Omega Protein Corporation
Third Quarter 2016 Earnings Conference Call
November 3, 2016
8:30 a.m. ET

John Held - EVP, General Counsel and Secretary

Good morning, and welcome to Omega Protein's third quarter 2016 earnings conference call. By now, everyone should have had access to the earnings release for the third quarter ended September 30, 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 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 and Form 10-Q for the third quarter ended September 30, 2016, the Company’s 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 by offering a brief summary of our business performance for the third quarter of 2016. Our CFO, Andrew Johannesen, will then provide you with a more detailed review of our financial results. Finally, we will open the call to take questions.

We are generally pleased with the overall strength of our third quarter operational and financial performance.

We reported consolidated revenues of $109 million, adjusted earnings of $0.67 per diluted share and adjusted EBITDA of $29 million for the third quarter 2016. Our animal nutrition segment continued its strong performance which produced the highest quarterly consolidated Adjusted EBITDA since we started calculating it. While we still have areas for improvement across our business, these results demonstrate our progress, and we remain committed to building a stronger nutrition company.

Industry trends continue to support demand for our products and we are well positioned to capitalize on future opportunities. In addition, we are excited about opportunities to further enhance our operating and capital efficiency, to drive organic growth and to generate higher profitability which will allow us to maximize shareholder value over time. With our strong balance sheet and competitive position in the marketplace, we believe Omega Protein is the strongest in our 100-year history.

I will now provide a more detailed update of our business, beginning with our animal nutrition segment. As a reminder, this segment includes sales of specialty ingredients to formulators of companion and production animal diets. Our Animal Nutrition business has maintained its strong, multi-year financial performance, largely as a result of continued high demand for our products, solid harvest results, and improved operational efficiencies.

We gauge the animal nutrition segment's success by three primary drivers: production volumes, revenue per ton and cost per ton.

Production volumes are the result of our harvest and product yields, and we expect our total production in 2016 to be approximately 170,000 to 175,000 tons. While we do not expect production this year to match the production achieved in 2015, it should be consistent with our three-year average. Our Gulf fishery ended its 2016 season on November 1, and we expect our Atlantic season to continue until we have caught our quota.

We have been pleased with this season's solid fish catch and fish oil yields. Harvest results for the season were adversely impacted by persistent weather systems in the western Gulf of Mexico where our largest plant is located. However, these lower harvest figures were partially offset by higher oil yields in the Gulf. For the season, our total yield overall has been 38%, an increase compared to both 2015 and the three-year average. Despite the earlier mentioned weather conditions in the western Gulf, our eastern Gulf operation had one of its best seasons. Our Atlantic operations are having a good season, but unusually difficult weather will force us to fish longer this season in order to catch our quota.

We are encouraged by regulatory decisions made last month that reaffirmed the health of both the Atlantic and Gulf Menhaden populations. An updated Gulf Menhaden stock assessment was released last month which again confirmed that the population continues to be harvested sustainably and is not overfished. We were also encouraged by the ASMFC's decision to raise the Atlantic Menhaden quota by 6.45% beginning next season. This decision is a testament to the health of the Atlantic menhaden stock. We believe that scientific analysis indicates that the ASMFC could have increased harvest beyond the 6.45% increase with no risk of overfishing.

The second driver of success for the animal nutrition segment is revenue per ton. This metric reflects the global supply and demand dynamics of fishmeal and fish oil which continue to be favorable for producers and has had a positive impact on pricing. Global demand remains strong, and industry consumption data reflects the increasing competition for these ingredients by industries that most highly value the nutritional benefits.

Global supply of these nutritional ingredients also impacts revenue per ton. Global supply has been more constrained than usual this year due to prolonged environmental conditions impacting South American quotas and fishing efforts. While the industry is awaiting Peru's announcement of its second season quota, we expect global supply in 2016 to be slightly less than that of the past few years.

The third driver of success for this segment is our cost per ton which is calculated by dividing the cost to catch and process fish by our annual production. We continue to strategically invest capital in our fishing operations which has allowed us to harvest fish and manufacture our products more efficiently, notably by upgrading vessels to allow for increased catch-per-vessel over historical averages, increasing plant throughput capacity, and continuing to upgrade our processing equipment. Managing our costs remains a recurring priority for our team, and as a result, we expect to end the season with a cost per ton that is slightly greater than 2015 but lower than our three-year average.

I will now discuss our Human Nutrition segment which includes sales of nutritional ingredients and products to food and supplement manufacturers and retailers. This segment continues to underperform, and we are focused on improving our operational execution to generate better results. As part of this plan, we sold our Batavia oil concentration facility in early October. This operation had been producing losses, and earlier this year we announced our intention to exit the concentrated oil business. The sale has enabled us to exit this business and the Batavia facility sooner than originally expected.

As I have stated previously, we do not plan to make meaningful additional investments near term in this segment as we focus on driving sales growth, operating efficiencies and increased profitability. We believe sales growth is the biggest driver to future success because of its impact on segment performance and operating leverage.

We were not able to grow sales in the third quarter of 2016 compared to the same period in 2015. The biggest challenge to sales growth has been the performance of virgin coconut oil, a product category that has declined due to increased competition and lower global pricing. Despite these challenges, we are pleased to have recently completed our first full quarter of sales to a major Canadian retailer, and we are seeing success with our liquid coconut oil line extensions introduced earlier this year.

Gross margin is the second driver of success for the human nutrition segment, and results for the third quarter were approximately 13% which is slightly higher than the year to date margin and the trailing twelve-month average. This improvement occurred as a result of our specialty oils and nutraceuticals product lines, and in spite of disappointing results in our Dairy business. As mentioned earlier in this call, selling our fish concentration facility will also eliminate some of the losses that have negatively impacted our earnings.

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

Andrew Johannesen - EVP and CFO

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

At a consolidated level, revenues for the third quarter were $109 million, down from $112 million in the same period last year, as increased animal nutrition revenues were offset by decreased sales in human nutrition.

Gross profit for the third quarter was $33 million, compared to $35 million in last year's third quarter. Gross profit as a percentage of revenues, or gross margin, decreased from 31% in the prior year period to 30% due to decreases in both segments.

Looking further into the animal nutrition segment results, revenues increased from $73 million in the previous third quarter to $78 million, as a 16% increase in fish meal sales volumes and 4% rise in average fish oil prices exceeded the impacts of a 1% decrease in fish meal prices and an 11% decline in fish oil volumes. In the quarter, we sold approximately 55,000 tons with a revenue per ton of $1,419. This revenue per ton was up slightly from $1,400 a year ago. Compared to the second quarter of 2016, revenue per ton was down from $1,486, due to a shift in product mix that saw fish meal comprise a larger proportion of sales volumes in the quarter just ended.

Segment gross margin for the third quarter of 38% was down 2% from a year ago and in-line with those from the second quarter of 2016. The year-over-year decline reflects slightly higher unit costs for 2016 fishing season production. Note that estimated unit costs for 2016 production were virtually unchanged from the second quarter, resulting in no meaningful third quarter true-up of prior period sales.

In the human nutrition segment, revenues decreased $8 million from the third quarter of 2015 due to a decline in sales of specialty oils, most notably coconut oils. Segment gross margin for the third quarter was 13%, down from 17% in the third quarter of 2015 but up from 9% in the second quarter of 2016. This mirrors the trend in gross margins for specialty oils, which were down about 1 percentage point from a year ago but up nearly 5 percentage points from the second quarter, due to changes in product mix and the benefits of scaling back our fish oil concentration business. Dairy gross margins declined against both periods while nutraceuticals margins improved.

Returning to the consolidated results, third quarter selling, general, and administrative expenses, including research and development, were $10 million, down from $12 million in both the same period a year ago and the second quarter of 2016. The decrease was primarily due to reductions in professional fees, the Bioriginal earn-out, and, for the year-over-year comparison, labor expenses.

Net income for the third quarter was $14.6 million, or $0.64 per diluted share, compared to net income of $10.6 million, or $0.47 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 third quarter of 2016 was $15.2 million, or $0.67 per diluted share, up modestly from $14.8 million, or $0.66 per diluted share last year.

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 22.6 million shares to net income.

Wrapping up the quarterly review, Adjusted EBITDA was $29 million, up 1% from the prior year period.

For the year-to-date periods, revenues increased 11% from last year to $306 million. Gross profit was $91 million in the first nine months of 2016, up from $76 million in the prior year. Consolidated gross margins increased from 27% to 30% due to the animal nutrition segment, where gross margins increased from 36% to 38%, as lower unit costs more than offset a decrease in revenue per ton from $1,500 to $1,452. Animal nutrition revenues also grew as a percentage of consolidated revenues, reducing the overall impact of a decrease in human nutrition gross margins from 14% to 12%.

Net income for the first nine months was $29 million, or $1.27 per diluted share, compared to $21 million, or $0.95 per diluted share, for the same period last year. Adjusted net income for the nine months ended September 30, 2016 was $38 million, or $1.70 per diluted share, compared to $27 million, or $1.21 per diluted share.

Adjusted EBITDA also grew, increasing 29% from $61 million to $78 million for the year-to-date period.

Turning to our balance sheet, strong operating cash flow allowed us to pay down $19 million of debt year-to-date. With a very low debt level and significant liquidity available under our corporate credit facility, we believe we are well-positioned to fund both our animal nutrition growth capital projects and share repurchases.

Looking ahead, our animal nutrition segment ended the quarter with approximately 75,000 tons of product in inventory. Last year, we sold just over 20% of that season's production in the fourth quarter, and we anticipate a similar relationship this year assuming full season production of 170,000 to 175,000 tons.

As of September 30th, we had sold forward roughly 26,000 short tons of fish meal and 9,000 metric tons of fish oil for anticipated 2016 delivery at prices generally in-line with those realized year-to-date. This should provide segment gross margins near the mid-30% range that we have seen in recent quarters, although lower than expected October catch in the Atlantic increases the risk that adverse weather or other factors prolong the fishing season or even prevent us from catching our quota, which could add to unit costs and lower gross margins.

In the human nutrition segment, performance will continue to be influenced by sales volumes, product prices, raw material costs and capacity utilization. In the fourth quarter, we also recognize the potential for sales to slow as we enter the holiday season. Segment gross margins have ranged from the high single digits to mid-teens over the last several quarters, and are likely to continue to experience some variability quarter-over-quarter.

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 closing, we believe Omega Protein is well positioned for the long term. Earlier this year, we announced a $40 million, three-year opportunistic share buyback program. While we have not yet made any purchases under the plan, we expect to complete the program within the original time frame. We are also bullish about the fundamentals driving the specialty protein and oil sectors, especially the fish meal and fish oil markets. We are optimistic about the strategic investments that we have made to increase our fish meal and fish oil production and improve our cost structure. The capital projects announced earlier this year are on track to contribute in 2017. As a reminder, these projects are expected to enhance yield and increase processing rates at our Abbeville facility and convert two newer vessels to replace older vessels in our Atlantic fleet.

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