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NACCO Industries, Inc. (NC)

Q3 2017 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning my name is Emily and I will be your conference operator today. At this time, I would like to welcome everyone to the NACCO Industries 2017 Third Quarter 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] As a reminder, this call is being recorded today, November 2, and will be available until November 9 by dialing 800-585-8367 and entering pass code 3397937.

With that Christina Kmetko, you may begin your conference.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

Thank you. Good morning, everyone, and welcome to our 2017 third quarter earnings call. I'm Christina Kmetko, and I'm responsible for Investor Relations at NACCO. I'll 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 J.C. Butler, President and Chief Executive Officer of both NACCO and North American Coal; and Elizabeth Loveman, NACCO's Vice President and Controller. Also joining us today for the first earnings call post-spin is Al Rankin, NACCO's Chairman of the Board.

Yesterday, we published our third quarter 2017 results and filed our 10-Q. 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 For anyone who is not able to listen to today's entire call, an archived version of this webcast will be on our website later this afternoon and available for approximately 12 months.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-Q.

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 that I have the formalities done, let's talk about the quarter. We've had quite a bit of activity at NACCO this past quarter, so before I talk about our results let me talk through the changes that took place and how those changes have translated into our earnings release.

On September 29, 2017, we successfully completed the tax-free spin-off of our housewares-related businesses of Hamilton Beach Brands and Kitchen Collection. This new public company is called Hamilton Beach Brands Holding Company which now trades on the New York Stock Exchange under the ticker symbol, HBB.

As a result of the spin, the 2017 and 2016 financial information in our earnings release and 10-Q reflect the housewares businesses' operating results as discontinued operations. Today's discussion will focus on income from continuing operations as this reflects our post-spin ongoing business. All of our comments today will exclude the housewares business unless specifically called out. We do not plan to discuss Hamilton Beach Brands Holding Company's results or outlook. They published third quarter results and filed their 10-Q yesterday as well and will be holding their own earnings call.

NACCO's ongoing operations now consist of our North American Coal subsidiary and NACCO and Other, which includes the parent company operations of approximately 15 people and our non-operating subsidiary, Bellaire Corporation. We did not change our segment reporting for these entities and these two segments are the same as they were before the spin.

For this quarter and going forward, we have and will discuss segment results to pre-tax income and taxes and net income only on a consolidated basis.

There's one other change that I want to note before talking about our results. As Centennial's ongoing expenses from operations have moderated, we are no longer providing non-GAAP reconciliations that exclude Centennial. With that said, the prior year third quarter results include a $17.4 million pre-tax impairment charge at Centennial.

To aid in understanding year-over-year operating fluctuations, we have described financial results excluding this non-recurring impairment charge only from both The North American Coal and the consolidated results.

Now, let me discuss our results for the third quarter. Yesterday, we reported consolidated income from continuing operations of $3.3 million or $0.49 per diluted share compared with the consolidated loss from continuing operations of $2.1 million or $0.31 loss per diluted share for the third quarter of 2016.

As I mentioned, the 2016 third quarter results included the $17.4 million impairment charge or $12.5 million after tax. Excluding this impairment, North American Coal income before tax increased in the third quarter of 2017 to $8.2 million from adjusted income before income tax of $5.7 million last year.

However, on a consolidated basis and due to changes in consolidated income tax expense as a result of spin-off, our consolidated third quarter 2017 income from continuing operations excluding the impairment actually decreased.

I'll come back to what happened with taxes in a moment. But first, let me discuss the reasons for the improvement in North American Coal's pre-tax income. The increase was attributable to higher royalty and other income, an improvement in Centennial's ongoing operating results and an increase in the earnings of unconsolidated mines as newer mines increased production. These improvements were partially offset by substantially lower results at Mississippi Lignite Mining Company. Mississippi Lignite's results decreased due to a substantial decline in tons sold because of reduced customer requirements, mainly caused by an outage at the customer's power plant in the third quarter of 2017. The reduction in tons sold was also the primary driver for the significant decrease in reported revenues.

Our NACCO and Other segment reported a pre-tax loss from continuing operations that was comparable to the prior year third quarter. So overall, our consolidated third quarter pre-tax income improved compared with last year. However, as I mentioned, the consolidated income from continuing operations excluding the effect of the prior year asset impairment, decreased as a result of changes in income taxes.

In the 2017 third quarter, the effective income tax rate on our pre-tax income from continuing operations was 44.1% compared with an 84.5% effective income tax rate benefit on a pre-tax continuing operations loss in the 2016 third quarter.

The 2017 effective income tax rate includes discrete income tax expense of $1.9 million, primarily due to the establishment of a valuation allowance on deferred tax assets. The valuation allowance was established because we expect to be subject to AMT beginning in 2018 due to the change in the mix of earnings as a result of the spin-off of the housewares business.

The 84.5% benefit effective income tax rate in the third quarter of 2016 was the result of the mix of earnings between The North American Coal business and the spun-off housewares business now included in discontinued operations. The intra-period tax allocation in 2016, required when calculating discontinued operations, resulted in an unusual relationship between the loss from continuing operations and the related tax benefits.

Looking forward, on a consolidated basis we expect a substantial increase in consolidated pre-tax income from continuing operations in the fourth quarter of 2017 compared with last year. And we expect the fourth quarter effective income tax rate related to continuing operations, excluding discrete items, to be approximately 15%. When you include the discrete items recognized in the first nine months of 2017, we expect the full year effective income tax rate related to continuing operations to be between 20% and 25%.

At The North American Coal business, we expect a moderate increase in tons sold in the fourth quarter of 2017 compared with the prior year quarter. We also expect income before income tax to increase, resulting in a substantial increase in full year 2017 pre-tax income.

Lower operating expenses including a reduction in lease expense and an increase in earnings from the unconsolidated mining operations are expected to contribute to the increase in pre-tax income but we expect these lower expenses and higher unconsolidated earnings to be partially offset by a substantial decrease in Mississippi Lignite Mining Company's fourth quarter 2017 results.

During the outage at Mississippi Lignite's customer's power plant in the third quarter, production costs were capitalized into inventory. In the fourth quarter we expect these costs to be recognized as the inventory is sold resulting in an increase in cost of sales. Also excluding the impact of the fourth quarter 2016 legal resolution charges and a mine reclamation adjustment that was recognized, we expect Centennial's operating loss to be modestly higher in the fourth quarter of 2017 than it was in 2016. While we expect an improvement in the fourth quarter of 2017 over the prior year, North American Coal's fourth quarter pre-tax income is expected to be lower than our third quarter pre-tax income of $8.2 million, due to a decrease in earnings from unconsolidated mines and a reduction in royalty and other income.

Finally, to wrap up 2017, we expect full year cash flow before financing at North American Coal to increase moderately compared with 2016.

Now, let me provide a high-level look at what we expect for 2018. While we are providing this first look at 2018, I'd like to remind you that we are currently going through our detailed annual operating planning process, and we will provide more color on 2018 with our year-end earnings once we have finalized our annual operating plan.

In 2018, we expect consolidated pre-tax income from continuing operations to decrease moderately compared with 2017. And we expect our effective income tax rate to be approximately 25%.

At North American Coal, we expect 2018 income before tax to decrease compared with this year, primarily because of an anticipated substantial decrease in royalty and other income. In addition, the absence of $3.5 million of gains on the sales of assets realized thus far in 2017 and higher North American Coal operating expenses, which are expected to be partially offset by lower NACCO parent operating expenses, are also expected to contribute to the decrease in pre-tax income. We are expecting these decreases to be partially offset by improved results at Mississippi Lignite Mining Company due to an anticipated increase in customer demand, although we believe customer demand will be higher in the first half of the year compared with the second half of 2018 because Mississippi Lignite's customer anticipates a planned outage at its power plant in the second half of the year.

An increase in income from unconsolidated mines is also expected to partially offset the decline in income before tax.

We expect cash flow before financing activities to decrease in 2018 due in part to an increase in capital expenditures.

One additional item we would like to point out with regard to our North American Coal business, the future of the Kemper County coal gasification facility is still under review and as such, the status of that project remains uncertain, which means the future of the Liberty Mine remains uncertain.

Lastly, regarding our balance sheet, after the completion of the spin-off, we ended the third quarter with consolidated cash on hand of $93.9 million, debt of $58.7 million and net cash of $35.2 million. Cash on hand includes the $35 million dividend received from the housewares business, prior to the completion of the spin-off.

At the next regularly scheduled board meeting in November, our Board of Directors will evaluate and determine an ongoing dividend payout rate. We do not have any information to provide on the dividend rate at this time.

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

QUESTION AND ANSWER SECTION

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

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Hi. Congratulations, guys, on this successful spin-off.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.
A

Thank you.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Thank you.

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Just one or a couple of questions if you don't mind. So, cash flow from financing activities for 2017, I think you guys are saying you're now going to increase it moderately. Am I right in comparing that versus last quarter when you said it'd be down significantly? If that's true, maybe you can help understand why it's so much better?

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

Are you looking at consolidated or just – you're probably looking at North American Coal specifically?

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Just that. Yeah. Just the coal business separately.

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

I'd have to – I don't remember exactly what we had – what changed in front of me.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.
A

I didn't remember that it went – that we changed it that dramatically, Mike.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Yeah, I don't either.

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Okay.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.
A

Yeah. Sorry. But we can follow-up with that.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

I know – look, we know that fourth quarter CapEx for us is a little higher than we thought it was going to be before. We know that we had another strong quarter of royalties but there hasn't been that much else changed from a cash standpoint.

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

Yeah. I can't think of anything.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

I can't think of anything else.

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Okay. And then within the 2018 outlook you talk about lower NACCO parent operating expenses. Is that the same thing as SG&A within the supplemental information you provide or is that something different?

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

No. That's SG&A.

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Okay. Have you guys thought about giving any long term targets on where that SG&A can be over the next three to five years?

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

On where the SG&A at the parent company level?

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Yeah. Where it can go over the next three or five years. There's opportunity here to reduce that number over time?

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Well, I don't know why there would be an opportunity to reduce it. I mean, I think we've got some noise that we all need to work through from the prior nine months and I think that's going to continue right now as we're going [indiscernible] . Last nine months obviously Al was still on the payroll. We were configured a little differently, we're incurring other expenses, we're still going to have some of that in the fourth quarter. I think we have to let that work its way out but the functions that happen here in Cleveland and if they weren't here, they'd have to be in Dallas. And I don't – it'd probably be more expensive to do it in Dallas than it is here. It's not like we have anything that's [ph] duplicated (15:52) between the two, the two locations.

Michael Fisherman
Analyst, Zuckerman Investment Group LLC
Q

Okay. Thank you, guys. Good luck.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.
A

Thank you.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.
A

Thanks. Thanks.

Operator: [Operator Instructions] Your next question comes from the line of Robert Chapman. Please state your company name. Your line is open.

Robert Chapman
Analyst, Chapman Capital Family Office
Q

Chapman Capital Family Office. First of all, I want to thank you all very much for completing the spin-off. This has probably been one of the best investments I've made in years. But I have a question about it, even though I still don't look at all my position. I have a small position left. The value of this sub, which was the parent company less the value of when you issued the spin-off of Hamilton, was it trading around $20 per share before the confirmation of the spin-off.

And then in the brief period since the spin-off, the value of the sub, which now is no longer technically a sub, is it trades standalone. And it's simple. NC has gone close to $40 and even $44, which again, I'm very thankful of because I made lots of sales during that period.

You ought to have an explanation on why the value has gone up over 100%? Despite the fact that the outlook for 2018 does not appear to be salubrious and that coal prices have been stable, but down slightly. And royalty and production from the mines at North American Coal does not appear to have skyrocketed or done anything exceptional.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Well, as we were out talking with some investors before the spin actually happened on a little road show for NACCO, folks were asking us what our views were about valuations and things like that. My answer generally was my job's – our job is to manage the business and other people are professional investors and understand the stock market better than I. You know, why the stock trades up, why it trades down is often a mystery.

Your comment about the coal prices. Our business model really doesn't have us with any exposure whatsoever to coal prices. Our unconsolidated mines really operate as a service business, and our one-consolidated mine has a formula price for the coal it's sold. So it's not like any of this is driven by coal prices.

Robert Chapman
Analyst, Chapman Capital Family Office

Q

No, no, it don't. Would you agree the higher coal prices might lead to higher production at the associated mines?

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

I don't know that it's really connected. Our mines are individually dedicated to a single customer and it's really, it's really just that customer's demand for electricity that determines how much coal we sell to them.

Robert Chapman
Analyst, Chapman Capital Family Office

Q

Right. [indiscernible] (19:03).

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

Not like – we really don't have any exposure to the market either on the supply and demand side or the pricing side.

Robert Chapman
Analyst, Chapman Capital Family Office

Q

Right. Well, the reason I ask is the value based on projected 2018 estimates of the stock now is two to three times the value of comparables. And again, I couldn't be happier about that. I have maybe 5% of my position left, but I've been scratching my head at my good fortune, and I was wondering maybe you guys found a cure for cancer and haven't disclosed it.

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

It's not – that's not what we do.

Robert Chapman
Analyst, Chapman Capital Family Office

Q

[indiscernible] (19:40).

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

A

But, there's – there's. Yep. Thank you.

Operator: [Operator Instructions] And there are no further questions at this time. I'll turn the call back over to the presenters.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

Okay. Did you have any wrap-up comments?

J.C. Butler
President & Chief Executive Officer - NACCO; President & Chief Executive Officer – The North American Coal Corporation, NACCO Industries, Inc.

No.

Christina Kmetko
Investor Relations Consultant, NACCO Industries, Inc.

All right. Thank you for joining us today and we do appreciate your interest. If you have additional follow up questions, please call me, 440-229-5130. Thanks and have a great day.

Operator: This concludes today's conference call. You may now disconnect.