

Hallador Energy Company

Q1 2021 Earnings Conference Call

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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 First Quarter 2021 Earnings Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing "*", then "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*", then "1" on a touchtone phone, to withdraw your question, please press "*", then "2." Please note, this event is being recorded.

I would now like to turn the conference over to Becky Palumbo. Please go ahead.

Becky Palumbo

Thank you, Betsy. Yesterday afternoon, Hallador Energy released its first quarter 2021 financial and operating results on Form 10-Q and issued a press release containing certain financial metrics. Both documents are posted on our website. Today, we will discuss these results, as well as, our perspective on market conditions and outlook. Following our prepared remarks, we'll open the call up to your questions.

Before beginning a reminder that 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 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 unless required by law to do so. Brent Bilisland, our President and CEO, and Larry Martin, our CFO, are on the call with us today, and with the required preliminaries out of the way, I'll now turn the call over to Larry.

Larry Martin

Thank you, Becky. Good afternoon everyone. Before I get started, I'd like to define a couple of definitions for our items that I'm going to go over. We define free cash flow as net income plus deferred taxes, plus depreciation, depletion, and amortization, 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 EBITDA plus stock compensation and changes in fair value of hedges, less the effects of our equity method investments.

So, for the quarter, we had a net loss of a \$1 million or \$0.3 a share. We generated free cash flow of \$5.4 million. We had adjusted EBITDA of \$11.4 million, and we decreased our bank debt by \$1.7 million. Our bank debt at the end of the quarter was a \$136.1 million. Our net debt at the end of the quarter a \$132.2 million, and our leverage ratio, which is debt to adjusted EBITDA was 2.78 times.

I'll now turn the call over to Brent Bilisland, our CEO.

Brent Bilisland

Hi, thank you all for joining. During the quarter, our operations team performed exceptionally well. Production costs were significantly lower when compared to prior quarters. This increased

productivity has yet to be turned into cash as shipments were interrupted, due to the coldest February in 30 years. Though the cold weather has delayed our cash flow, it has led to continued improvements in market conditions, which allowed us during the quarter to increase our sales by roughly 400,000 tons for the year. In Q1, production costs were \$28.88 a ton, roughly \$5 a ton lower than last quarter and significantly lower than Q1 2020 costs of \$31.67.

Looking just at Oaktown, its costs were \$27.21 for Q1 '21 versus \$29.92 for Q1 2020. Hallador's excellent operating results will be turned into cash soon as the 180,000 tons of Q1 shipment delays will be delivered in the second and third quarter, resulting in roughly \$1.8 million of additional EBITDA for those three quarters.

Total shipments for the quarter were 1.2 million tons, though the cold weather did delay our cash flow, it led to multiple solicitations and additional sales. If market conditions continue to stay at this level or improve, we anticipate additional sales later this year. Increased productivity coupled with shipments' delay caused coal inventory to rise by \$9.4 million, however, this coal inventory will be needed to meet increased shipments for the balance of the year.

Hallador was able to reduce bank debt by \$1.7 million during the quarter and maintain \$27,900,000 in liquidity, despite the shipment delays. Our EBITDA ratio rose slightly to 2.78 times at the end of the period. As we have discussed on past calls, Hallador expected its \$10 million Paycheck Protection program alone to be forgiven by the SBA, this past April 8th, as recommended by our bank. However, we were told the SBA is delayed in processing all claim that we patiently await their response. Had the SBA forgiven our loan on the required April 8th date our liquidity today would be roughly \$41 million.

Looking forward, energy markets are recovering, as evidenced by increasing gas prices. The NYMEX price, a competitor to coal, average \$1.99 in 2020. That's the lowest average in over two decades. As of yesterday, the NYMEX 12 month, gas strip was 299, so \$1 increase. This is a price where Indiana coal plants, 77% of our customer base, are dispatching in front of gas plants.

Coal export prices are also improving, API 4, which is the Asian marker for Q3 2021 is at \$86 a metric ton for 2021 third quarter, that's up 26% year-over-year. We also see the API 2 marker in Europe for the third quarter of 2021 at \$74 a metric ton. That's up 24% year-over-year.

As we look at the general economy, it seems likely It will be good for the foreseeable future. The Federal Reserve has indicated it plans to continue with policy of easy monetary policy, meaning it will do everything...they will do everything in their power to keep interest rates low.

Much like prior administrations, President Biden has announced his desire to continue providing unprecedented levels of financial stimulus. Just to provide a little scale as to how big the U.S. fiscal stimulus is, MUFG reports, the total U.S. fiscal stimulus announced since COVID crisis accelerated 13 months ago is now in excess of \$10 trillion.

Remarkably, this translates to just over 45% of U.S. GDP and over 35% of the \$28 trillion of total U.S. gross debt outstanding. The growth in national debt scares me, the positive side of this equation does consumers have cash in their bank accounts.

Harvard economist, Jason Furman estimates that the combination of above trend income and below trend spending has created roughly \$1.8 trillion of extra disposable income since the beginning of the pandemic. So, it appears that there's plenty of money to fuel the economy.

Howard Marks, who I believe is a fantastic investor and writer, points out in his latest newsletter, and I quote, "the biggest risk of all is the possibility of rising interest rates; rates have declined quite steadily for the last 40 years. This has been a huge tailwind for investors, since the declining rate environment lowers the demand return on assets, but lowers the demanded returns on assets, making for higher asset prices. But the downtrend in rates is over; if we can believe the Fed's assurance that won't take nominal rates into negative territory." That's why interest rates can rise from here, implying higher demand and returns on everything and that's why our asset prices, they can decline. This creates a negatively asymmetrical proposition.

So, today's high asset prices may be at justified today's interest rate, but that's clearly a source of vulnerability if rates would rise. I would argue the opposite, could be true today for fossil fuel energy companies, as the fossil fuel energy companies already have high...higher cost of capital as the market perceives the need for added risk premium.

As the call for carbon-free electricity has increased over the last four years, politicians may have over promised on the timing of what is practical to deliver. And as a result, Hallador went from trading at an enterprise value of 7.1 times in 2017 EBITDA...7.1 times EBITDA, they are trading at roughly half that multiple today. The question is, will the need for a risk premium increase or decrease from current levels over time.

Is Hallador more likely to return to multiples of 7x or drop to multiple of 2x over the next few years. President Biden says carbon-free electricity by 2035 is our goal, and that's a national admirable goal. However, we find the electric grid operators and the utility CEOs are more tempered in their statements.

MISO says 40%, and MISO is the grid operator for the Midwest, says 40% renewables might be possible, but they neglect to say, by when? During February's extremely cold weather for several days MISO's generation was approaching 60% coal-fired power. So, that's roughly 60 days ago, MISO's grid was roughly 60% coal-fired power. That figure does not even include other types of fossil fuel plants that were also running at that time.

If we look at January and February of 2021, MISO is averaged 46% coal and 24% gas generation, meaning 70% of MISO's generation was powered by fossil fuels during the January/February time period was the last reporting period. I asked the question, is it likely that MISO replace 70% of its 2021 generation in just 14 years? Duke Indiana or Duke Energy, Indiana's largest coal consumer has a net zero target of 2050. That's 29 years from now.

Last month, Indiana's governor signed a bill enabling the Indiana Utility Regulatory Commission to take into consideration Federal phased-out [ph] requirements i.e. carbon free electricity by 2035 of a particular energy resource and adjust depreciation rates of new planned future generation sources...resources in a manner that is in the best interest of the Rate Payers. This bill potentially requires utility to desire to build a new gas plant to shorten their depreciation schedules from 30 years to something much less.

On April 22, Nick Akins, AEP's Chairman and CEO said Indiana Michigan Power and AEP Generating Company have recent agreement to acquire the 1,300 megawatt Rockport Plant Unit number two, from the current owners, when the lease expires at the end of '22. This has significant...this has the significance of extending the life of a coal unit.

This acquisition will provide a short term capacity bridge for customers as they transition to more renewable generation and we're sure that both Rockport units are retired by the end of 2028. These investments, and I'm quoting Akins here, in our generation portfolio support our goal of making our generation cleaner, more economical and achieving net zero carbon dioxide emissions by 2050. Again, note the reference to 2050.

But also of importance here is...this is a case in Indiana, where coal unit had been announced for closure in 2022. And to be replaced with the new natural gas plant, but the utility has now decided to extend the life of the coal unit and utilize the existing asset to bridge to the greener future. What might the value of coal equities do if this trend of using coal to bridge to renewables catches on? Is this concept priced into the market today?

Could the future of coal be dramatically changed, if there is successful penetration of carbon capture and storage technology? Tax credits for both carbon capture and storage have been increasing. Today, there are bills in both the House and the Senate, they would further expand the 45-Q tax credits both in size and duration. At least 10 utilities are considering carbon capture projects at coal plants here in the U.S. carbon capture was embraced by candidate Biden as...and is expected to be a component of President Biden's compliance plan.

Carbon capture has domestic appeal, because it allows the continued use or produce fossil fuels. It also has enormous international appeal in countries currently depending on coal generation.

I would also add that those two energy companies are working on some sort of business pivot. We see some coal mining companies divesting of steam coal assets and increasing their metallurgical exposure. Others are focusing on owning reserves of renewable elements. Others may focus their attention on developing solar projects while helping their customers' transition to greener electrons.

Some are just focusing on generating cash for as long as they can. So, there are two questions investors in this space I think must ask. How long will the transition take? And which companies have the management teams that will make the transition?

I think it is unlikely that an electric system that took well over 100 years to develop can be replaced in 14. I also believe our customers desire to transition with the help of a familiar face and Hallador is working every day to try to be a partner, to be that partner for our customers. In both cases, a longer transition period and/or a successful pivot of the company, risk premiums will fall and valuations will rise. Time will tell what Hallador investors think is most likely to happen.

So with that, I will open up to questions from the audience.

QUESTION AND ANSWER

Operator

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. If at any time your question has been addressed and you would like to withdraw your question, please press "***", then "2." At this time, we will pause momentarily to assemble a roster.

Our first question comes from Lucas Pipes with B. Riley Securities. Please go ahead.

Lucas Pipes

Hi, good afternoon, everybody, and thank you very much for your very interesting comments just now. I first wanted to ask a little bit about the current market environment, you mentioned strengthening prices internationally, domestically. But I wondered if you could maybe hone in a little bit on the Illinois basin and what you're seeing there specifically or where would you put pricing for average products today? And what sort of term business might be available, would appreciate your thoughts on that.

Brent Bilsland

Well. You know, today, as far as, term goes and we've seen...if you look back, last year, energy demand was way down the struggling economy with COVID pandemic although yet most utilities had more coal than needed. And so everyone kind of went in the last winter, pretty long in their positions. October was...the demand, November was terrible, December, January were good, and February was fantastic from a demand perspective.

So, we've seen coal inventories kind of come back into alignment, so everyone is starting to look much more comfortable levels. I think that on one hand, the utilities are looking at...It's been long and wrong over the last several years, and they've taken some heat over that at their various regulatory committees. So, they've had a desire to stay shorter. When gas prices popped here in the last month, I think that made them also demand better than we thought and we need to run out and buy some coal. We're expecting to see that, as I said in the comments, that if the market stays this stronger, or better, I expect to see more buying in the back half of the year.

So, all that kind of playing out like we thought. But as...but we see big open positions in our customers portfolio starting next-year. So, we really think business for us is better next year than this year. We're starting to better the year off in a little better our hedged position. And just from talking to customers that they have bigger open positions.

And I think they're also grappling with, as the market has consolidated, in some cases mergers, but in other cases just suppliers went away, I think you're going to see a return to utilities, tying up for longer periods of time because they want to make sure that it's one thing to have a plant that's going to run for the next 10, 15 years. They want to make sure they've got a supplier to work with for the next 10 to 15 years, and that list is getting shorter. So, from now, because we've had such extreme changes in coal inventories in 2021 from...going from very high inventory levels to February from a demand perspective, got things back in line. I think they're trying to make sure that demand recovery has happened and they'll just keep filling in with spot, but it does feel like to me we are seeing conversations that are much longer term in nature that are being originated by the utility.

Lucas Pipes

Very, very helpful. Thank you for that color. And then, you touched on a couple of really interesting points in your prepared remarks and...specifically around the, time...rising interest rate environment to valuations in the core and NPE sectors. I want to pull on these steps a little bit and ask you if we are in a rising interest rate environment, what are the implications for this renewable energy transition directly? Obviously, makes capital more expensive, but would appreciate your thoughts on that.

Brent Bilsland

Well, I think that it definitely raises the cost of any new construction to the higher capital cost. All these new generation is going to have to be paid for potentially with rising interest rates. Certainly, the Fed is doing everything in its power to keep interest at or near zero, very low. But the question becomes though if we start to see inflation, are people going to buy 10-year treasuries at 1.5% yield if we have 3% inflation? So, can the Fed keep interest rates low forever?

I don't know the answer to that. I think that it is far less risk for that in the cost base because if you look at the core group it that already had higher interest rates. I mean if you look at the coal space's bonds, they are trading anywhere from 7% to 36%, depending on who the group is. And to me especially as we start to see a return to longer-term coke supply contract, and I think as time goes on, it will become more evident that we are not going to be covered for electricity by 2035. It is going to be something longer like 2050, like all the utilities are signaling, right is this too complex.

If we want Green energy part of the time, then it can be done. It is 24/7 and the resiliency that we want when it is cold in Texas and nobody was expecting it, that's where it becomes really difficult. So, I think the higher interest rates, I think it will affect renewables that have yet to be built. It will just make their cost profile go up. Now, are people still going to pay that, for that? It worked, right, so it's a matter of cost. What will people pay?

So that's...but I think the transition from the point of all of my comments really were two-fold. One is this transition is going to take much longer than people think and because of that there is going to come a point a time where this risk premium that people are putting on in coal space, I think has a potential to alleviate, right. We traded at seven times. Our enterprise value was seven times EBITDA four years ago, but what's really changed? What's changed is the perception of risk but as you look at our business, one thing that is valuable to it is long-term contracts, right.

So, as we see the return to long-term contracts, I think that the risk premium could start to alleviate. So, we'll see. I also think that...I know most of the CEOs of all these different companies and they are all, you know...Hallador signaling in the public call, they are trying to figure out. Hey if our customers want to make a change, great, then we have got to figure out how to meet their goals and their needs and we have decades, multiple decades loan relationships with 19 different utilities and industrial customers here in the U.S. So, I think those people do want a transition, everyone has a different timing for that transition. But I think by and large those customers are signaling to us, they want to do that with familiar face. Can we help them? And that's also part of the reasons with those discussions that we think this transaction period is much longer than what the press might have you to believe. For both of those two reasons, when I look at us and I look at even many of our competitors, I think the opportunity for all of these energy companies to trade at a higher multiple is greater than its probability of trading at lower multiple in the future.

Lucas Pipes

Very helpful. And last one from me, you mentioned inflation earlier, are you seeing inflationary pressures? If so, where? I'd assumed defaults are getting more expensive labor type. We had some comments from some of your peers this earning season that were pretty interesting along those lines, would be curious to hear what you are seeing on the ground today? Thank you.

Brent Bilisland

Well...I would like...reports definitely yes, steel prices were up of course, they are costing more, bids are costing more. We were able to get our cost down significantly for the quarter, so kudos to our production team for that. Labor, I think that today we've been able to find the people to do the work and retain those people. Our job is typically the highest paying in the counties that we are in. You know, so far, so good. I am not saying that we are not...could labor become an issue down the road, we certainly could, and we just haven't...we haven't experienced that quite yet.

Lucas Pipes

Thank you, very much. And continued, best of luck.

Brent Bilisland

Thank you, Lucas.

Operator

As a reminder, if you have a question, please press "**", then "1" to be joined to the queue.

Our next question comes from Rob Litzow with Lakeway Capital. Please go ahead.

Rob Litzow

Yes, thanks for taking my call. So, you guys use to pay dividend and obviously things changed. You took the dividend away. When might that be something you would be considering putting back in, obviously, that would probably help your stock price as well?

Larry Martin

Yes, I think when our company gets under two times debt-to-EBITDA we will consider it. But, prior to that, it's unlikely. Our first goal is to preserve our balance sheet, so that we can make the necessary changes that we see coming down the road. And that might mean investments in slightly different types of assets than we have invested in the past. And so, we are just really trying to keep our balance sheet where we can be in position to take advantage of that. I mean there is...the grid is in a period of transition; I think that's going to take decades now not a couple of years. But, but still when we think about the grids, its fairly rapid change, right. It took 100 years to build. It's going to take 20 something to change and that creates a lot of opportunities for us, right. Our goal is to solve the problems of our customers and the best that we can and help them solve their problems and but all of that's a really long way of saying, we probably won't pay a dividend until we are under two times debt-to-EBITDA.

Rob Litzow

Okay. That's fair enough. I think you are not that far away from that the way you are generating cash right now. So seems reasonable? Thank you.

Larry Martin

Thank you for your question.

Operator

If you have a question, please press "**", then "1" to be joined into the queue.

Company Representative

Alright. Well, that....

Operator

With no other questions, 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**

I want to thank everyone for taking the time today listening to our call and their continued interest in Hallador Energy. Thank you very much.

Operator

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