Acadian Timber Corp.
2014 Second Quarter Results
Conference Call Transcript

Date: Tuesday, July 29, 2014

Time: 1:00 PM ET / 10:00 AM PT

Speakers: Reid Carter
President and Chief Executive Officer

Erika Reilly
Chief Financial Officer

OPERATOR:

At this time, I would like to turn the conference over to Ms. Erika Reilly, Acadian's Chief Financial Officer. Please go ahead Ms. Reilly.

ERIKA REILLY:

Thank you operator and good afternoon everyone. Welcome to Acadian's second quarter conference call. Before we get started, I would like to call your attention to the following:

This conference call is being webcast simultaneously through our website at www.acadiantimber.com where you can also find a copy of the press release including the financial statements.

Please note that in responding to questions and talking about our second quarter financial and operating performance as well as our outlook for the remainder of 2014, we may make forward-looking statements. These statements are subject to known and unknown risks and future results may differ materially. For further information on known risk factors, I encourage you to review Acadian's Annual Information Form, dated March 28, 2014, and other filings of Acadian with securities regulatory authorities, which are available on SEDAR at www.sedar.com and on our website.

I will start by outlining the financial highlights for the second quarter. Then Reid Carter, Acadian's Chief Executive Officer, will provide comments about our operations, market conditions, outlook for the remainder of the year and business development activity.

Acadian's operations performed largely as expected through the second quarter. As those familiar with Acadian's operations already know, the second quarter is traditionally our weakest as the spring thaw period, known in Acadian's operating region as "mud season", makes much or our infrastructure unusable for the first two months of the period. Last winter's extended cold and heavy snowfall did cause this year's mud season to extend for a couple of weeks longer than normal, particularly at the New Brunswick operation. This led to harvest volumes in the quarter, excluding biomass, falling 21% compared to the prior year to 138 thousand cubic metres.

This lower harvest volume coupled with the impact of last year's vendor managed inventory program that deferred $2.9 million dollars of sales from the first quarter to the second quarter, caused net sales to drop to $12.0 million dollars from $15.6 million dollars in the same period last year. On a year-to-date basis, net sales are just 2% lower as the slower than normal post mud season start-up of the New Brunswick operation has been offset by improved log pricing for most of our products.

Adjusted EBITDA was $1.9 million dollars, down $1.0 million dollars compared to the second quarter of 2013. The 2013 results, however, included $1.6 million dollars deferred from the first quarter as a result of the VMI program whereas this year's short-term log delivery arrangement that we noted on last quarter's call deferred only $0.4 million from the first quarter. Our overall Adjusted EBITDA margin was 16 percent compared to 19 percent in the same period last year, again reflecting the impact of the VMI program.

Net income for the quarter totaled $4.7 million dollars compared to a net loss of $0.9 million dollars in the second quarter of 2013. The increase in net income primarily reflects the impact of the strengthening Canadian dollar on the carrying value of our US dollar denominated long-term debt as we moved to a non-cash gain of $2.7 million dollars from a loss of $2.5 million in the same period of last year. The non-cash fair value adjustment on our timber was also up $0.5 million compared to the prior year reflecting the lower harvest volume this year compared to last.

Free cash flow was down $0.7 million dollars from the second quarter of 2013 to $1.0 million dollars once again reflecting the impact of last year's VMI program. On the more meaningful year-to-date basis, free cash flow is up $1.0 million resulting in a payout ratio of 104% compared to 121% to date last year.

I will now briefly review the segmented results for Acadian's New Brunswick and Maine operations.

Net sales from our New Brunswick operation for the second quarter totaled $9.3 million dollars compared to $13.5 million dollars for the same period last year. The decrease reflects the impact of not operating under the VMI program in the current year, partially offset by increased softwood sawtimber and hardwood selling prices.

The weighted average selling price across all log products was $61 dollars and 11 cents per cubic metre in the second quarter of 2014, up 9 percent compared to the same period last year. This year-over-year increase in the average log selling price primarily reflects a higher proportion of hardwood logs in the sales mix. Other sales were in line with the prior year's result.

Costs for the second quarter of 2014 were $7.6 million dollars as compared to $10.6 million dollars in the comparable quarter of 2013. The decrease in total costs was due to lower harvest volumes of primary products, partially offset by 3% percent higher variable costs per cubic metre as a higher proportion of hardwood products were supplied from log handling yards.

Second quarter Adjusted EBITDA for the New Brunswick operation was $1.7 million dollars, down $1.2 million dollars compared to the second quarter of 2013 again reflecting the discontinuation of the VMI program. Adjusted EBITDA margin decreased to 18 percent from 22 percent in the prior year.

Switching to the Maine operation, net sales for the second quarter of 2014 were up year-over-year, increasing $0.6 million dollars to $2.7 million dollars. Increased hardwood sales volumes, improved pricing across all log products and the positive impact of the weaker Canadian dollar drove this improvement. The weighted average log selling price was $68 dollars and 34 cents per cubic meter in the second quarter of 2014, a 19 percent increase from $57 dollars and 30 cents per cubic meter in the same period of 2013 in Canadian dollar terms. Weighted average log selling prices in U.S. dollar terms increased 11 percent year-over-year as a result of stronger market demand for most of our products and higher proportion of hardwood in the sales mix.

Costs for the second quarter were $2.3 million dollars, compared to $2.0 million dollars during the same period in 2013. This increase reflects increased harvest volume and adverse foreign exchange movements year-over-year.

Improved log prices and higher sales value compared to the second quarter of 2013 resulted in Adjusted EBITDA for the Maine operation increasing $0.2 million dollars from the prior year to $0.4 million dollars. Adjusted EBITDA margin, at 14 percent for the second quarter of this year, was up from 10 percent in the prior year.

Moving away from operations and over to our cash position…at the end of the second quarter, Acadian had cash on hand totaling approximately $7.9 million dollars, which is $2.5 million dollars higher than the cash balance at the same time last year. The primary drivers of the increased cash balance include the generation of $1.0 million dollars of free cash in excess of dividend payments over the last twelve months and decreased working capital mostly as a result of below-normal sales volumes from the New Brunswick operation in late June. The cash balance is down $3.1 million dollars from the end of the first quarter of 2014 reflecting the typical seasonally low cash generation during the second quarter.

As at June 28, 2014, Acadian had net liquidity of $69.6 million dollars, including funds available under Acadian's Revolving Facility and our stand-by equity commitment with Brookfield. The balance sheet remains strong leaving Acadian well positioned for the future.

During the quarter we distributed $0.21 per share to our shareholders, a dividend that is in line with previous quarters and supported by our steady performance.

I will now turn the call over to Reid.

REID CARTER:
Thank you Erika, and good morning or afternoon everyone.

During the quarter, Acadian's operations experienced no recordable incidents among employees or contractors and to date this year there has only been one recordable incident. We are pleased with this performance and continue to work with our contractors and employees to ensure the highest standards of workplace safety are maintained.

We are also pleased to note that in early June, the New Brunswick operation successfully completed a surveillance audit under the Sustainable Forest Initiative with no non-conformances. The New Brunswick operation has been recommended for re-certification to the SFI standard.

Acadian's weighted average log price for the second quarter of 2014 increased 11% year-over-year on steady customer demand with a bit of help from the impact of a weaker Canadian dollar on our U.S.-

based sales. Softwood sawlog prices were up 10% relative to the same period last year, benefiting from our customers' continued positive outlook for lumber demand. Prices for hardwood sawlogs and pulpwood were both up 7% relative to the second quarter of last year reflecting strong market demand. Softwood pulpwood pricing has weakened, declining 8% year-over-year, with fewer groundwood customers operating in our region. The biomass gross margin was down 27% year-over-year as our primary export customer continues to work through logistical issues.

Acadian's financial outlook for the remainder of 2014 remains positive despite the struggling U.S. housing market. North American lumber prices have remained strong throughout 2013 and 2014 encouraging Acadian's key solid wood customers to continue to operate at, or near, full capacity. As such, we expect to see ongoing strong demand for softwood sawlogs in the region.

In addition to our positive outlook for softwood sawlogs, markets for hardwood sawlogs remain solid and are expected to remain so while demand and pricing for hardwood pulpwood continues to be strong. Acadian has been successful in selling its softwood pulpwood production, but this market continues to be challenged by the closure of regional groundwood mills. Fortunately, this product represents only a small portion of Acadian's sales and an even lower proportion of our operating earnings. Biomass demand is expected to improve over the remainder of the year as our primary export customer has resolved their logistical issues which should return margins to more typical levels.

On the business development front, we continue to actively pursue business development opportunities in support of Acadian's growth strategy in the U.S., Australasia and South America. After a prolonged period of limited investment opportunities, we are currently seeing an increasing number of owners willing to test the market. Our growth strategy aims to build a timberland portfolio with an attractive balance between cash flow and capital appreciation with the ultimate focus being on our long-term total return target of 10-12% per annum. This goal drives our disciplined approach to evaluating opportunities in today's competitive environment.

In closing, I'd like to remind everyone that Acadian benefits from a strong balance sheet and a very capable operating team who remain focused on improving our financial performance by minimizing costs at all levels in the organization and always seeking the highest margin market opportunities for the products we produce. We look forward to continued improvement in Acadian's performance in the coming quarters.

We thank you for your continued support of Acadian.

That concludes our formal remarks and we are available to take any questions from participants on the line. Operator…?

OPERATOR:

Thank you …The first question is from Paul Quinn of RBC Capital Markets. Please go ahead.

PAUL QUINN:

Yes thanks, and good morning. It sounds like, and it looks like, there's a number of potential timberland transactions for the balance of the year. Can you comment on that in North America and also what you're seeing outside of North America?

REID CARTER:

We've been very active this year and in 2013 as well. Looking at quite a number of timberland opportunities, really carrying out full underwriting on many of them. A number of these have the auction processes that, as we've said in that, you know, these tend to be very, very competitive and frankly, we haven't had a tremendous amount of success in them because the—you know, the win environment (ph 00:48), it tends to be very aggressive right now with quite a bit of capital available.

We've also been working on quite a number of negotiated transactions and continue to work on those. So, we're active in a pipeline in the Pacific Northwest, in the US South and the Great Lakes region in the US, and very hopeful, as we've said in past quarters, that we're going to have some success in these.

As we've mentioned, I think also, we tend to look at larger transactions, so we aren't usually looking at sort of the $25 million and $50 million and $75 million type opportunities unless we already have operations in the region and could have some good scale efficiencies. We've been looking, you know, certainly very actively, in New Zealand and Australia, particularly in New Zealand recently and also remain very active in Latin America, primarily in Brazil, Uruguay, Chile. So, you're right, there has been—there have been more offerings; a number of them have been smaller.

We're also seeing, I'd say, a broader range of buyers. It's not just been the traditional TIMO financial buyer. We're seeing, direct acquisitions by major pension funds and sovereign wealth funds. We're seeing, of course, the US public timber REITs being quite active, particularly in the US south. It's, as I said, a very competitive playing field out there, but we've been successful many times. In Brookfield, as I'm saying, we have been successful many times in the past and expect to – in our own disciplined, patient way – to be successful again.

PAUL QUINN:
Okay, and it sounds like mud season, I guess for Q2, lasted a little bit longer. Do you expect to pick up the volumes in the back half of the year?

REID CARTER:
We do. We actually carried more volume into, the very cold, snowy winter, so we were able to operate into the beginning of Q2, but then we got squeezed in the back end by a lot of rain and the late snow melt and the like. So, it did go a little longer. You know, we also had some of our customers carried a little more inventory into the end of end of Q2, so were a little slower in their off take but we fully expect to make that up in Q3 and Q4 and are well underway in doing that. We've got a very confident outlook for the remainder of the year.

PAUL QUINN:
Great. That's all I had. Good luck.

REID CARTER:
Thanks.

OPERATOR:
The next question is from Andrew Kuske of Credit Suisse. Please go ahead.

ANDREW KUSKE:

Thank you, good morning. Just a question relating to New Brunswick's changing policies in the forestry sector and it seems to be a lot more amenable and I know it was announced a while ago, but do you have any updates on how this affects Acadian or could affect Acadian as we look in the quarters ahead on your core operations?

REID CARTER:

Well, I mean, it's a multi-faceted initiative under the province, sort of the broad aspects of their forestry plan which they released in the first quarter. They have tried to make a meaningful amount of more fiber available to their provincial converters. Certainly, the wood products converted both hardwood and softwood, but also their pulp and paper players and, in response, have managed to gain some pretty significant capital investments. You may have seen Twin Rivers this week announce – not only a chopping up of their former Fraser Papers pension plan over a prolonged period of time – but much more importantly, a series of capital investments, both in their Edmundston pulp mill and in their plaster rock sawmill.

So, you know, we think the competitive positioning of our—particularly of both our pulp and, particularly hardwood pulp and sulfite pulp and solid wood customers will improve with these capital investments. The flipside of that is that we may see more crown timber competing in the marketplace. As much as we can in the analyzing of this period, at this point in time we think that the desire to add shifts and to put their capital to work should result in a net increase in timber consumption and should result in a tighter market.

You know, it seems, if you look at the response of the various marketing associations for the woodlot owners, it's been a bit mixed but most seem to be at least giving the benefit of the doubt that, you know, private landowners are going to be net beneficiaries of this initiative. But there's always concerns. Crown wood tends to be the lowest-cost wood and if there's too much made available it could depress prices. We haven't seen that yet and we're certainly watching it.

ANDREW KUSKE:

Okay, that’s very helpful. Then, I guess somewhat related but maybe a bit broader in the nature of the question; do you see an environment in New Brunswick, just in, say the next few years, of some potential conditions for labour to be a little bit tighter? I ask the question – part is – you've got the Energy East Pipeline proposal that could be built, you know, there's sort of a bit of consternation, I guess, on fracking and bad activity happening in New Brunswick. So, there's a lot of things that look economically positive overall for the province, but could that result in some tightness on labour availability for you?

REID CARTER:

We have remarkably few labour challenges in New Brunswick. We have a large and stable contractor environment that have long histories in the business. I'm sure, as you're aware, there's just a tremendous number of – I'm not sure what the right age I should use here is – I'll call them 45 and under people from New Brunswick who have left the province to work in Fort McMurray, you know, Northern Saskatchewan, Northern Alberta and who return home on their – whether they're two weeks on, a week off or whatever – have maintained houses in New Brunswick and return home on their off times. I think, you know, many of them would still like to be working in New Brunswick but don't have the same employment opportunities there. So, I think that if you did have a meaningful change in oil and gas or a pipeline development creating jobs in New Brunswick, I think there is quite a large-scale workforce that, you know, should there be good employment opportunities there, would return.

So, we had quite a bit of more significant labour challenges, I guess in 2011, in Maine when the foreign workers who were restricted in 2010 and '11, particularly Quebec loggers restricted from working in Maine and we had quite a bit of difficulty in sort of rebuilding that workforce, of course, as it was no longer available. But that stabilized as well and we've actually got some excellent new contractors in Maine so things look good right now. We really are anticipating, you know, we're so heavily mechanized that we're not talking about hundreds and hundreds of workers in either of our operations. We certainly do have hundreds of workers but we're easily able to keep them employed.

ANDREW KUSKE:

Okay, that's good to know. Then just finally, if I may, on any kind of conversations you're having for biomass supplies, any European buyers? Because we've seen some of the European biomass players really look very far afield for supply and I'm just wondering if you have any update on that potential?

REID CARTER:

We have, over the last – probably six or seven years – you know, talked with pretty well everybody who either wants biomass locally to convert to pellets or certainly mill residuals which we don't have but we certainly are very aware of who's looking for them. Then straight biomass exports, not pelletized for operations like the recently funded MGT development in Teesside in the UK.

Every indication is that there's lots of demand for the products and these things always come down to price. We're not immediately situated next to a port, so there's freight costs for us to get to good export ports and these are all low-margin opportunities. So, you know, certainly as the port efficiencies and handling efficiencies improve and as prices become not just higher but more confident, we have continued to sell more and we expect to sell more. But we do expect this to remain a low-margin opportunity and I think, certainly, our best opportunities are on the biomass rather than really having anything that we can sell to a pellet operator. You know, currently our pulp market opportunities for pulpwood are just—offer just dramatically better margins than selling to a pellet producer. But we certainly play in that. We are starting to, over the last year and a half, have been selling increasing volumes to exporters, primarily to the UK and expect that to continue to grow.

ANDREW KUSKE:

Okay, very helpful. Thank you.

REID CARTER:

Thank you.

OPERATOR:

The next question is from Mark Kennedy of CIBC World Markets. Please go ahead.

MARK KENNEDY:

Good morning. Just a couple of questions. I guess first of all, just like to understand a little more—you're seeing some softness, you said, in—for softwood, pulp logs. Is that market sort of near trough, or how much further downside might there be there?

REID CARTER:

Well, that market – the big issue there – the Edmundston Pulp Mill is our local customer and their strong preference is to run off residuals from the plaster rock sawmill and other regional sawmills but they do use significant pulpwood and we are their primary supplier of softwood pulpwood. The Great Northern Paper Mill in Millinocket had been our second-best opportunity and that's been down now for – it must be more than half a year – and I think is not a very strong expectation that it's going to start up. We'll call it indefinitely closed right now.

So, that's created a surplus in the region. The Crown last year responded by creating opportunities to leave softwood pulp within the woods and you pay a different stumpage arrangement when you do that, but—and, you know, a number of players have taken the Crown up on that. That has helped keep softwood pulpwood prices reasonable so they continue to offer a small margin.

The Woodland, Maine mill has been working to use some more softwood and has been doing—it's primarily a hardwood pulpwood mill but has been doing softwood runs and we're not really sure just where they'll go with that, how much they'll—you know, how much they'll blend in or choose to use. But certainly, there's a meaningful price differential for them right now.

But I think it's our expectation—you know, how low could it go? As I just mentioned in regard to biomass, I think we are still getting reasonable pulpwood prices and the way we account for our costs, we're still getting a small margin on our softwood pulpwood. The cost of our biomass, we treat differently, they—it's not really the primary product that bears the full load of these—of our logging development opportunities.

You know, conceptually, if the pulp mill's went away, the alternative would be a fuel alternative and if that happened we would have to look at leaving significant volumes. In the woods, I think, it would no longer make a contribution to our costs – a meaningful contribution – to our costs. We're not anticipating that will happen anytime in the near term and I think the most important thing, as we've said in our presentation, this is a very low-volume product for us. It's about 6% to 8% of our harvest volume and it's 1% or 2% of our cash flow. So, it's certainly something we watch. We're always trying to find solutions to it but it is very challenged. It has been for the better part of a couple years here.

MARK KENNEDY:

Yes, yes. Then finally, Reid, just in terms of your cut and haul costs. Do you expect those to stay relatively flat through the balance of the year or just like to get your views on that?

REID CARTER:

Yes, I would say you should expect that they'll be very stable. We negotiate all of our contracts on an annual basis in the April/May period; those are in place and we've got a very, very competitive workforce and those negotiations went well, as have our various union negotiations. They're excellent partners with us in their business and I think we should—you shouldn't expect any meaningful changes in that area.

MARK KENNEDY:

Okay, great. Thank you.

REID CARTER:

Thanks.

OPERATOR:

The next question is from Daryl Swetlishoff of Raymond James. Please go ahead.

DARYL SWETLISHOFF:

Well, thanks. Good morning. Just one question left for me to ask and it's on the hardwood pulp markets. Of course, Reid, we've seen markets adjust to the new capacity; we've seen the spread with softwood and hardwood open up. Does this challenge the competitive position of any of your customers?

REID CARTER:

Well, you know, I mean, I think all of you are probably at least as qualified as I am to have your views on these things. Our customers currently, I know the last few years, have been running full; have been really buying almost all the volume they can get their hands on and many of these customers, as you know well, these are small mills and old mills. They have very, very, you know, little capital employed. They're mostly, you know, third and fifth owners. So, you can be very committed to keeping their mills going and while, certainly the new Fibria and Eldorado type mills that we're seeing have a very low cash cost, they do have a lot of capital employed. It's going to be interesting to see how, when we talked to the Brazilians, they have an expectation of there's going to be, you know, 30 Northern hemisphere small hardwood pulp mills that were closed. But, you know, we see a few but they seem to keep moving.

I think the big challenge will be our prices, which I'm sure you would expect that hardwood prices would be under pressure and a lot of that really reflects on which customers they're supplying, whether they have specialty products that these customers currently require, and their freight positions. If they're selling to, you know, very close proximity paper mills and things, they'll remain the best suppliers. So, there's a lot of dynamics that go on.

Right now, most of the paper mills are the pulp and/or paper mills that we worried about are those that have already gone down. You know, there are—over the long term, clearly we'd expect some more to go down, but so far we've been able to move our volume and I think we're not really overly anxious about this in the next couple of—next year or two. Beyond that, I'd be a bit nervous to guess.

You know, as we've said in the past, we are very keen to grow Acadian, not just to improve its liquidity, but really to diversify out of the region. We think that, you know, not only would improved liquidity benefit investors, but we think that having more geographic and product differentiation, really, could lower the risk profile of the investment meaningfully and, on a risk-adjusted return basis, you know, position Acadian very favourably.

So, our acquisitions strategy; we would like to think that it's quite thoughtful in trying to really look at sort of overall risk-adjusted returns to investors, and we certainly watch our regional customers in Acadian and try to think about what those risks might represent if we remain positioned exclusively to that smaller region.

DARYL SWETLISHOFF:
That's a fair comment. Thank you, Reid.

REID CARTER:
Thanks.

OPERATOR:

There are no more questions at this time. I will now hand the call back over to Mr. Carter for closing comments.

REID CARTER:

Well, once again, thank you very much for participating and your interest in Acadian. We certainly look forward to talking to you in the coming quarters. If you have any further questions, please feel free to reach out to us. Thank you and enjoy the rest of your day.

OPERATOR:

This concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.