

Hallador Energy Company

Second Quarter 2021 Earnings Call

Tuesday, August 10, 2021, 2:00 PM Eastern

CORPORATE PARTICIPANTS

Brent Bilsland - *President, Chief Executive Officer*

Larry Martin - *Chief Financial Officer*

Becky Palumbo - *Investor Relations*

PRESENTATION

Operator

Good day, and welcome to the Hallador Energy Company's Second Quarter 2021 Earnings Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. Please note, this event is being recorded.

I'd now like to turn the conference over to Becky Palumbo of Investor Relations. Please go ahead.

Becky Palumbo

Thank you, Jason, and thank you, everyone, for taking the time to join us today. Yesterday afternoon, we filed our second quarter Form 10-Q and issued a press release containing certain financial metrics. Both documents are posted on our website. Today, we will discuss financial results and our perspective on market conditions and outlook. Following the prepared remarks, we will open up the call to your questions.

As a reminder, some of our remarks today may include forward-looking statements that are subject to a variety of risks, uncertainties and assumptions contained in our filings from time to time with the SEC. While these forward-looking statements are based on information currently available to us, if one or more of these risks or uncertainties materialize or if our underlying assumptions prove incorrect, actual results may vary materially from those we projected or expected. In providing these remarks, we have no obligation to publicly update or revise any forward-looking statements whether as a result of new information, future events or otherwise required by law to do so. With us today are Brent Bilsland, our President and CEO, and Larry Martin, our CFO.

And with the required preliminaries out of the way, Larry can begin the financial overview. Larry...

Larry Martin

Thank you, Becky, and good afternoon, everyone. I'm going to go over the review of our operating results. And before I do, I want to get a couple of definitions out of the way. We define free cash flow as net income plus deferred income taxes, depreciation, depletion and amortization, accretion on our reclamation obligation, changes in fair value of hedges and stock compensation, less maintenance CAPEX, and the effects of our equity method investments.

We define adjusted EBITDA as earnings before income taxes, depreciation, amortization and interest plus stock compensation, our accretion on reclamation obligations and change in fair value of hedges, less the effects of our equity method investments in Hourglass Sands.

Our net loss for the quarter was \$3 million or \$0.10 a share and net loss for the year-to-date is \$4 million or \$0.13 a share. We had free cash flow of \$6.4 million for the quarter and \$11.8 million year-to-date. Our adjusted EBITDA was \$11.3 million for the second quarter, \$22.7 million for the six months ended. We decreased our bank debt by \$5.9 million for the quarter and by \$7.6 million for the year. Our bank debt on June 30 was \$130.1 million. Our net debt was \$127.5 million. And our debt-to-EBITDA leverage ratio was 2.76 times.

I will now turn the call over to Brent Bilsland to talk about our operating results and the rest of the year.

Brent Bilisland

Thank you. 2021 will be known as one of the most dramatic turnarounds for coal markets in decades. During the first quarter, cold weather brought power demand, but also weather-related shipment delays. Shipment delays experienced in the first quarter continued for several weeks into the second quarter to the point we slowed our coal production due to elevated inventories at the mines. Throughout the quarter, shipments improved, and both our inventory levels as well as our customers' inventory levels declined.

In July, we saw pricing significantly improve, and we were able to sell an additional 500,000 tons during the quarter. We are currently entering a period of time where if you can produce it, you can sell it. We are working diligently to increase production to our maximum output, but tight labor markets may delay the velocity at which we increase production.

During Q2, shipments improved to a 5.6-million-ton annualized pace from a 4.7 million annualized pace in the first quarter. We expect shipments in the last half of 2021 to run in excess of 7 million tons annualized pace. Thus, we expect to ship 1 million more tons in the last half of 2021 versus the first half, representing a 40% increase in shipments.

Coal inventory was reduced by \$1.7 million during the quarter as a result of the slowed production and increased shipments. Slow production did elevate Q2's production cost to \$32.20 per ton, a \$1.26 per ton increase over the second quarter of 2020. Oaktown's costs were up only slightly at \$27.85 for Q2 of '21 versus \$27.68 for Q2 of 2020.

As Larry said, we generated \$9.9 million of operating cash flow and paid down our bank debt by \$5.9 million, increased shipments and an expected drawdown on our inventory later this year will generate strong cash flow, which we will use to continue to reduce our debt load.

During the quarter, Hallador was able to reduce bank debt by \$5.9 million and maintain \$26.5 million in liquidity. Our leverage ratio decreased slightly to 2.76 times at the end of the period. On July 23, we received a notification from our lender that the SBA approved our PPP loan forgiveness application for the entire PPP loan balance of \$10 million, together with interest accrued thereon. The forgiveness of the PPP loan will be recognized during the company's third fiscal quarter ending September 30 as a reduction in liabilities and an increase in net income.

Looking at the markets, gas prices have dramatically increased. And we talked previously that gas is a competitor to coal and in 2020 averaged \$1.99, the lowest average in over 2 decades. As of April 27, we saw gas prices average \$3.01. As of August, we've seen it improve even further to \$3.70. We've witnessed the same increases in price in the export market. As of April 27, API 4, the Asian marker for the third quarter of 2021 was at \$86 a ton. By August 2, the balance of the year shipments had improved to \$130 per metric ton. Same for the API 2 marker, April 27, third quarter was \$74 per metric ton. By August 2, balance of the year shipments had improved to \$130 a ton.

As we mentioned, this significant improvement in markets allowed us to add 500,000 contracted tons to our position during the quarter, and we expect to add tons later in the year for 2022 and beyond at significantly better pricing.

The Hoosier transaction. On June 1, we announced we joined with Hoosier Energy Rural Electric Cooperative to develop up to 1,000 megawatts of renewable power. The new

generation will be located near the Merom Coal Generation Station in Sullivan, Indiana, which Hoosier Energy expects to retire in May of '23. The plan calls for Hoosier...excuse me, for Hallador to develop approximately 200 megawatts of energy from solar and battery, storage through power purchase agreements with Hoosier in 2025. Hallador will seek other customers to develop the remaining 800 megawatts of generation capacity at Merom in future years.

We are excited by the opportunity of this platform as it provides our customers and ourselves the opportunity to transition to renewable power and for Hallador to make investments in the renewable space for decades to come. In the short run, there will be little financial activity from this platform until the Merom Coal Generation Station retires, which is not expected until 2023. In the long run, the Merom interconnection is capable of supporting up to \$1 billion of solar investment, and we estimate an additional \$2 billion of battery investment. Hallador plans to act as the developer of such projects and bring in equity sponsors to project...finance these projects as they move forward.

At our last quarterly call, we spent some time discussing how trading multiples of coal producers had declined from an enterprise value of 7.1 times EBITDA in 2017 to roughly half of that multiple today, in large part because of investor angst over the trend towards the greening of the electric grid. And although we continue to believe this transition will take much longer than the 14 years politicians are targeting, we are thrilled to now have a renewable energy platform in which to invest our free cash flow for decades to come. Over time, Hallador's earnings will come from greener sources as the grid and our customer's transition.

Today, Hallador trades at an EV, enterprise value, of less than 4 times EBITDA, while ESG-related companies trade at enterprise values of over 50 times EBITD. So, we see great potential in the value add for the shareholders of Hallador Energy, as investments in our renewable platform take root over the coming years.

With that, I'll open up the call for questions.

QUESTION AND ANSWER

Operator

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

Our first question comes from Russ Berger from Turnaround Capital. Please go ahead.

Russ Berger

Yes, hi. I was wondering if you could discuss what your anticipated incremental EBITDA margins would be on the additional tons, you're planning to sell in the second half. Because I can see your margins have declined because you're producing less in this quarter versus the last quarter. Obviously, the market is disappointed in the earnings with the stock down, I guess, 13% today. So maybe you could give some assurance as to what the future looks like with EBITDA margins.

Larry Martin

So, with the production, we'll need to deliver the 3.5 million tons in the second half, our margin should return to the \$10 to \$12 range that we're used to getting when our sales are \$6 million plus.

Russ Berger

Okay. Thank you.

Brent Bilsland

Yes, I think for us...third quarter should be excellent for us, right? We're seeing shipments in excess of the 7-million-ton annualized pace. That's doing multiple things. We're running our production wide open as fast as we can hire people. So, more tons means our cost per ton drops, so widens...margins widen out in that regard. I think the market has read a lot of headlines about Wall Street Journal and the others saying that pricing is up. What everyone has to remember is pricing really didn't move up till...we probably saw the most dramatic price improvement in July, which is the third quarter, not the second quarter. We saw very slow shipments really in the first half of the second quarter, which is why we kind of talk about, this is just such a dramatic improvement that we've seen.

So as shipping has improved, and inventory has come down, we're seeing shipments pick up dramatically. That's pulling our inventory down, and we really kind of in the first quarter of the year had increased inventory levels, which we were happy with. We expected price improvement and more sales in the back half of the year. They've been much more...much stronger than we expected as of late.

So, if you look at it from a second quarter only perspective, we are shipping slow shipments on legacy contracts, slowing production because inventory levels got pretty high. And so, as we saw those inventory levels come down and shipments improve, we began ramping production back up and now pedal to the metal. If you can produce it, you can sell it. And so that's causing an increase in pricing. And some of that will be picked up in the back half of the year. Some of that will be picked up in all of next year.

Russ Berger

Can you give us an idea of the price increases you're talking about per ton because I guess is it above the \$40 that you're historically selling at over the past few quarters?

Brent Bilsland

Yes. So, we've seen about 40% price appreciation from March, so something in the low 30s in March to something in the mid-40s for next year and may be higher. Things are moving so quickly right now, and things are so tight, it's really hard to get a gauge for how much price has improved, it may have improved more. We're still trying to figure that out with customers because, again, it's just one of these periods of time where...I've been doing this for 17 years, this is probably the third time this has happened. And we've just seen almost a hockey stick approach to pricing. We saw export pricing was good early in the year and continues to get stronger, but the domestic market really hadn't reacted to that, I would say, until materially in July.

So, this is a relatively new occurrence or recent occurrence, I should say. And I think it's something...the market now is coming back to the coal industry. And we've read some of the headlines about coal plant retirements, but no one's really paid attention to is how much production retirement there's been. And so now as the market comes and tries to lean on coal,

is leaning on an industry that's, you know, much smaller than it was before. So, if we look at Indiana alone, we think 15 million tons of production that was here a year ago is no longer here now. And so that's great from a less supply, higher prices. We're trying to get a handle on where and how high and how fast this market is going to rise. And I think everybody is trying to do the same thing.

Larry Martin

Realize these large price increases that we are talking about are '22 and beyond because, you know, we hedge most of our tons and all of our tons except for a few hundred thousand tons were priced before we came into the soft [ph] market in June and July for '21.

Russ Berger

But do you still get the benefit from the additional tons that you're selling, right, you should be able to make, you know, you make money at \$40 if that's where you're hedged at. These additional incremental tons that you're selling, are these unhedged or hedged tons?

Brent Bilsland

I think what we're saying is, is that for 2021, we're pretty much sold out at this point and pricing is going to be pretty much in that \$39 range is what we're going to average. We think that 2022, we will see that average price move up into the 40s for all tons.

Russ Berger

Closer to what the market is what you're saying? If the market is in the mid-40s, this 40% price depreciation that you're talking about in the market is something that you'll be able to achieve in 2022?

Brent Bilsland

No. What we're saying is, if we've got 5 million tons sold for next year, we're trying to figure out are we going to produce 6.5 million, are we going to produce 7 million tons in 2022. That's going to be dependent upon labor. The market can support that demand. So, our pricing is already set on 5 million tons. We're trying to figure out what the pricing is on the remaining 1.5 million to 2 million tons and how much higher that will move our average price.

Russ Berger

Got you. Okay. Thank you.

Operator

Again, if you have a question, please press "*" then "1." The next question comes from Andrew Love from Hallmark Investment Corp. Please go ahead.

Andrew Love

Yes. Could you give us some enlightenment on the possible impact of technological advance in carbon capture and sequestration? I noticed that the current infrastructure bill has got \$10 billion for...I guess, for research and that area? And does that give us some prospects for relief from the downward pressure of environmental considerations going forward?

Brent Bilsland

Yes. I think it's very important for the U.S. government and all governments, they focus on reducing carbon, that really can't be done on a global scale without carbon capture because you've got China and India still building coal-fired power plants today, brand-new plants, some are under construction as we speak. We've seen in the last three years, the United States

reduced coal-fired generation by 118 gigawatts, and you've seen the rest of the world build 121 gigawatts. So, coal demand has gone up, not down from a global perspective. So, in the United States, we're saying, well, gosh, we've got to put some money into carbon capture and figure this out to get the rest of the world to buy into this technology eventually. So, we think you'll see several carbon captures projects in the United States. It's a little hard to say where. I think one of them, like Duke Energy's Edwards port plant would be a very good candidate for that, which is right in our backyard. But it's a little early to speculate on bills that haven't passed yet and what the exact ramifications of that are. But certainly, money towards carbon capture is helpful to the industry and could be very meaningful.

Andrew Love

Thank you.

Brent Bilsland

Thank you.

Operator

Again, if you have a question please press "*" then "1", the next question comes from Lucas Pipes from B Riley Securities. Please go ahead.

Matt Key

Good afternoon, everyone. This is actually Matt Key here asking a question for Lucas. Just a quick one from me today, are you experiencing any cost inflation related to higher raw material prices in or kind of increased labor costs? And if so, how do you expect that to kind of impact your operations in the second half of 2021?

Brent Bilsland

Yes, it's a great question. We have seen a little bit of inflation on things like roof bolts with steel prices being up. We've yet to see it in labor costs, and we are...at the same point in time, we are hiring people, which is challenging, I mean the market is tight. We're really looking to see what happens. We've got the additional funds...federal funds for unemployment expiring September 6, assuming that doesn't get extended. And we're seeing, to some degree, young people that have been taking those funds. Now as they say, all right, we're 25 days out, maybe we ought to start interviewing for jobs. So, we're seeing a little more activity from people who have accepted those funds saying, well, I see the end is near, it's time for me to start getting back into the employment realm. When we look at inflationary pressure, it's a little hard to decipher what is permanent and what is temporary, right? What is, hey, we're reopening? And so, there's transportation issues, there's a shortage of something. We don't think steel prices can stay where they're at. So, we don't view that as a long-term price increase.

The trick is to...right now, we want to hire more people, but we don't want to materially affect our labor costs. So, we're trying to be careful to add as quickly as we can without installing permanent change into our cost structure. So, so far, I think most of the cost increases that we've seen appear to be short-term in nature, something in the six-month realm. We'll see if that extends beyond that. And I think it's going to be more than offset by the gains that we're seeing on the sales side. I mean, like we said, we've seen huge price increases here in the last four months. All of it really came in the last 30 days. So, we're trying to take advantage of that. I think our cash flow in the back half of the year is going to be much, much stronger than it was in the first half of the year. We're going to use that to pay down debt. And you should see significant deleveraging of our company. So that's kind of the trend you're going to see from us in 2021.

Matt Key

Got it, that's very helpful. Best of luck moving forward.

Brent Bilisland

Alright, thank you.

Operator

Again, if you have a question please press "*" then "1." There are no more questions in the queue. This concludes our question-and-answer session. I would like to turn the conference back over to Brent Bilisland for any closing remarks.

CONCLUSION**Brent Bilisland**

Well, I just want to thank everyone for taking the time to join our call today. And we look forward to a very strong back half of 2021. Thank you.

Operator

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