THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

NC - Q2 2014 NACCO Industries Earnings Conference Call

EVENT DATE/TIME: JULY 31, 2014 / 1:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Christina Kmetko *NACCO Industries Inc. - VP IR*

Al Rankin *NACCO Industries Inc. - Chairman, President, CEO*

J.C. Butler *NACCO Industries Inc. - SVP Finance, Treasurer, Chief Administrative Officer*

Elizabeth Loveman *NACCO Industries Inc. - VP, Controller*

CONFERENCE CALL PARTICIPANTS

Craig Inman *Artisan Partners LP - Analyst*

Ryan Leonard *- Analyst*

PRESENTATION

Operator

Good day ladies and gentlemen, and welcome to the Q2 2014 NACCO Industries earnings conference call. My name is Tracy, and I will be your operator for today. (Operator Instructions). As a reminder, this call is being recorded for replay purposes. I would now like to turn the call over to Christina Kmetko. Please proceed. Thank you.

Christina Kmetko - *NACCO Industries Inc. - VP IR*

Good morning everyone, and welcome to our 2014 second-quarter earnings call. I am Christina Kmetko, and I am responsible for Investor Relations at NACCO Industries. Joining me on today's call are Al Rankin, Chairman, President and Chief Executive Officer; J.C. Butler, Senior Vice President Finance, Treasurer, and Chief Administrative Officer; and Elizabeth Loveman, NACCO's Vice President and Controller.

Yesterday, we published our second-quarter 2014 results and filed our second quarter 10-Q for the three and six months ended June 30, 2014. Copies of our earnings release and 10-Q 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 For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on your website later this afternoon and available for approximately 12 months.

Before 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 earnings conference call, if at all. Additional information regarding these risks and uncertainties was set forth in our earnings release and in our 10-Q.

Also, certain amounts discussed during this call are considered non-GAAP. The non-GAAP reconciliations of these amounts are included in our 2014 second-quarter earnings release available on our website.

Finally, we have made some changes to our presentation format. We are not going to provide as much detail from our earnings release as we have in the past. Instead, 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.

Now let's discuss the quarterly results. Results for this quarter were disappointing but not necessarily unexpected. Consolidated revenue increased to $200.4 million in the second quarter of 2014 from $196 million in 2013. However, we reported a net loss of $3.6 million, or $0.47 per share, for the 2014 second quarter compared with net income of $5.1 million, or $0.63 per share, in the second quarter of 2013.

Here's how our results, which include some unusual events, break down by business unit. North American Coal's revenues increased as a result of higher tons and yards delivered. However, our coal business reported a second-quarter 2014 net loss of $100,000 compared with net income of $9 million in the second quarter of 2013. The major contributing factor to this net loss was a significant decline in the operating results at the consolidated Mining operations, particularly from Reed Minerals, and from a $1 million pretax charge to reimburse a customer for damage to certain customer-owned equipment at the limerock dragline mining operations.

North American Coal also had reduced royalty and other income, an increase in operating expenses and a pretax charge of $1.7 million for a reserve against a receivable from its customer in India. Improved earnings from the unconsolidated mines and a tax benefit in the current year compared with tax expense in the second quarter of 2013 did partially offset the unfavorable items I mentioned.

Let me explain what happened at Reed in a bit more detail. Reed had a significantly larger loss than in the previous year, which we indicated last quarter would happen in part because we idled one of Reed's mining areas. However, results were even more unfavorable than we had planned for the following reasons. The operating and productivity improvements we are implementing began later than anticipated in the second quarter of 2014 primarily because of a delay in the start up of the new dragline. In addition to the dragline delay, Reed also had to contend with excessive water in the mine area that limited the ability to produce tons. As a result of the combination of these events, Reed experienced production shortfalls which caused a decrease in inventory levels and reduced tons sold. Also, Reed had higher depreciation expense on the equipment acquired during 2013 and 2014 to improve efficiencies and productivity, and it also had higher repairs and maintenance expense.

Finally, Reed experienced lower selling prices resulting from unfavorable market conditions which contributed to a decrease in revenues. We expect improved operating performance at Reed in the second half of 2014 as production efficiencies are achieved.

In addition, North American Coal transferred key management from other operations to Reed Minerals during the second quarter and these individuals are expected to help Reed Minerals achieve its planned operating and productivity improvements.

At our consolidated Mining operations, steamed coal tons delivered are expected to decline slightly in the last half of 2014 from the same period in 2013 based on the customers' currently planned power plant operating levels for the remainder of the year. Overall, North American Coal expects net income in the second half of 2014 to increase compared with the second half of 2013. The productivity improvements and increased mining efficiencies we mentioned at Reed Minerals are expected to result in breakeven results compared with a significant loss in the same period last year but are not expected to offset the substantial operating losses that Reed Minerals incurred in the first half of this year. These improvements at Reed Minerals in the second half of 2014 are also expected to be partially offset by significantly reduced deliveries at Mississippi Lignite Mining Company due to a planned outage at the customer's power plant as well as lower royalty and other income than in the second half of 2013. Cash flow before financing activities in 2014 is expected to be positive as compared with negative cash flow before financing activities in the prior year.

At Hamilton Beach, revenues increased moderately in the second quarter of 2014 compared with the prior-year second quarter. Overall volumes were down, primarily in the US consumer market, but this was more than offset by increased sales of products at higher price points mainly in the commercial market and in the US and Canadian consumer market. However, Hamilton Beach's net income decreased to $1.4 million in the second quarter of 2014 from $2 million in the prior-year quarter. If we remove the effect of environmental charges of $2.7 million in 2014 and $2.3 million in 2013, operating results decreased primarily due to an increase in operating expenses which were partially offset by a shift in mix, sales mix, to higher-margin products.

Unfavorable conditions are creating continued uncertainty about the strength of the retail market and expectations regarding consumer activity in the second half of this year. As a result, sales volumes in the middle market portion of the US small kitchen appliance market in which Hamilton Beach participates are projected to grow only moderately in the second half of 2014. The Canadian retail market is expected to follow US trends while other international and commercial product markets in which Hamilton Beach participates are anticipated to grow moderately in the second half of this year compared with the same period in 2013.

Sales volumes are expected to grow more favorably than the market at Hamilton Beach due to improved placements of products with higher price points over the remainder of 2014 compared with the second half of 2013. We expect an increase in Hamilton Beach's revenues in the second half of 2014 compared with the same period in the prior year. The anticipated increase in revenue is expected to be substantially offset by the cost of implementing Hamilton Beach's strategic initiatives and by increased advertising and promotional costs and outside service fees. As a result, overall, we expect Hamilton Beach's net income for the second half of 2014 to be comparable to or modestly lower than the second half of 2013. Cash flow before financing activities at Hamilton Beach is expected to be substantial in 2014 but down significantly from last year.

Finally, at our Kitchen Collection segment, while revenues continued to decline mainly as a result of the closure of over 50 unprofitable stores in the first half of 2014 and the closure of other unprofitable stores since June of 2013, the pretax operating results improved. Improved operating margins at both Kitchen Collection and Le Gourmet Chef stores, mainly due to the closure of the unprofitable stores, as well as a shift in mix to higher-margin product, a reduction in comparable store expenses and a decrease in corporate expense all contributed to the improvement in the results. Seasonal losses at newly opened stores partially offset these improvements.

Kitchen Collection's second-quarter 2014 net loss increased to $2.7 million from a net loss of $2.4 million in the second quarter of 2014. However, that increase in the net loss was mainly the result of a lower effective income tax rate that generated a smaller benefit from Kitchen Collection's loss from operations.

Unfavorable retail market conditions continue to affect traffic to all mall locations and particularly outlet malls. Traffic continued to decline in the second quarter of 2014 and prospects for the remainder of this year are uncertain. Kitchen Collection expects to continue to refine its business plan on the assumption of continued market softness and will continue to close underperforming stores and realign the business around core stores which perform with acceptable profitability.

A lower number of stores are expected to be maintained in the remainder of 2014. As a result, revenues in the second half of 2014 are expected to decrease substantially compared with the same period in the prior year. Despite a decrease in revenue, cost reduction actions and revisions to store layouts that focus on higher-margin products are expected to substantially improve net income for the second half of 2014 compared with a net loss in the second half of 2013. However, we do still expect a loss at Kitchen Collection for the 2014 full-year as the second-half improvements are not expected to offset the losses incurred in the first half of this year. Positive cash flow before financing activities in 2014 is expected to be generated at Kitchen Collection compared with negative cash flow before financing activities in 2013.

Before I open the call up for questions, I want to note that, during the six months ended June 30, 2014, we purchased $14.2 million of Class A common stock under our $60 million stock repurchase program. Since the program began in November 2013, we have repurchased approximately 282,400 shares for an aggregate purchase price of $15.2 million.

That concludes our prepared remarks. I will now open up the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions).

Christina Kmetko - *NACCO Industries Inc. - VP IR*

While we are waiting for questions, let me provide my contact information. If you do have any questions after today's call, my number is 440-229-5130. Are there any questions?

Operator

Craig Inman.

Craig Inman - *Artisan Partners LP - Analyst*

I wanted to talk a little bit about the Kitchen Collection business. You know, historically, just looking back, even at its best times, it was making $4 million and performance continues to deteriorate. And really over the life of it, it hadn't made a whole lot of money. So I just kind of want to understand your strategic thoughts around is this one going to be a business that you keep feeding money to, or are you trying to get capital out of it and just shrink it until it is profitable or earns a decent return on capital? I just want to understand what you all are thinking there in terms of the Kitchen Collection business. Thanks.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

This is Al Rankin. I'll comment on that.

I think the first perspective is that our view is that, in the last couple of years, the strategic position of that business has changed, that it's probably some combination of competitive characteristics in the factory mall environment as a result of increased Internet sales and a different competitive structure and a different customer prospecting structure emerging. And secondly, I think there is simply less traffic to factory outlet malls and to some degree to all malls for some of the same kinds of reasons.

As you note, this has always been a small business for us. Historically, we had some modestly profitable operations for a few years but we saw the opportunity for it to improve significantly over time. I think our views moderated in that regard.

And I'd only say that, at this point, we are closing all stores that don't meet our financial requirements, and that is leading to a shrinking of the business, and we will see just how far that process goes. As you point out, less capital will be deployed in the business. We are not at the capital levels that we want to be in because the business has been shrinking. But we feel that things should be pretty well stabilized by the end of the year and the second half should be significantly better than last year. So, we are pretty close to the point of stability. I'd just point out that it doesn't consume a lot of senior management time to have that (technical difficulty) generally speaking is a very sound -- should be a sound situation and we'll just have to manage it as we go forward with less capital. Does that answer your question?

Craig Inman - *Artisan Partners LP - Analyst*

Yes. That definitely makes sense.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Okay, thank you.

Operator

Ryan Leonard.

Ryan Leonard - *- Analyst*

I had just a handful of questions. If we can start on North American Coal, can we break down the cost of goods sold for the consolidated mines? More specifically, how much of that increase year-on-year was Reed? How is the underlying business of the consolidated mines performing? Because (multiple speakers) going forward.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

I think the best way to answer that is to say very explicitly that we've had considerable difficulty at Reed in the second quarter that we brought a lot of resources to bear to improve it. There were some factors that were beyond our control, but it's been a big drag, and we see that changing year-on-year very dramatically in the third quarter and in the fourth quarter. So I think by far the worst is behind us at this point.

But Reed is -- we don't really look at it from a cost of goods sold point of view so much as just the profitability. And obviously the lack of adequate productivity leads to high costs, but it's really, in our view, variances from where we expect to be in the future. So, it is the biggest issue in the consolidated mines, and we expect that as we go into the third quarter, that we are going to have some dramatic year-on-year improvements.

J.C. Butler - *NACCO Industries Inc. - SVP Finance, Treasurer, Chief Administrative Officer*

This is J.C. Butler. If I could just add to that, to the cost, and we've been talking about this for a while in our earnings release. We're installing a new dragline at one of the largest mine areas at the Reed operation. It will bring significant cost reductions. The reason we've invested in this equipment over the last few quarters and got it installed is to drive down the costs so that you can be profitable even in a low price environment. So the actions we've been taking are directly related to driving down costs.

Ryan Leonard - - *Analyst*

Is that dragline up and running as we speak, or is that still to come?

J.C. Butler - *NACCO Industries Inc. - SVP Finance, Treasurer, Chief Administrative Officer*

No. The dragline that we mentioned was delayed in the earnings release is now up and running and we are in training mode and we're making nice progress.

Ryan Leonard - - *Analyst*

Okay. Because if you look at the overall revenue growth of the consolidated mines, it was very solid for the quarter, that the underlying trends, if you look kind of gross profit point of view, I don't think really show the positive. I think it outweighs it. Did the one-time charges that you guys put in the release, I think they were in total $2.7 million, did that fall through the -- run through the cost of goods sold on the consolidated side?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Well, again, I think the way we think about this is we think about the results in our consolidated mines and the results in our unconsolidated mines. And I think specifically you asked about the performance of the consolidated mines, and it was Reed that was driving the big negative in the second quarter, and it's for the reasons we think were outlined in the earnings release and that we think are going to be dramatically improved in the third and fourth quarters. So, I think that's really the way I'd look at it, is that the operating profit contribution perspective, which is the way we present the numbers in the MD&A analysis.

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

One other item is that the Florida operations did have a $1 million charge in the quarter that ran through cost of goods sold. That's impacting operating profit.

Ryan Leonard - - *Analyst*

So the $1 million did, but the $1.7 million did not. What did the $1.7 million run through? The dispute with the Indian client?

Christina Kmetko - *NACCO Industries Inc. - VP IR*

Yes, India falls in other below operating profit.

Ryan Leonard - - *Analyst*

Below, okay. Given all the talk on environmental regulations, what have your utility clients been talking about? I know there's a pretty big outage coming up here in the second half this year at one of your mines. How about on the unconsolidated mines? What have you been hearing from your utility customers on the regulation front?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

J.C., why don't you just answer that if you would.

J.C. Butler - *NACCO Industries Inc. - SVP Finance, Treasurer, Chief Administrative Officer*

Yes. So, obviously, we are starting this and we're spending a lot of time talking with our customers as well as state officials and other regulators and folks at the federal level. I mean I think the jury is still out broadly about what this rule really means. There's a lot of questions about its enforceability; there's a lot of questions about how it might play out in the changing markets within states. And of course it's -- energy is not dispatched by state. It's dispatched by region, and I think there's a lot of questions about that.

You mentioned the outage at the Red Hills customer, the Mississippi Lignite Mining Company customer, in the fall. I mean I think that's a good example of what we are seeing. Our customers are continuing to make substantial investments in their coal-fired power plants because they just see that these are good, reliable, low-cost, environmentally up-to-date power plants that they believe should continue to run and they are continuing to invest a lot of money on. It's not just our customers. And it's not just the power plants that we serve. There are all sorts of coal-fired power plants. People are continuing to make investments in them. So, I think there's some real doubt about whether this really plays out as dramatically as some in the press have speculated.

Ryan Leonard - - *Analyst*

Okay.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Let me just add to that that I think the -- we have regular outages for maintenance purposes in all of our -- the power plants that we serve with our mine-mouth operations. And so those are regular near-term events, and as J.C. has indicated, we don't see any change in behavior. People are continuing to be committed. And I'd just emphasize that the EPA rules that are being hotly debated in terms of what their impact may or may not be and the lack of clarity of all of that is an impact that wouldn't come for several years under any circumstances. So, there isn't anything immediate about those rules. They will only affect things several years from now.

Ryan Leonard - - *Analyst*

Okay. You guys owned Reed for about eight quarters now. What have you kind of learned over this time period? Because it seemed, in the recent past, that trouble started to kind of bubble up in a pretty big way. What have you kind of learned from that and how to implement certain things going forward?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

I think there are a couple of things that I'd say. First is you know we did not buy at the peak. Looking backwards, we probably didn't buy at the trough either. I think we feel we made a good long-term acquisition.

What we have been able to do is to add reserves and capabilities at the trough that are going to significantly benefit us in the long-term in that operation. So, we feel on balance that we've got in a good strategic position.

I think if we learned anything it's that we have to move faster to implement the professional mining practices that we have in all of our other mines, in existing mines that we acquire, and get those practices in place more quickly and more comprehensively. But we've got a good operation for the future. We've brought the resources to bear on it, and we feel that, on balance, we are positioned well for the future.

Ryan Leonard - - *Analyst*

And speaking of investments, CapEx has been running pretty heavy in this segment. How do see that for the second half of the year playing out?

J.C. Butler - *NACCO Industries Inc. - SVP Finance, Treasurer, Chief Administrative Officer*

I actually think that's -- the number is in the 10-Q. Elizabeth, maybe you've got the number, but we don't have a lot of capital investment forecasted into the future.

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Total North American Coal future CapEx for the remainder of the year is $21.8 million.

Ryan Leonard - - *Analyst*

Additional on top of what you spent in the first half, correct?

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Right, yes.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

But remember that's for all sorts of things. That's not just at Reed.

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Right. That includes Mississippi, Florida.

Ryan Leonard - - *Analyst*

Okay. Switching gears to Hamilton Beach, can you remind us what this environmental charge is for?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

We have a Canadian distribution center that we have leased for many, many, many years. And going way back, it had some manufacturing activities in it that were quite traditional at the time. And like many of our other manufacturing sites, it has -- they have environmental problems today. These really didn't surface until just recently. And so, as they surfaced, we put them on the books. And, we feel that we have a reasonable handle on them now and we are -- so the last two years have been -- of charges for that facility have related to that.

We've also had another facility where we've had environmental obligations for a long time. And actually in that particular case, we have received some additional proceeds or the promise of additional proceeds from a predecessor company and that has offset some of those charges. So, it's all related to long-passed activities.

Ryan Leonard - - *Analyst*

Of the two charges, are we kind of at the point where we are done with kind of these one-off things or there could be possibly more to come?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Well, there is always possibly more or less to come, but our obligation under GAAP principles is to book a charge that we think is reasonable as it is defined by GAAP principles, and that's what we've done based on all the knowledge that we have at this point. And we had a study done and the study gave us more knowledge and that's why we increased the reserve.

Ryan Leonard - - *Analyst*

Got it, okay. Any updates on the agreement with Sub-Zero Group? Is that progressing along as you --?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

It is progressing along. I've had a review of the program. I think everyone is very pleased with how that program is coming at this point and it's moving along right on schedule.

Ryan Leonard - - *Analyst*

And that's still for products to be available spring of 2015, or everything just gets in motion by spring of 2015?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

We begin to have products I believe in spring of 2015. Isn't that right Elizabeth?

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Correct.

Ryan Leonard - - *Analyst*

Okay. And then how about just underlying new products? I know you've been pointing some out in the release but they've been kind of been playing out in the release for quite some time. But do you have any new products that will be new to the market from Hamilton Beach for this coming-up selling season?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

I don't expect to see anything that we haven't announced that will dramatically affect the 2015 selling season. Now, what we do mean by continuing to emphasize those is they haven't fully played out in the marketplace, and they are still gaining traction, but we do have others that we are going to be pushing forward here on, but not in the time period that you're asking about.

Ryan Leonard - - *Analyst*

All right. And then lastly, our favorite, Kitchen Collection. I noticed that the gross margin has increased to a pretty -- the highest level in five quarters at least, this 42.7%. Is that sustainable or was there anything one-off in that that really pushed that gross margin up to --?

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

No. I think it's really the reverse, that we've had one-offs that have reduced the gross margin. And when you have contraction in the number of stores of the quantity that we've had, you're going to have the need to sell off products.

Secondly, we have changed the formats and the product lines to some degree. I think that's pretty much behind us, but I would say, to your point, that we have also got in place I think an enhanced system for managing our gross product by product category in terms of ensuring that the markdowns and other promotional activities are at budgeted levels and not more than that. And so I feel that that's a sound number that you're looking at.

Ryan Leonard - - *Analyst*

You have been true to your word of reducing stores, but I'm surprised that you didn't call out any kind of one-time costs coming through, because one would think, with a higher gross margin, your operating profit would have been better. So, are there some one-time charges coming through or any higher charges due to store closures or severance or whatnot that maybe running through the P&L?

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Nothing material -- go ahead, sorry.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Sorry, Elizabeth, you go ahead.

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

Yes, there have been no material charges running through the current year -- the current quarter.

Ryan Leonard - - *Analyst*

Okay.

Elizabeth Loveman - *NACCO Industries Inc. - VP, Controller*

We took some charges in the fourth quarter of 2013, but nothing this year.

Ryan Leonard - - *Analyst*

Got it. Okay. Well, thank you very much. That's all for me.

Operator

Thank you. You have no further questions at this time. (Operator Instructions)

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Okay, Christy. I think we've addressed the questions and you've given people the telephone number to call you. You might repeat the number so that if there are additional questions people can be directly in touch with you. But I think we'll conclude now.

Christina Kmetko - *NACCO Industries Inc. - VP IR*

Okay. Thank you for joining us today. We do appreciate your interest, and if you do have any future or additional questions, please give me a call. My number is 440-229-5130.

Operator

Thank you.

Al Rankin - *NACCO Industries Inc. - Chairman, President, CEO*

Okay. Thanks very much everybody.

Operator

Thank you. Ladies and gentlemen I would now like to provide you with the dial-in details for the replay service of this presentation which will be available to yourselves until the August 8, 2014. The dial-in details are as follows. If you'd like to use the US toll-free number, the number is 1-888-286-8010. There is also the US international direct number, which is 001-617-801-6888. And the replay code that you will need to enter to listen to the replay is 78864118. (Operator Instructions).

Thank you for your participation in today's conference. This does conclude the presentation. You may now disconnect. Have a good day. Thank you.