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# NACCO Industries, Inc. (NC)

Q4 2016 Earnings Call

# CORPORATE PARTICIPANTS

Christina Kmetko
*Hyster-Yale Investor Relations Consultant, NACCO Industries, Inc.*

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*

Elizabeth I. Loveman
*Vice President & Controller, NACCO Industries, Inc.*

# OTHER PARTICIPANTS

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*

# MANAGEMENT DISCUSSION SECTION

**Operator**: Good morning. My name is Jodi, and I will be your conference operator today. At this time, I would like to welcome everyone to the NACCO Industries Fourth Quarter 2016 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Christina Kmetko, you may begin your conference.

## Christina Kmetko
*Hyster-Yale Investor Relations Consultant, NACCO Industries, Inc.*

Thank you. Good morning everyone and welcome to our 2016 fourth quarter earnings call. I am Christina Kmetko, and I am responsible for Investor Relations at NACCO Industries.

I will 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 Al Rankin, Chairman, President and Chief Executive Officer; and J.C. Butler, our Senior Vice President ,Finance, Treasurer and Chief Administrative Officer, as well as the President and Chief Executive Officer of our North American Coal subsidiary. Also joining us is Elizabeth Loveman, NACCO's Vice President and Controller.

Yesterday, we published our fourth quarter and full year 2016 results and filed our 10-K. Copies of our earnings release and 10-K are available on our website at nacco.com. For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.

As we begin, I would like to remind participants that this conference call may contain certain 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, in either our prepared remarks or during the following question-and-answer session.

We disclaim any obligation to update these forward-looking statements, which may not be updated until our next quarterly conference call, if at all. Additional information regarding these risks and uncertainties was set forth in our earnings release and in our 10-K. Also, certain amounts discussed during today's call are considered non-GAAP. The non-GAAP reconciliations of these amounts are included in our earnings release available on our website.

Now, let me discuss our results for the fourth quarter. Our consolidated revenues were $284.2 million compared with $286.5 million in the fourth quarter of 2015. The decline in our consolidated revenues was driven primarily by a reduction in the number of stores at our Kitchen Collection subsidiary. We reported consolidated net income of $24.1 million, or $3.53 per share this quarter compared with net income of $18.1 million, or $2.63 per share last year. Net income increased at all three of our subsidiaries this quarter.

We have continued to provide financial results excluding Centennial to allow for a better understanding of the performance of the company's active operations. However, it should be noted that Centennial's operating losses are decreasing. Excluding Centennial, our fourth quarter consolidated revenues were $284.2 million compared with $282.2 million in the prior year quarter. Consolidated adjusted income increased to $25.9 million, or $3.80 per diluted share from $22.8 million, or $3.32 per diluted share in the fourth quarter of 2015.

Revenues at North American Coal including Centennial were $25.3 million in the fourth quarter of 2016 compared with $26 million last year and income before income tax was $1.1 million in 2016 compared with the net loss before income tax of $3.9 million last year. However, North American Coal reported net income that was higher than the income loss before income tax in both years, $9.3 million this quarter compared with $2.2 million in 2015. This occurred primarily because of the mix of taxable earnings between profits at entities that benefit from percentage depletion and losses at entities with higher effective income tax rates, including losses related to Centennial. North American Coal also realized a $1.2 million tax benefit in the fourth quarter of 2016 as a result of the resolution of an uncertain tax position adding to this improvement.

Now, let me focus on Centennial for a minute before I talk about results excluding net operations. As I mentioned previously, Centennial's losses are moderating. Centennial had an operating loss of $2.9 million in the fourth quarter of 2016 compared with an operating loss of $7.5 million in last year's fourth quarter. There are a few smaller unusual items affecting these results, which we've spelled out in our earnings release, but in general, Centennial's operating loss declined as expected because substantially lower operating costs were required to conduct the remaining day-to-day operations of selling equipment, maintaining permits and mine reclamation.

Excluding Centennial, North American Coal's revenues increased $3.6 million from the prior year fourth quarter primarily because of an increase in tons sold at Mississippi Lignite Mining Company and an increase in reimbursed costs at the North American Mining Company, which we previously referred to as the limerock mining operations. Income before income tax excluding Centennial's results also improved moderately to $4 million compared with the prior year. The moderate improvement was primarily attributable to an increase in operating profit at the unconsolidated mining operations, as newer mining operations began or increased production. These increases were mostly offset by expected lower operating results at Mississippi Lignite Mining Company and increased costs associated with land leases for the Otter Creek reserves.

Looking forward to 2017, we expect a significant increase in North American Coal's tons sold and income before income taxes compared with prior year excluding the effect of the 2016 asset impairment and legal resolution charges. Results in 2017 are expected to benefit from substantially higher income before tax from the unconsolidated mining operations due to the start of production at Bisti Fuels in January and to a full year of income at the Coyote Creek mine. In addition, this past October, the North American Mining Company commenced operations at new limerock quarries for a new customer, which is also expected to contribute to the increase in income from the unconsolidated mining operations.

Finally, we also expect income before income taxes to benefit moderately from fewer expenses related to the Otter Creek reserves and a lower, more moderate, operating loss at Centennial as it manages ongoing mine reclamation obligations. We expect a significant decrease in royalty and other income and lower results from North American Mining's consolidated limerock mining operations because of reduced requirements of existing customers to partially offset these improvements.

Mississippi Lignite Mining Company's 2017 results are expected to be comparable to last year with a decrease in the first half of the year expected to be offset by improvements in the second half. We expect cash flow before financing activities to be strong in 2017, but decrease compared with 2016 and we expect capital expenditures at North American Coal to be approximately $16 million for the year. Moving on to Hamilton Beach, Hamilton Beach had a very strong quarter. Fourth quarter of 2016 revenues were comparable to 2015, but operating profit and net income increased substantially, 32% and 30% respectively over the prior year fourth quarter. An improvement in gross profit as a result of shift in sales mix to higher priced and higher margin products and reduced costs were the main drivers for the improved operating profit and net income.

Looking forward, we believe overall consumer confidence and financial pressures experienced by the middle-market consumer and changing consumer buying patterns continue to create uncertainty about the overall growth prospects for the U.S. retail market for small appliances. In this context, 2017 U.S. and Canadian consumer retail markets for small kitchen appliances are expected to be comparable to 2016 while international and commercial markets in which Hamilton Beach participates are expected to grow moderately. Sales are expected to continue to shift from in-store channels to internet sales channels. As a result of this market environment and with a number of new products in its product pipeline, we expect Hamilton Beach's sales volumes and revenues to increase modestly in 2017 compared with 2016. This increase is expected to be slightly more than the anticipated market growth due to enhanced distribution and increased higher margin product placements resulting from the execution of the company's strategic initiatives both domestically and internationally.

In addition, we expect Hamilton Beach's 2017 net income to increase modestly compared with last year as benefits of the increased revenues are expected to be mostly offset by the costs to implement these initiatives, as well as increased advertising and distribution costs. Cash flow before financing activities is expected to be substantial, but lower than 2016 and capital expenditures are estimated to be approximately $8 million.

Finally, at our Kitchen Collection business, net income for the fourth quarter of 2016 increased to $4.2 million, up from $3.9 million in the prior year fourth quarter on a moderate decrease in revenue. Net income increased primarily as a result of improved gross margins and lower store operating costs at comparable stores. We expect the shift in consumer shopping patterns and ongoing financial pressures on middle-market consumers to continue to persist and limit Kitchen Collections' target consumer spending on housewares and small appliances resulting in continued market softness in 2017.

Given this market environment, Kitchen Collection expects to aggressively manage and reduce its store portfolio and continue its focus on a smaller core group of profitable outlet stores. Kitchen Collection closed 17 stores early this quarter and plans to open a limited number of new stores throughout the remainder of the year in locations that are expected to generate acceptable profitability. As a result of these actions, we anticipate Kitchen Collections' revenues to decline modestly in 2017 compared with 2016 with full-year 2017 results comparable to last year. Cash flow before financing activities is expected to be positive this year, but substantially lower than last year and capital expenditures are estimated to be approximately $1.6 million. Before I open up the call for questions, we want to note that the company did not repurchase any shares under our stock repurchase program this quarter.

This concludes my prepared remarks. I will now open up the call for your questions.

# QUESTION AND ANSWER SECTION

**Operator**: [Operator Instructions] Your first question comes from the line of Michael Fisherman from Zuckerman. Your line is open.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*

Q

Good morning, Al. How are you?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

A

Fine, thanks.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*

Q

So a couple quick questions if you don't mind. Hamilton Beach, I know that 2016 [ph] cash flow before financing (11:31) was very strong at $54 million, usually it's like $20 million, $25 million. So I understand that you're guiding it lower. But could you quantify substantial or maybe give us a range for modeling purposes?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

A

No, I don't think we're going to get into that kind of detail. I think that if you look at the working capital variances depending on performance in the last three days in collections, working capital can change a lot and it's not necessarily a very good indicator. So I would think about it from the point of view of the base underlying cash flow that comes from the earnings of the business. And depreciation, net of capital expenditures and then the rest is kind of fluctuation around that number as the best way to think about it. So I think your best bet is to parse those numbers.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*

Q

Okay. And the only reason I ask is because for the coal piece, it's very similar where you say you expect strong 2017, but a decline from 2016 as well. So I guess what's the difference between strong and substantial?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

A

Well, I think we just stick with the comments that we made. That's really what we say. It depends a lot there not only on the operating earnings, but on the level of capital expenditures. J.C., I think that tends to be the biggest variable and I do think we give you a forecast of capital expenditures as a part of our 10-K as you look forward.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay. And then with Hamilton Beach, can you give a timeline on when you expect to hit the $750 million sales and 10% EBIT margin?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

I think we have divided it into two parts. One is the near-term aspiration for 8% on a somewhat lower number. The other is longer-term and harder to predict. I think that what we do feel however and want to convey is that – if we can reach those kinds of numbers that the business, it has the opportunity to leverage itself considerably. So it's going to come in fits and starts. It's going to depend on new products and it's hard to forecast. But I think those kinds of numbers are well out into our planning period. They're not near-term.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay. And then just switching gears, back to coal, could you just give us some color on – I mean SG&A was up 15%. It seems high. Any opportunity in 2017 to take that lower?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

I'd ask J.C. to comment on that with the note that sometimes our incentive compensation can fluctuate depending on certain things that happen during the year that can change the employee compensation levels. And J.C., do you want to elaborate on that or [indiscernible] (15:06)?

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*
A

Al, I mean, you're exactly right. That's what drove the increase in 2016 SG&A really in the fourth quarter. That will be described more clearly when the proxy is published here pretty soon. I think 2017, we expect to be at a more normal level.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

So, Al, if I understand correctly, you're saying your SG&A in 2017 for the coal was driven by incentive comp. but does that seem fair to shareholders if you're pushing back your timeframe for your unconsolidated mining EBIT growth? I would think that incentive comp would have been lower.

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

Well...

Elizabeth I. Loveman
*Vice President & Controller, NACCO Industries, Inc.*
A

One other [ph] piece (15:53) in SG&A is we had a $3.3 million legal charge in the fourth quarter that's driving up our SG&A. That's a one-time item in 2016.

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*
A

Oh, that's true.

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

That's the bigger piece. So I think I'd concentrate on that.

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*
A

That is the bigger piece.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay. And then Al, could you give any color or J.C. give some more color on what lower index-based coal sales price like, just help us understand what's embedded in that, so we can figure out for ourselves? Thank you.

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*
A

Al, I'll take that. I think, in prior releases, I think we've described pretty clearly how the pricing mechanism at Mississippi Lignite Mining Company's Red Hills Mine works. Coal sales price is determined by a basket of indices that reflects things that are included in their cost of production. I think we – I know that we've called out diesel fuel as one of those. And it recalculates every month and it uses an index that's based on the changes in those indices over time. And as the price levels of those changes, their weightings of them change and it's really – it's purely formula based. And as we called out in prior earnings releases, the substantial drop that we saw in diesel fuel has decreased our coal sales price at that mine. We all see what's going on with diesel fuel prices. They're inching up a little bit at a time much more gradually than they came down and we'll just have to see how all those play out over time. But if you look at prior releases, you'll see a lot of description about how this mechanism works.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Is diesel the biggest component? Is there anything else you could elaborate on?

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*
A

It's a basket of indices and their weightings change overtime based on what's been going on in those prices – with those individual indices. You have an individual indice that shoots way up or drops way down, it'll change the weightings. But, yes, diesel is one of the substantial – more substantial indices in the basket.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay, and...

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

The way I would just leave it is if diesel prices go up, overtime that would have an increasing positive effect on that particular mine. Our other mines tend to be much more broad general baskets such as the Producer Price Index, but all of our mines have some component of inflationary adjustment. And obviously, during a time when there is no inflation in those indices, price increases are occurring even if we incur cost increases in certain areas of our business, which we do.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

So when you think about our new President, President Trump, I guess the easy way to go is he's already stripping coal regulation. I mean, he mentioned it in his address to Congress, but then the other part is, I mean, people think he's going to drive inflation. So that I guess the byproduct, there could be two positives for you from the new administration. Do you have any comment on that, Al?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

On the first, I'd simply say that our business is really built on the margin mainly, not entirely, but mainly around the construction of new coal fired power plants. And at the current time, we don't see that on the horizon even given some of the changes that have been suggested. We think that the plans that we have are even more secure than they were before, that's different from having new coal fired capacity come on stream. There are a lot of other factors that influence that including what administration will follow the Trump administration. With regard to inflation, I think for many reasons not limited to the new administration, that inflation is headed up from the lower non-existent levels that have existed for a while. So when that will play back into particularly diesel prices and some of the more specific indicators that we have, very hard to say. So we don't forecast those.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay. And what about it, because I think also last quarter someone asked about what you're doing with your cash and you talked about how banks, you want to pay down debt because of coal. Does this change your spot? The only reason I'm asking is because you have $135 million of debt, generated $84 million of cash last year, you're maybe, I don't know, call it $15 million whatever. This year, you tie that in with the potential value of Hamilton Beach. Your stock is very cheap. I just wonder if it's better to use the cash flow to continue to buy back stock. Do you have any comments on that?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*
A

Well, first of all, we do want to watch very carefully what the bank loan market is like and how it's reacting to our specific situation and we'll continue to monitor that. With regard to a stock purchase plan, I think, Christie indicated that we didn't make any purchases in the last quarter and are continuing share buyback against our continuing share buyback authorization. But it's certainly possible that share repurchases maybe made, but again, that's not something we would ever forecast.

Michael Fisherman
*Analyst, Zuckerman Investment Group LLC*
Q

Okay. Thank you very much.

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

A

Yeah, thank you.

**Operator**: There are no further questions in the queue at this time. I turn the call back over to the presenters.

Christina Kmetko
*Hyster-Yale Investor Relations Consultant, NACCO Industries, Inc.*

Al or J.C., do you have any follow up questions or comments?

Alfred M. Rankin
*Chairman, President & Chief Executive Officer, NACCO Industries, Inc.*

I do not. None from me.

John C. Butler
*Senior Vice President - Finance, Treasurer & Chief Administrative Officer, NACCO Industries, Inc.*

No.

Christina Kmetko
*Hyster-Yale Investor Relations Consultant, NACCO Industries, Inc.*

All right, thanks. All right, thank you very much for joining us today. This concludes our call. If you do have any follow up questions, you can reach out to me. My phone number is 440-229-5130. Thanks and have a great day.

**Operator**: Thank you for participating in today's NACCO Industries fourth quarter 2016 earnings conference call. This call will be available for replay beginning at 1:00 PM Eastern Standard Time today through 11:59 PM. Eastern Standard Time on March 9, 2017. The conference ID number for the replay is 48473978; again the conference ID number for the replay is 48473978. The number to dial for the replay is 1800-585-8367 or 1855-859-2056. If dialing internationally, the number is 1404-537-3406. This concludes today's conference call. You may now disconnect.