Omega Protein Corporation
Second Quarter 2017 Earnings Conference Call
August 3, 2017
8:30 a.m. ET

John Held - EVP, General Counsel and Secretary

Good morning, and welcome to Omega Protein's second quarter 2017 earnings conference call. By now, everyone should have had access to the earnings release for the second quarter ended June 30, 2017. 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 a transcript of the prepared remarks will be available on our 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, the Company's Form 10-K for 2016, the Company's Form 10-Q for the second quarter of 2017, 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 with a summary of our operational and financial results. Our CFO, Andrew Johannesen, will then provide you with a more detailed review of second quarter and year-to-date financials. Finally, we will open the call to take questions.

We reported second quarter consolidated revenues of approximately $94 million, adjusted earnings of $0.34 per diluted share and adjusted EBITDA of $18 million. Results for our human nutrition segment continued to improve in the second quarter, although softer pricing and a slower than average start to the fishing season impacted animal nutrition segment results.

First, I will discuss our animal nutrition segment, which includes sales of specialty ingredients to formulators of companion and production animal diets. As mentioned on previous calls, we measure the animal nutrition segment's success by three primary drivers: production volumes, revenue per ton and cost per ton.

As many of you know, production volume is a key driver for both sales and unit costs, and it is a result of our fish harvesting and processing efforts as well as product yields. Fishing was slow through June due to weather conditions in the Atlantic and Western Gulf of Mexico that limited our ability to keep vessels on the fishing grounds. It is important to note that our Abbeville facility in the Western Gulf is our highest yielding and lowest cost facility, so lower results at this plant have a meaningful impact on our overall results. These harvest results combined with lower yields have led to the production results to date.

Fortunately, weather conditions improved significantly in July, particularly in the western Gulf. Through July 30, 2017, our total production was approximately 68k tons, a 25% decrease compared to the corresponding period in 2016, and 18% lower than the prior three-year average. Harvest results were 16% lower than at this point last year. They were also lower by 16% compared to the prior three-year average. Yields were 10% lower than at this point last year and 3% lower than the prior three-year average.

Despite the challenges in the western Gulf, fishing in the eastern Gulf has been on a record pace. Our Moss Point facility has leveraged our investments to increase meal yields and reduce logistics costs through increased product storage and handling capacity. We enjoyed much better weather conditions and strong results in July, so we are looking forward to the balance of the season. We still have three months of fishing remaining in our Gulf season and approximately four months in the Atlantic, so we have time to make up ground if Mother Nature cooperates with us.

Revenue per ton, the second driver of success for the animal nutrition segment, is a result of global supply and demand dynamics for fish meal and fish oil. We continue to see strong demand for our products, notably from the aquaculture and pet food sectors. In fact, we have seen growing demand in pet food markets for naturally stabilized fish meal, which has helped to increase our product diversity and domestic sales.

To date, we have seen significantly greater global production of fish meal and fish oil. As a result, and consistent with our comments on our first quarter call, we have seen, and expect to see, softer prices for both fish meal and fish oil in 2017 versus 2016. The extent of the near term softness will depend on two factors: the demand response to the lower prices and the success of other fisheries in the second half of 2017.

On the demand side, some formulators are increasing fish meal inclusion rates as a result of increased global supply and softer pricing. On the supply side, producers in Peru made significantly more fish meal and fish oil in their first season, but they were not able to catch their full quota and fish oil yields were lower than expected. Specifically, producers failed to catch 400,000 MT or 15% of the quota which would have produced approximately 94,000 MT of fish meal and over 12,000 MT of fish oil. As a result of strong demand and Peru's harvest not reaching their quota, we have seen evidence of pricing firming up and even recovering the last few weeks. The industry will be closely monitoring Peru's second season which will likely begin in late October and last 2-3 months.

We continue to be optimistic on long-term pricing dynamics given global supply and demand fundamentals. The aquaculture feed industry consumes over 70% of the global fish meal and fish oil production, and this industry is projected to grow at a compounded annual growth rate of approximately 10% over the next several years. In addition, we have developed a value added business for premium pet food applications that is growing at a good rate. So while higher global quotas and fish catch have pressured fish meal and fish oil prices, we believe these near-term volatilities are transitory in nature, and the macro-economic and industry trends that continue to drive positive demand for our products give us confidence in our long-term opportunities.

Cost per ton, which is calculated by dividing the cost to catch and process fish by our annual production, is the third driver of success in the animal nutrition segment. Costs to harvest and process the fish have been consistent with expectations so far this year, but production has been impacted by the slower start to the season as just discussed.

The strength of our balance sheet provides us with the financial flexibility to make certain strategic investments expected to increase our operating efficiencies, support our future growth and enhance value for our shareholders. As previously discussed, in 2017 we are investing in a handful of additional growth opportunities and accelerating some hybrid growth and maintenance projects, for a total of about $25 million in addition to our normal maintenance capital of approximately $20 million. These projects include converting one offshore supply vessel to a carry boat for our Gulf operations, additional product storage and equipment improvements. We remain committed to continuously strengthening our animal nutrition business by reducing operating costs, maximizing yields, increasing production and efficiencies, and improving product quality.

I will now review our Human Nutrition segment, which includes sales of nutritional ingredients and products to food and supplement manufacturers and retailers. We posted one of our best quarters in the segment's history with gross profits and operating income setting new records. We continue to focus our efforts on operational execution, including more effective sales, marketing and new product development. As I have stated previously, we do not plan to make meaningful additional investments near term in this segment as we focus on sales growth and increased profitability.

Sales growth is the biggest driver for success in this segment because it will drive our revenues and allow us to leverage fixed costs to increase profitability. For the quarter, we posted $37 million dollars of sales, an increase of 18% compared to the second quarter of 2016. This increase was driven by most of our major product categories, including coconut oils, marine oils and bulk dairy. We continue to strengthen our customer relationships, and work to introduce new products to the market. We are also pleased with the sales force realignment we introduced in the second quarter of 2016.

Gross margin is the second driver of success for the human nutrition segment. We recorded gross margins for the segment of 20% which is higher than the 9% recorded in the second quarter of 2016 or the 18% posted in the first quarter of 2017. The increases in margin have been driven by improved dairy and specialty oils results and our decision to exit the concentrated fish oil plant in Illinois.

Our management team and board of directors remain focused on creating value and strategically aligning our human nutrition segment to best generate financial results and value for shareholders. We are currently in the midst of our previously announced strategic review of the human nutrition business segment. This is a comprehensive review, and while it is taking some time, you can be assured that we will complete it as expeditiously as possible. We are focused on a timely resolution and will provide further updates as appropriate.

With that business overview, I would now like to turn the call over to our Executive Vice President and CFO, Andrew Johannesen.

Andrew Johannesen - EVP and CFO

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

At a consolidated level, revenues for the second quarter of 2017 were $94 million, down from $113 million in the same period a year ago due to lower animal nutrition revenues.

Gross profit for the second quarter was $23 million, decreasing from $33 million in the second quarter of last year. Gross profit as a percentage of revenues, or gross margin, decreased from 30% a year ago to 24%, as an increase in the human nutrition segment was more than offset by a decrease in the animal nutrition segment.

Looking further into the animal nutrition segment results, revenues declined from the prior year to $57 million, as lower beginning inventory volumes drove a reduction in sales volumes. Product pricing also softened, as revenue per ton decreased 6% from last year's second quarter to $1,400.

Taking into account the challenging weather conditions and below average yields we experienced through June, we are currently estimating that total 2017 production will fall somewhere in between the 138,000 tons produced in 2014 and the 170,000 tons produced last year. As a result, we are assuming a higher cost per ton for 2017 production than we saw in 2016.

This current season production accounted for 29% of sales volumes in the second quarter of 2017, and along with the lower pricing, contributed to a decrease in animal nutrition gross margin from 37% in the second quarter of 2016 to 27%.

In the human nutrition segment, revenues increased $6 million from the second quarter of 2016 to $37 million, driven by increased specialty oil sales, primarily coconut and marine oils. As Bret mentioned, segment gross margins improved from 9% to 20%, primarily as a result of improved margins on specialty oils sales, as well as our exit from the oil concentration business last fall.

Returning to the consolidated results, second quarter selling, general, and administrative expenses, including research and development, decreased from $12 million last year to $10 million due to lower professional and labor expenses.

Net income for the second quarter was $7.4 million, or $0.32 per diluted share, compared to net income of $5.7 million, or $0.25 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 second quarter of 2017 was $7.6 million, or $0.34 per diluted share, compared to $14.1 million, or $0.62 per diluted share in last year's second quarter.

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 for the second quarter of 2017 by applying an average diluted share count of 22.7 million shares to net income.

Wrapping up the quarterly operating results, Adjusted EBITDA was $18 million, compared to $29 million for the prior year period.

For the year-to-date periods, revenues were $167 million in the first six months of 2017, down from $197 million last year, which contributed to a decline in gross profit from $58 million in the prior year to $43 million. Consolidated gross margins declined from 29% to 25% as animal nutrition gross margins decreased from 39% to 30% as a result of a decline in revenue per ton from $1,472 to $1,426 and increased unit costs. Human nutrition segment gross margins, in contrast, increased from 11% to 19%.

Net income for the first six months was $13 million, or $0.59 per diluted share, compared to $14 million, or $0.62 per diluted share, for the same period last year. Adjusted net income for the six months ended June 30, 2017 was $14 million, or $0.60 per diluted share, compared to $23 million, or $1.03 per diluted share.

Adjusted EBITDA for the first six months of 2017 was $34 million, compared to $49 million a year ago.

We continue to maintain a strong balance sheet with $10 million in cash and $2 million of debt as of June 30, 2017. Stockholders' equity stood at $349 million, and book value per share was $15.52. We believe we remain well-positioned to fund growth and other capital projects in our animal nutrition business, as well as our quarterly dividend program.

Looking ahead, our animal nutrition segment ended the second quarter with slightly over 30,000 tons of product in inventory, which is towards the lower end of the typical mid-year range due to the below average early season production. Over the last four years, third quarter animal nutrition sales volumes, in tons, have ranged from the low-40,000s to the mid-50,000s. At this point, we expect to be towards the lower end to middle of that range in the third quarter of 2017, although actual sales volumes will be influenced by fish catch during the quarter and the timing of sales deliveries.

As of June 30, 2017, we had sold forward roughly 33,000 short tons of fish meal and 11,000 metric tons of fish oil for anticipated 2017 delivery at prices modestly below those realized in the second quarter of 2017. Depending on market conditions, 2017 sales that are priced in the second half could be lower as well. Given these pricing dynamics, and the higher cost per ton assumptions noted earlier, we would not be surprised to see third quarter segment gross margins decline from second quarter levels.

In the human nutrition segment, performance will continue to be influenced by sales volumes, product mix, prices and raw material costs. Segment gross margins are likely to continue to experience some variability quarter-over-quarter, but we believe the normal range has improved to the mid-to-high teens.

That concludes our financial review. I will now turn the call back to Bret for some brief closing remarks.

Bret Scholtes - President & CEO

Thank you, Andrew.

In summary, we are working through the near-term volatility in our fish meal and fish oil business and its impact on our near-term results, but volatility is something we are familiar with within our industry. Those who have followed us for more than a few years have seen similar periods in our past. What remains consistent, and gives us great confidence in our long-term opportunities for growth, are the macro-economic and industry trends that continue to drive positive demand for our products.

We believe we have a strong competitive position through our diversified product offering, supply chain and customer relationships. In addition, we maintain a strong balance sheet and we plan to continue to leverage these competitive advantages to enhance our operational and capital efficiencies over time which we expect to increase profitability, cash flow and value for our shareholders.

This concludes our prepared remarks for today. On behalf of Andrew, John and myself, 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.*