Omega Protein Corporation
First Quarter 2016 Earnings Conference Call
May 5, 2016
8:30 a.m. ET

John Held - EVP, General Counsel and Secretary

Good morning, and welcome to Omega Protein's first quarter 2016 earnings conference call. By now, everyone should have had access to the earnings release for the first quarter ended March 31, 2016. For a copy of the release, please visit Omega Protein's website at www.omegaprotein.com under Investor Relations. This call is being webcast, and a replay as well as the prepared remarks will be available on the Company's website for 30 days.

Before we begin, we would like to remind everyone that comments made by management during today's call will contain forward-looking statements. These forward-looking statements discuss plans, expectations, estimates, and projections that might involve significant risks and uncertainties. Actual results may differ materially from the results discussed in these forward-looking statements.

Additional information about risk factors and the uncertainties associated with Omega Protein's forward-looking statements can be found in the Company's earnings release and Form 10-Q for the first quarter ended March 31, 2016, our Form 10-K for 2015, and in the Company's other filings with the SEC. Because of these risks and uncertainties, investors should not place undue reliance on forward-looking statements. Omega Protein disclaims any intention or obligation to update or revise any forward-looking statements, except as required by law.

Please also note that on today's call, management will be discussing non-GAAP financial measures, including adjusted EBITDA, adjusted earnings per share and other metrics. Historical non-GAAP financial measures are reconciled to the most directly comparable GAAP measures in our press release, which is available on our website. Some of the information presented is derived from third-party sources. And while we believe this information to be reliable, we have made no independent investigation of these third-party sources or attempted to verify the veracity of the third-party data in any way.

I would now like to turn the call over to our President and Chief Executive Officer, Bret Scholtes, for opening remarks.

Bret Scholtes - President & CEO

Thank you, John. Good morning, everyone, and thank you for joining us today. I will begin the call with a few comments regarding our strategic alternatives review process, followed by a brief overview of our business performance for the first quarter of 2016. Our Chief Financial Officer, Andrew Johannesen will then provide you with a more detailed review of our financial results

Yesterday we announced that the Company's Board of Directors had completed the strategic alternatives review process that began in September 2015. The Board of Directors, in consultation with the Company's financial advisor, J.P. Morgan, determined that the continued execution of the Company's strategy represents the best path forward to maximize value for stockholders. This strategy leverages Omega Protein's core nutritional capabilities to supply customers in the feed, food and supplement sectors while focusing on growth and efficiency initiatives. It includes the two strategic actions we announced in March: 1) the decision to invest an additional $18 million on high-return capital projects for our fish harvesting and processing operations, and 2) the decision to refocus our fish oil for direct human consumption on unconcentrated products that will result in relocating certain assets and exiting or selling our Chicago area manufacturing facility. In addition, the Board has authorized a share buyback program that reflects our confidence in the business while allowing for continued investment in our future growth. It also allows us to maintain the Company's strong balance sheet.

By leveraging our competitive advantages to drive sales growth and further improve operational efficiency, our strategy is designed to maximize financial results and cash flow and increase shareholder value.

We plan to drive revenue growth by expanding sales to our existing customers, securing new customers and developing new products and line extensions. We have built strong relationships with our customers, and we expect to support their growth by supplying the products they purchase today while pursuing opportunities to sell them additional products from our current product portfolio. We also plan to develop new products and line extensions that fill gaps in our customer's product portfolio.

Our plan to drive operational efficiencies focuses on reducing bottlenecks and improving our capacity utilization. By increasing our processing rates and yields, we can increase the volume available for sale and lower our unit costs. A good example was our 2014 investment to increase the processing rate at our Abbeville fish processing facility that resulted in additional throughput and lower unit costs last season. In fact, for the first time in a decade, Abbeville processed the most menhaden of any facility in the United States. The growth capital program we announced in March contains similar projects, in line with our strategic plan.

Going forward, we expect this strategy to produce strong financial results and cash flows that can be reinvested in the business. In addition to maintaining our annual maintenance capital commitment of $20-25mm, we see a number of good opportunities to reinvest in our current businesses to drive additional revenue and improve our margin profile, especially in our fish harvesting and processing operations. Finally, we expect to have excess cash flow after investing in the business that can be used to opportunistically repurchase the Company's stock.

Turning to our first quarter highlights, we reported consolidated revenues of $85 million, adjusted earnings per diluted share of $0.40, and adjusted EBITDA of $20 million for the first quarter of 2016. We continue to post strong consolidated financial results, and we are making progress on our goal to build a stronger nutrition company with additional opportunities for growth and operational efficiency.

I will now provide more insight into our businesses by discussing each segment in more detail.

Our Animal Nutrition segment continues to capitalize on favorable global market dynamics and strong operations. Progress toward executing our strategy should be evident in production volumes, revenue per ton and cost per ton.

Production volume has a big impact on both sales growth and unit costs, and it is the result of our harvesting and processing efforts as well as yields. We do not produce fish meal and fish oil during the first quarter, so all of our product sold during the quarter was processed during the successful 2015 season. We are hoping to build on that success during the 2016 fishing season which began on April 18th at our Gulf of Mexico facilities. Our Atlantic fishing season will begin on Monday, May 16th.

Our revenue per ton also has a big impact on sales growth, and it is driven by the global supply and demand dynamics for fish meal and fish oil. We also continue to see good demand for our products, and we are closely monitoring the global supply of fish meal and fish oil, including the impact of the Peruvian quota. This information will be available soon and we expect to have more

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information on our second quarter earnings call. As I mentioned on last quarter's call, we have not seen a large supply response to the historically strong pricing. For example, last year represented the fourth consecutive year that global fish meal production was less than 4.7 million metric tons, which has led to more stability and returns for producers.

Lastly, the third driver of success is our cost per ton, which is calculated by dividing the cost to catch and process fish by our annual production. I touched on the importance of operating efficiently and realizing a cost per unit that provides attractive profitability in a variety of pricing environments. Thanks in part to our recent capital investments, we completed our 2015 fishing season with a cost per ton similar to 2012 and 2013, which has resulted in strong financial results. We are optimistic for the next several years as we see more of these efficiency projects come online to help us minimize our unit costs.

I will now discuss our Human Nutrition segment in more detail. Our human nutrition business rebounded in the first quarter of 2016 and posted quarter-over-quarter improvements in gross profit and gross margin. Adjusting segment operating income for deferred acquisition consideration and segment plant closure costs yields $0.8 million, or $2.1 million after adding back segment depreciation and amortization.

We are focused on optimizing and growing the human nutrition platform we acquired through several acquisitions over the last few years. Now that we have a platform to formulate and supply products to the food and supplement industry, we expect near term growth to come from continued optimization, organic growth and modest, high return capital expenditures.

Our plant oil category makes up over half of the sector's revenue, and it is led by our coconut product lines. The established virgin coconut oil product line continues its growth with existing customers, and we expect to add new customers as the year progresses. We are also encouraged by growth of our liquid coconut oil line that was introduced in late 2014 and is beginning to contribute more each quarter. This category will play an important role in our future growth and new product innovation.

Our marine oil business, which consists of products that include menhaden, anchovy, tuna and krill oils, is a category in transition. This will be a difficult category to grow in 2016 as we wind down our concentrate manufacturing, but we believe there is a big opportunity for increased profitability. For example, excluding our concentrated oil and tolling results from the first quarter financial results would have increased segment gross margins by 300 basis points to 16%.

Our dairy protein business continues to make adjustments to increase sales growth and profitability, and we are encouraged by the progress. Sales for the quarter were the highest since we entered the category, and gross profits were the highest in the last ten quarters. We continue to focus on more specialty products in our bulk business, including manufacturing for third parties, and we are seeing positive results.

With that brief business overview, I would now like to turn the call over to our Executive Vice President and Chief Financial Officer, Andrew Johannesen to discuss our first quarter financial results in more detail.

Andrew Johannesen - EVP and CFO

Thank you, Bret, and good morning everyone. I will begin by reviewing our first quarter financial results, followed by some balance sheet highlights and thoughts on the upcoming quarters.

At a consolidated level, revenues for the first quarter of 2016 were $85 million, up from $72 million in the same period a year ago due to increased sales to our animal nutrition customers.

Gross profit for the first quarter was $25 million, up from $15 million in first quarter of the prior year. Gross profit as a percentage of revenues, or gross margin, increased from 21% in the prior year to 29% due to improved results in both the animal nutrition and human nutrition segments.

Looking further into the animal nutrition segment results, revenues increased $13 million from the previous first quarter due to higher sales volumes. Fish oil volumes doubled from the lower-than-normal levels sold in the prior year period, and fish meal volumes increased 35%. Pricing for fish meal declined 5%, and overall fish oil pricing fell 20%. The decline in fish oil pricing was attributable primarily to shifts in product mix, as our lower priced crude oils comprised a larger proportion of fish oil sales. Consistent with our guidance from the last call, revenue per ton for the quarter declined less than 1% from the 2015 average, coming in at $1,448. Gross margin for the first quarter was 41%, roughly in line with the fourth quarter of 2015, and up from 29% in the first quarter of 2015 due to lower unit costs.

In the human nutrition segment, revenues were nearly flat compared to the first quarter of 2015, as increased sales of protein products were offset by declines in other nutraceutical ingredients as well as the oil concentration business that we are in the process of exiting. Human nutrition gross margins increased from 12.2% in the first quarter of 2015 and 7.2% in the fourth quarter of 2015 to 12.6%, due to improved protein products gross margins.

Returning to the consolidated results, first quarter selling, general, and administrative expenses, including research and development, were $9.6 million, down from $10.2 million in the same period a year ago and $10.8 million in the fourth quarter of 2015.

Net income for the first quarter was $8.4 million, or $0.37 per diluted share, compared to net income of $1.7 million, or $0.08 per diluted share, for the same period a year ago. After making certain adjustments, which are detailed in our earnings release, adjusted net income for the first quarter of 2016 was $9.1 million, or $0.40 per diluted share, compared to $2.6 million, or $0.12 per diluted share.

As a reminder, GAAP requires us to use the “two class method” of calculating EPS as explained in the footnotes to our 10-Q. The same EPS results can be derived by applying an average diluted share count of 22.53 million shares to net income.

Adjusted EBITDA doubled from $10 million in the prior year period to $20 million for the first quarter of 2016.

Turning to our balance sheet, stockholders’ equity increased $10 million from year-end 2015 to $305 million, and book value per share stood at $13.70. We typically do not see meaningful debt reductions in the first quarter due to seasonal working capital flows, and this year total debt remained essentially flat at $24 million. Our balance sheet remains strong, with a total debt to EBITDA ratio for the trailing twelve months of 0.3x, and we entered the second quarter with $95 million of liquidity available under our corporate credit facility.

We believe this balance sheet strength enables us to both withstand the volatility of our business and allocate capital to create shareholder value. As Bret noted, in addition to the $18 million of growth capital that we are currently deploying in our animal nutrition businesses, we have announced a share repurchase program of up to $40 million over the next 3 years.

I would like to highlight a few elements of this program. First, it is intended to be opportunistic; we plan to be more aggressive at lower share prices, and less aggressive at higher share prices. Our stock price has historically experienced periods of volatility, and while we continue to take steps to reduce that variability, this program provides an opportunity to capitalize on lower relative market valuations. In addition, we expect the majority of the repurchases will be covered by excess operating cash flows. We remain firmly committed to a balance sheet philosophy that emphasizes strength and flexibility over high leverage. Finally, we will not sacrifice compelling, value-accretive investments in our business in order to fund repurchases.

Looking ahead, our animal nutrition segment ended the quarter with approximately 40,000 tons of product in inventory, which is more than a 50% increase from a year ago. As a reminder, in the second quarter we typically sell all but a few thousand tons of our beginning carryover inventory, along with a smaller amount of current season production. Over the last several years, second quarter sales volumes have generally exceeded beginning-of-quarter inventory by zero to 10 thousand tons.

As of March 31st, we had sold forward approximately 54,000 short tons of fish meal and 15,000 metric tons of fish oil for anticipated 2016 delivery at prices generally in-line to slightly below those realized in the first quarter. Gross margins on second quarter sales of carryover inventory should be similar to the 37% to 41% range we have seen in recent quarters.

However, at this time we have significantly less visibility into gross margins on sales of current fishing season production, which will comprise a portion of second quarter sales and virtually all of third and fourth quarter sales. Prices will in many cases be determined by future market conditions, and volumes and unit costs will be heavily influenced by 2016 fish catch and yields.

For example, in the last two seasons annual production ranged from 138 thousand tons in 2014 to 182 thousand tons last year, and this had a meaningful impact on cost per ton. For second quarter results, we will have to make assumptions about a fishing season that is only in its earlier stages. As a result, second quarter sales of 2016 production will likely assume a production level somewhere inside this range, which would imply unit costs above those experienced in the 2015 fishing season. This, in turn, could lead to second quarter segment margins below our recent range.

In the human nutrition segment, performance will continue to be influenced by sales volumes, product prices, raw material costs and capacity utilization. For full year 2015 and the first quarter of 2016, gross margins were in the 12 to 13% range. Subject to some degree of quarter-over-quarter volatility, this is the baseline from which we expect to grow as we continue to leverage our capabilities, integrate the human business and address underutilized capacity.

That concludes our prepared remarks for the day. On behalf of Bret, John and I, we would like to thank everyone for their interest in Omega Protein. The three of us, along with other members of our management team, are now available to take your questions. Operator?

NOTE: *A Question and Answer session follows the above prepared remarks. For the content of the Question and Answer session please listen to the webcast of the call, which is available at www.omegaprotein.com under the Investors tab.*