First of all, it does seem like you guys are making fair bit of free cash flow for 2019. So could you give a bit more color on what you guys might be doing? What you guys might do with the cash flow generated this year? Are you guys thinking about like potentially increasing dividend or is your focus still on paying down the debt?

Brent Bilsland
Well, our primary focus is to paying down debt. And a magical number for us is getting under two times debt to EBITDA which should happen in a quarter or two. So that's where we're at. We are also are working on the sand project in Colorado, that if we can get a mine opening contract, that potentially will be a significant capital investment that we will need to make late this year, early next year. I mean, that's what we're trying to accomplish. But to what size and to how that's been designed, those discussions are ongoing now. So we haven't pulled the trigger on that. We're trying to get in position to do that. But we're not there today. So those

are the two…so in the meantime, we're just really trying to de-lever our balance sheet. So that as opportunities come along, we can take advantage of those opportunities.

Ethan Park
Okay. And I guess the second question is, do you guys expect more potential cost savings at the Carlisle Mine? I know that you guys been ramping up your production and the second unit there. Should we expect or I guess, do you guys have any kind of expectations on lower unit cost there even further?

Brent Bilsland
We will certainly tell our guys that they need to. And they've done a nice job. Part of that is going to be sales dependent. If we see more sales for that particular quality of coal, we may add a third unit to that mine, but as we sit here today that that's not currently planned to do, but if a customer were willing to commit to us over a period of time, then we would look to do that. And I think that would further help the cost structure. I mean, we've been pretty…if you look at us over time, as volume goes up our costs typically come down. Today, we're saying, hey, we've got 8 million tons contracted. We think we'll…we're comfortable saying we'll sell another 200,000 in spot solicitations this summer in this fall. But beyond that, that's all we're prepared to commit to today. And things change quickly, I mean, what is the trade deal, would China do the export market? That's a big wild card out there. And that's a market that just comes and goes so quickly.

So I don't get overly concerned that, the number is out of the money today. What's it really a matter. No one is buying today. What I mean, I mean, I see these market indicators and people say we get these newsletters that say, well the market is here, based on indications of interest. Well, nothing traded. So if there is nothing traded, is that really a real market? We just don't put as much weight into that, into what the market is? We don't see a lot of volume trading. All we can tell you is, we saw a buyer come out, make a large purchase, we were part of that. And pricing really didn't deteriorate. So we felt pricing had not moved materially. So from our perspective, we certainly read a lot of press, but the press is got to write something. And right now, the only thing to really talk about is export prices look like they're out in the market. And there are a lot of companies out there that are selling a fair amount to the export market. Most of those tons don't flow well to Indiana. So I'm not sure where they're going to go. There I can get a lot of time professing about that, but I don't think they come back to Indiana.

Ethan Park
Thank you.

Brent Bilsland
Thank you for your question.

Operator
Ladies and gentlemen, this will conclude our question and answer session. At this time, I'd 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 today and all the questions. Again, we are very happy with our business. We had a fantastic quarter. And I think we've got more great quarters in front of us. So with that said, thank you for calling.

Operator
The conference has now concluded. We thank you for attending today's presentation. You may all now disconnect your lines.