Hallador Energy Company

2018 Full Year Earnings Conference Call and Webcast

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CORPORATE PARTICIPANTS

Brent Bilsland - *President, Chief Executive Officer*

Larry Martin - *Chief Financial Officer*

Becky Palumbo - *Director, Investor Relations*

PRESENTATION

Operator
Good day, and welcome to Hallador Energy's 2018 Full-Year Earnings Conference Call and Webcast. 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. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your touchtone phone, to withdraw your question, please press star then two. Please note this event is being recorded.

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

Becky Palumbo
Thank you, Andrea. Thank you everybody for taking the time out today to join us for today's call to discuss our fourth quarter and full-year 2018 earnings. If you haven't had time to review our Form 10-K and earnings release we issued yesterday, they are both posted on our website today. This call is being webcast and a replay will be available on our website along with the transcript later this week.

Participating on today's call with me are Brent Bilsland, our President and CEO, and Larry Martin, our CFO. Larry will begin with the financial overview followed by Brent with comments on operations and 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 regarding 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. Also, I would like to remind you that we have a reconciliation of the non-GAAP financial measures that we discussed this morning in our press release issued yesterday, which again is posted on our website.

So with that, I will turn the call over to Larry to go over our highlights. Larry.

Larry Martin
Thank you, Becky. Good afternoon, everyone. I will review the operating results for the fourth quarter and year-to-date. For the fourth quarter, net income was $2.6 million, $0.09 per share, for the year $7.6 million, $0.25 per share.

Our free cash flow, which is defined as net income plus deferred income taxes, plus DD&A plus ARO, plus accretion in stock compensation, less maintenance CAPEX and the effects of our equity method investments. Free cash flow was $9.3 million for the quarter, $35.8 million for the year.

Our adjusted EBITDA which is defined as EBITDA plus stock compensation plus ARO accretion, less the effects of our equity method investments in Hourglass Sands. Adjusted EBITDA for the quarter was $18.7 million and $74.1 million for the year. We decreased our debt by $11.5 million in the fourth quarter, $13.5 million decrease for the year. We paid dividends of

$1.2 million in the fourth quarter, $0.04 a share, total was $4.9 million or $0.16 a share for year-to-date.

Our bank debt at the end of the year was $188.5 million and our net debt was $170.6 million at the end of the year. Our debt target for the end of 2019 is $155 million to $160 million, that is debt owed to the bank and our leverage ratio at the end of the year was 2.55 times adjusted EBITDA.

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

Brent Bilsland
Thank you, Larry. Well, on previous calls, we have spoken a great deal about positioning Hallador to grow our sales and I'm happy to report that those initiatives have paid off.

In 2018, or wholly-owned subsidiary, Sunrise Coal, contracted 12 million tons of additional coal sales for the 2019, 2022 time periods. As a result, we are raising our 2019 sales guidance to 8.2 million tons annually from 7.3 million tons previously. Additionally, we are forecasting sales of 8 million tons annually for the 2020, 2022 timeframe.

Currently, we have 78% of our production sold for the next four years at an 8 million tons pace, I want to repeat that. We have 78% our production sold for the next four years at an 8 million tons pace. I do not know of another producer in the industry that is hedged that well for the next four years.

Additionally, we have nearly doubled the number of power plants we serve from 9 in 2017 to 17 power plants today located in eight different states. The total estimated co-consumption of our 2018 customers is roughly 43 million tons versus 16 million tons for our 2017 customer base, a 165% increase in demand providing exciting new sales opportunities going forward.

When we look at customer concentration, in 2017, we served nine plants in three states, estimated demand was 16.2 million tons. We sold 6.6 million tons thus making us roughly 40%, 41% of our customers' supply.

In 2018, we served 17 plants in eight states with estimated customer demand of 42.9 million tons. We sold 7.4 million tons which made us 17% of our customers' supply. Our eight new customers represent an average of roughly 3% of our sales, but each have the ability to become much larger customers in the future.

This increase in customers is a result of three fundamental changes in our market that have increased demand and reduced supply. A largest Indiana industrial customer has decided to close their coal mines and purchase coal from Sunrise under long term contracts.

The addition of our Princeton Loop has allowed us to access new markets served by the Norfolk and Southern Railroad and lastly, a greater percentage of Illinois Basin coal is going to the export market that is tightening supply. This has led to new customers contracting with Sunrise for the first time.

Now there has been much debate about the sustainability of Illinois Basin exports. IHS market reports for every megawatt coal-fired power generation that's being closed in the world, mostly in the U.S. and Europe, three to four megawatts coal-fired power generation is being built mostly in Asia.

At this time, we do not see enough new coal supply coming online and [indiscernible] Illinois Basin coal exports will be needed to meet this new demand throughout the world. And I think that sentiment is echoed by some of the comments from some of the largest coal producers in the world such as Glencore or BHO. Glencore recently announced that they will cap their production at 150 million tons annually and that they see no growth in supply.

BHP has stated that steam coal production is not something they will seek to grow in the future and we certainly have seen comments from other executives in the industry echoing the same sentiment. All three of these are fundamental changes that we believe are sustainable and will allow Sunrise to ship eight million tons annually going forward. We have had a fantastic sales season and customers will likely be taking a breather from additional contracting until they see what whether the summer brings, but the environment is still ripe for additional sales.

According to plant analytics, utility coal stocks are 40% below the five-year average. On the natural gas front, natural gas inventories are 25% below the five-year average. If any weather presents itself this summer, we think the opportunities to make additional sales are certainly present.

Looking at our cost structure, our cost structure in the first half of 2018 was $26.84. In the second half of the year it was $30.97. This increase was primarily due to transferring employees and equipment from Oaktown to Carlisle, retraining those employees and reopening a mine that had remained idle for slightly less than three years.

For nearly all of second half of 2018, we operated Carlisle with only one unit of production which is very inefficient. However, Carlisle provides us with a slightly different quality that is very desirable, especially in the southeast.

Thus by late December, we had sold enough Carlisle coal to justify adding second unit production at Carlisle, and we have seen a dramatic reduction of the cost structure of that mine. Thus we are comfortable projecting that our company wide mine costs will be in the $28 to $30 per ton range in 2019.

Looking at cash flow, cash provided by operations was $51.6 million for 2018 compared to $65.8 million for 2017. The decrease in cash generation was due to increasing inventories at locations such as reopening Carlisle, building the inventories backup, opening our new Princeton Loop, getting a base of inventory there and by and large we increased inventories at Oak Town as well.

Also on the cash flow front, as we previously mentioned, our increased costs associated with reopened Carlisle Mine resulted in tighter margins and lower cash flow generation. We see that trend changing as we have brought on the second unit at Carlisle.

For Hourglass Sands, we have completed one of three anticipated test wells in DJ Basin and expect to complete the remainder by the second quarter of this year. In Colorado, we continue to work towards being part of an industry trend of switching to locally produced sands versus frac sands produced roughly 1,000 miles outside the Basin.

As I have stated before, we believe frac sand mine is well within our core competency, exceeds our investment criteria, and though we do not expect it to be profitable in 2019, we believe it can meaningfully contribute to Hallador in the future.

Looking at our balance sheet in the fourth quarter, we reduced our debt by $11.5 million, as Larry previously mentioned, at the end of 2018 our debt was $188.5 million, which is a reduction of $13.5 million year-over-year.

Our leverage ratio decreased to 2.55 times from 2.73 times during the quarter and well within our 3.75 times covenant. Our liquidity also improved by $5 million in the quarter to a healthy $80 million of liquidity. Our CAPEX budget for 2019 is $31 million of which $22 million is for maintenance CAPEX.

In summary, 2018 positioned Hallador for great success going forward, we increased our annual sales pace to roughly 8 million tons annually, we decreased our market concentration by adding eight new customers, and we were able to contract 78% of our sales for the next four years. All of which creates great cash flow visibility and value for the Hallador shareholder.

With that said, I would like to open up the call for questions.

QUESTION AND ANSWER

Operator
We will now begin the question and answer session. To ask a question you may press star then one on your touchtone phone. If you are using a speaker phone, please pickup your handset before pressing the keys. If at anytime your question has been addressed and you would like to withdraw your question, please press star then two. At this time, we'll pause momentarily to assemble our roster.

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

Lucas Pipes
Hey. Good afternoon gentlemen.

Brent Bilsland
Good afternoon, Lucas.

Lucas Pipes
Brent, I wanted to follow-up a little bit on the domestic market, it seems like things have been tightening on the seaborne side, and softening a little bit over the recent weeks. Now, what's your sense at this point in time for prices in the domestic market, how utilities are positioned, do they need to buy more coal? I would very much appreciate your perspective on that, and then of course, especially how Hallador is positioned in the mix of that? Thank you.

Brent Bilsland
Well, we believe that utilities do need to buy more coal and some will take a peek and see what the weather has done, but we have seen several utilities report that their coal inventories levels decreased over the winter months, and some will jump on that earlier than others, every utility has their strategy, but we are seeing a couple RFPs now that quite frankly have surprises that they were so big and so early. We think that there are several domestic utilities that need to buy coal.

Lucas Pipes

That's good to hear. And do you see longer term contracts as well or do they more top things off on a short-term basis?

Brent Bilsland
We signed several contracts that were in the two to four-year range. Definitely saw a return to term contracts that we haven't seen for several years.

Lucas Pipes
Very good to hear, great. And then, can you provide us a little bit more color on how the restart of Carlisle has been progressing? Any unexpected issues, how would you think about costs at this operation going forward, I would appreciate you update on that situation. Thank you.

Brent Bilsland
Well, sometime in July, we restarted that mine. There is a period of time there were a unit production was shutdown at Oaktown. Some of that equipment and those people were moved to Carlisle, retrained, we restarted that mine anytime mine is set for almost three years. There is a lot of work to be done to bring that mine back into production conditions. For the most part we ran it at one unit mostly because we thought sales would develop, but they hadn't maybe there was a couple month delay there from the time we thought they would development and actually developed. But by, I think December 18th, we added a second unit and we have been pleasantly surprised what those cost numbers have looked like since we have added that unit. Certainly, there is the potential to run maybe a single minor unit there later this year, if sales continue to progress like we think they might, production up in any mine helps the cost structure.

And we think in general that's going to help Hallador's cost structure. I mean traditionally we have run somewhere between 6.3 million tons and 7.4 million tons, and now we are forecasting 8.2 for this year. And we certainly think the market again…we have commented from coal inventories, dramatic improvement over the last three years. And I think there is always people say, well the export market is not in the money today, and that is a correct statement. But I mean, the export market can move $30, $35 in a 30-day window. When the export market decides it wants to come in and buy, that's pretty fast movement, and, certainly thinks that when you look at the macro view point of what's going on in the world for coal outside of the U.S., there is a lot of power plants being constructed.

Coal is growing outside of the U.S. and because of that, we are seeing a lot of suppliers that had all increased the percentage that their selling to that market. And part of that, we have been the beneficiary of improving our logistics with the addition of the Loop, improving the variety of coals that we can sell to the customer with the addition of Carlisle, all of that has allowed us to pick up eight new customers this year. Going from nine to 17, that is huge and some of these customers are quite large. We think there is going to be add-on tons down the road. Traditionally once we get in a plant, we have a tendency to stay in a plant. They may vary their volumes up or down, but we have a tendency to stay there. I think this has been a dramatic change. We worked a long time trying to get into this position and right at the end of 2018, everything kind of came together and I think we are in dramatically a better position than we were this time a year ago.

Lucas Pipes

This is great to hear and congratulations on all that progress. I want to quickly touch on the sand side. Any update on Hourglass?

Brent Bilsland
We are still working there and still talking to customers. It's our goal to get our permits in place to where we potentially could be contracting to open something late this year. That being said, we are not in that position at this moment. We are working to get there. We still like that business. We still liked that market and we are still going to work on it every day.

Lucas Pipes
Got it. Great. I will turn it over for now. But really appreciate all the color and good job.

Brent Bilsland
Thank you, Lucas.

Larry Martin
Thanks Lucas.

Operator
Again, if you have a question please press star then One. And our next question will come from Ethan Park of Extract Capital. Please go ahead.

Ethan Park
Hi, Brent and Larry. Congratulations on the increased sales guidance for 2019. That's great.

Brent Bilsland
Thanks, Ethan.

Ethan Park
I mean maybe that's related to the last question, but let me further ask about the upside for your sales number. I noticed on the 10-K that your annual capacity was 10.5 million tons, if you can sell more coal in 2019 or 2020, can you comment on how much in ramp-up costs may be associated to ramp-up from that 8.2-million-ton guidance to 10.3 or 10.5 even? And also, if you can elaborate a little more on what the per ton production cost may be at 8.2 and 10.5, that will be helpful for me?

Larry Martin
Well, Ethan, to get to 10.5 the sales would have to show up. We have extra units, we have talked about this before, we always have units at all of our mines. If something happens, we can move from that unit to idled unit and keep production going. We are set up where we can get to the 10.5 with very minimal capital investment. There is a few things we have to do, but nothing major that we would have to do to invest to get to that 10.5 million tons. The cost structure...it would come down for sure, with Oaktown ramping up to be over seven million that it operated out last year. I think our cost structure will come down below that 28 to 30 range for sure with that 10.5 million tons sold. For any business if you are operating at full capacity, you are going to be your lowest cost structure.

Ethan Park
Yes. Okay, thank you.

Brent Bilsland

Thank you.

Operator
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
I thank everyone for taking the time today to join us. We are very excited about what 2019 holds for our company and for our shareholders. And with that, we will conclude today's call. Thank you.

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