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Algoma Steel Group, Inc. (ASTL)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

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Rajat Marwah
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MANAGEMENT DISCUSSION SECTION

Operator: Greetings. And welcome to Algoma Steel Second Quarter 2022 Earnings Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Brenda Stenta, Manager of Communications and Branding. Thank you. You may begin.

Brenda Stenta
Manager-Communications & Branding, Algoma Steel Group, Inc.

Good morning, everyone. And welcome to Algoma Steel Group Incorporated Second Quarter Fiscal 2022 Earnings Conference Call. Leading today's call are Michael McQuade, our Chief Executive Officer; and Rajat Marwah, our Chief Financial Officer.

As a reminder, this call is being recorded and will be made available for replay later today in the investor section of Algoma Steel's corporate website at www.algoma.com. I would like to remind you that comments made on today's call may contain forward-looking statements within the meaning of applicable securities laws, which involve assumptions and inherent risks and uncertainties. Actual results may differ materially from statements made today. In addition, our financial statements are prepared in accordance with IFRS, which differs from US GAAP. And our discussion today includes references to certain non-IFRS financial measures.

With that in mind, I would ask everyone on today's call to read the legal disclaimers on slide 2 and 3 of the accompanying earnings presentation and to also refer to the risks and assumptions outlined in Algoma Steel's second quarter fiscal 2022 management's discussion and analysis. Please note that our financial statements are prepared using the US dollar as a functional currency and the Canadian dollar as our presentation currency. Our fiscal year runs from April 1 to March 31 and our financial statements have been prepared for the three and six months ended September 30, 2021.

Please note, all amounts referred to on today's call are in Canadian dollars unless otherwise noted. Following our prepared remarks, we will conduct a question-and-answer session.

I now turn the call over to our Chief Executive Officer, Mike McQuade. Mike?

Michael A. McQuade
Chief Executive Officer & Director, Algoma Steel Group, Inc.

Thank you, Brenda. Good morning, welcome, and thank you for joining Algoma's earnings call for our second fiscal quarter ended September 30, 2021. Our first earnings call since closing our merger with Legato and returning to the public markets.

I will start my comments by addressing what really matters most to us, the safety of our employees. At Algoma we believe in safety without compromise, and our continued focus has resulted in substantial improvement over the last decade in our lost time injury frequency rate, which I'm proud to say was zero for the second consecutive quarter. I commend our entire team for the collective success on safety performance, a top priority for Algoma.

Before we get into a discussion about our exceptional results for the quarter, let me address the two transformative announcements that we made this morning. First, we are happy to report with the approval of our board, we have reached this positive final investment decision for our proposed electric arc furnace project. This announcement marks a major milestone for the business evolution of Algoma and demonstrates our commitment to producing greener, more sustainable steel. Project entails dual furnaces that are designed for a combined annual raw steel production throughput of 3.7 million tons, matching our downstream solution capacity. Is also expected to lower our carbon emissions by approximately 70% when fully operational. Additionally, the project adds new vacuum degassing to increase the product capability of our steel plate grades. Project is expected to increase productivity and make Algoma a more agile and profitable company. But just as importantly is expected to result in a 3 million tonne per year reduction in our CO2 emissions, as we drive towards a more sustainable method of steel production.

The CO2 reduction would represent 11% of the federal and 100% of the provincial targets for industrial emitters have set for 2030 under the Paris Accord. The total project cost is expected to be approximately CAD 700 million funded with previously announced financing commitments. The proceeds of a recently completed merger and ongoing cash flows.

We expect the [indiscernible] (00:04:59) to come online in 2024, following a 30-month construction phase, with continued transition away from blast from steel production to follow as increased power supply becomes available.

The other strategic announcement we made this morning was that our board has approved a plan to retire all of our outstanding senior secured debt, which totals $358 million, leading us of an even stronger balance sheet to support critical investments like the AEF to drive growth and create additional long-term value for all of our stakeholders. We expect the process of retiring the debt to be completed by the end of next week. Combined these two announcements mark the next great milestones in our company's evolution.

Now let's turn to the quarter's results. Our strong fiscal second quarter results displayed the impressive cash generating potential of Algoma.

I'll remind you again that all numbers are expressed in Canadian dollars, unless otherwise noted.

The results were highlighted by record net income of CAD 288 million, quarterly adjusted EBITDA of CAD 431 million, reflecting an EBITDA margin of 43%, as well as cash generated by operating activities of CAD 380 million.

We finished the quarter with a total liquidity of CAD 659 million, including a cash position of CAD 367 million and availability under our credit facility of CAD 292 million. Rajat will expand on the numbers and give our outlook for the third fiscal quarter in a moment.

Optimism continues for steelmakers across North America. Strong demand in key end markets continue and pricing remains at near-record levels. The strong cash flows we are generating. Our focus on operational efficiency and the strategic moves made on our capital structure, our positioning Algoma as a next generation steelmaker focused on sustainability with attributes that we believe will make Algoma successful across the steel market cycles.

You have several reasons to be very optimistic about what lies ahead for Algoma, and we'll share more details later on the call. But first, I will pass it over to Rajat to go over the financial highlights of the last quarter.

Rajat Marwah

Chief Financial Officer, Algoma Steel Group, Inc.

Thanks, Mike. Good morning, and thank you for joining the call. Before we get into these details, I'm happy to report that we had another very successful quarter, the second quarter of our fiscal year ended September 30, 2021. Total revenue in the quarter was CAD 1.01 billion, up 168% year-over-year, our steel revenue was CAD 936.5 million which was up 179% versus the prior year quarter. We shipped 587,000 net tons in the quarter, up 14% from 516,000 net tons in the same quarter of last year, primarily as a result of a return to near run rate utilization levels compared to the pandemic low was experienced last year. This resulted in average steel revenue per ton of CAD 1,594, up 146% from CAD 649 a year ago. As a reminder, both our contract and spot orders are subject to our pricing [indiscernible] 00:08:39 due to price mechanics and mill lead times. We started to see these positive results flow through our earnings last quarter and that impact continued in this quarter.

Steel markets have remained strong and prices while off from record levels achieved in last summer remained near those elevated levels. On the cost side, Algoma's cost of goods sold per ton increased quarter-over-quarter as some commodity price increases had an effect on selected raw material inputs. In an effort to offset these increases, Algoma remains focused on our cost saving initiatives, and to date, we have captured [ph] hundred savings of approximately CAD 45 million on an annualized basis and we remain on track to reach our CAD 50 million target.

When compared to the same quarter of last year, cost of steel products sold per ton is approximately 37% higher. The year-over-year increase was primarily driven by higher commodity pricing, impacting some of our raw material input costs and higher cost of utilities.

Please keep in mind that last year, Algoma was eligible and did receive benefit under the Canadian Emergency Wage Subsidy Program as the pandemic impacted our business substantially, which allowed us to keep our employees working during this period of low production volume and mitigated higher fixed cost on a per ton basis, regenerated $431 million of adjusted EBITDA during this quarter, compared to $281 million of adjusted EBITDA in the prior year quarter. We are continuing to reap the rewards of even higher pricing, moving through our results. However, due to the lagging nature of our order book, we expect to realize higher prices in the subsequent months. We generated $380 million of cash from operating activities and ended the quarter with $367 million of cash on the balance sheet, which resulted in liquidity of approximately $659 million including availability under our credit facility.

I'd like to take a moment to follow up on Mike's comments around our announced debt retirement. It truly is a remarkable achievement that when you consider our September end cash position and add the cash received in connection with the closing of the merger transaction, Algoma today is in a position where our cash exceeds our outstanding debt. We have begun the process of retiring all of our senior secured outstanding debt at par. We expect that this positive cash flow will only improve going forward considering the strong steel market and our competitive cost position. We feel this places us with a stronger balance sheet as we began constructing the ES, which puts us in our tremendous position to create long-term stakeholder value for the – from a position of strength.

Now turning to outlook, as you all know that has been a sustained significant increase in the index price of steel since August of last year. Strong demand, coupled with low customer inventory levels across the supply chain, continue to support flat role steel prices above historical peaks. Demand from key end markets including automotive remains strong, and we expect this to continue into next year. We feel that the investments we have made in a Plate Mill was serving us well as traditionally as Rolled Plate is priced higher than what Rolled Coil. Today that relationship is important.

However, with infrastructure spending we believe the traditional relationship will return and Algoma will be ready at that point with higher production capacity and broader market reach for our products.

With the macroeconomic drivers and North American market that includes projected infrastructure spending, 232 tariffs, replacement tariffs, rate quarters and discussions around carbon border adjustment, we believe that pricing will remain elevated for the foreseeable future, resulting in a new paradigm for steel setting prices.

All of these factors support our positive guidance. Shipments in the third quarter of 2022 ending December 31st are expected to be in the range of 590,000 to 610,000 [indiscernible] (00:13:31). Net sales realization are again expected to be directionally higher as we expect to see our released prices climb month-by-month in parallel with the significant index price increase we have experienced. We expect adjusted EBITDA performance of at least CAD 450 million.

I would like to add that subsequent to quarter end, we announced that we had established metals sourcing joint venture with Triple M one of the North America's largest privately owned ferrous and non-ferrous metals recycling companies. We expect this JV to add stability to our scrap supply chain, helping us take some of the volatility out of our cost structure.

To take us further through our strategic activities, I will pass on the call to Mike.

Michael A. McQuade

Chief Executive Officer & Director, Algoma Steel Group, Inc.

Thanks Rajat. As you are aware on October 20 we celebrated a milestone day in this company's rich 120 year history with our return to public markets. Together with a number of employees and other stakeholders, we opened the Toronto Stock Exchange the following day and what was a short one minute ceremony. A one minute ceremony that was only made possible by countless hours of hard work and dedication from our team and while the ceremony was brief, this moment served as validation for the value we have created in this business.

For the past three years, we have taken a dedicated strategic approach to improving Algoma whether it is our approach to operational and capital improvements, improvements made to the balance sheet or our focus on organizational excellence and ESG, we have developed the building blocks to position Algoma as a successful next generation steelmaker. Powered by our employees, it's the collective effort of our team that has facilitated our return to public markets.

In connection with the successful merger Algoma receive proceeds of over $300 million former private Algoma's shareholders received public shares of the new company with contingent rates to traditional shares and in target calendar year, earn-out adjusted EBITDA numbers. These will be fully earned if the company generates 2021 calendar year earn-out adjusted EBITDA of greater than $900 million. Our current EBITDA guidance projects that we will surpass the earn-out threshold and achieve a calendar year adjusted EBITDA of approximately $1.1 billion. This will truly represent a win-win for the company and its shareholders.

On the opening of the Toronto Stock Exchange provided a moment to reflect on all the work we have done to get to this point, we are by no means resting on our laurels. With cash injected from the merger, record earnings performance and a commitment of $420 million from the federal government, we are moving on to our next strategic focus. Our team has already mobilized to begin work on the electric arc furnace transformation. And we believe this to be a generational investment that will forever change how steel is manufactured in Sault Ste. Marie and that Oklahoma is well capitalized and positioned to execute.

Our team is focused both operationally and financially on these critical investments to make our business greener, more competitive and more resilient. We expect this transformation will create a compelling value proposition for all of our stakeholders. Exciting times to say the least for the steel sector and for Algoma Steel in particular. Thank you very much for your continued interest in Algoma Steel. We very much look forward to what the future holds. At this point, we would be happy to take your questions. Operator, please give the instructions for the Q&A session.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, at this time, we will be conducting a question-and-answer session.

[Operator Instructions] Our first question comes from the line of David Gagliano with BMO Capital Markets. Please proceed with your question.

David Gagliano

Q

Okay. Great. Thanks for taking my questions. Before I ask my questions, I just want to congratulate the Algoma team as well and be back in the, in the public equity market. Great to see Algoma back, strong balance sheet and solid strategic outlook here. Congrats again.

A

Thanks so much, David. Really appreciate you dialing in this morning and look forward to your questions.

David Gagliano

Q

Great. So, just on, on capital allocation, first of all, given the obviously free cash flow of $350 million, I think [indiscernible] 00:18:34 one quarter, probably a higher number this current quarter, we've got the [indiscernible] 00:18:38 proceeds. Looks like Algoma and calendar year 2021 with over $700 million of cash on the balance sheet and no debt once these bonds, bonds are redeemed. And then we don't, we haven't even talked about 2022, which is probably going to be another strong free cash flow yield. So, I thought it was interesting to see within the, the EAF go ahead press release a couple of days ago that the plan is still to fund the EAF in part with the previously announced government financing agreements. Just given the strength in the balance sheet now, the upcoming cash generation, number one, do you still plan to draw on the entire government funding package or would you instead just draw on the forgivable portion, for example?

And then number two, what are the restrictions if any related to shareholder returns, for example, if you draw on either the, the CIF Forgivable Loan or the CIB loan?

A

So David, sitting on the front end, we share your optimism with respect to, to the steel markets and we'll let that play out. And with the certainly the EAF final investment decision behind us final investment decision behind us as well as the debt retirement as we will turn our minds to are turning our minds to the alternatives that are available to us, and it's really focused on maximizing shareholder value. So the degree to which the debt is required, the other strategic options that we have with respect to rewarding the shareholders regular dividends, special dividends, share repurchases, obviously subject to the lock ups that exist, warrants settlement strategic investments all of those things are on the table, if you like. So at this point in time we're not declaring or are we able to declare the plans going forward with respect to specifically the financing that's available from the government I would note that it is very attractive debt and it may make sense to proceed and we'll see how the market unfolds and whether that continues. And obviously, this is all done with oversight of the board with the stakeholder and shareholder value in mind.

With respect to the restrictions there are some and it's basically the availability and a reduction of what's available to us from the government as we do that. And again, that will factor into the decisions.

Q

Okay, that's helpful, thanks. Just switching gears just to the contract versus spot mix here, I think it's about 10% of the volumes that actually tied to annual contracts. I believe that reset at the end of the calendar year, just assuming you're mostly done with these, those negotiations, now what's a reasonable average year-over-year price increase for 2022 for that 10% of your business?

A

So to be clear, there is approximately two thirds of our business, 65% that is in fact covered under contract. Some on a fixed price over the course of the year, some on a one month lag and some on a three month lag. But if you were to look at the year-over-year increase of where spot is in late in calendar Q3 and into Q4 as they're being renewed relative to last year, and that would be a good proxy for the negotiating starting point.

Q

Okay. So just to clarify how much of that two thirds is actually tied to full year annual contracts that reset at the end of this year?

A

I think you have the number right, it's 10% that is fixed price for the full year with the balance being indexed either quarterly or monthly.

Q

Okay. And your point was that if we just look at year-over-year price changes in the spot market that actually is a reasonable proxy for the magnitude of the increase for that 10% of the business.

A

Yes, I believe so.

Q

Okay. Okay, great. And then just quickly on the cost side coal producers in the US have been flagging some pretty meaningful cost increases, up $100 a ton. Is that a reasonable expectation for your 2022 coal costs? And if you can remind us what is your annual coal consumption?

A

Sure. Hi, David, this is Rajat. The coal consumption normally from on an annualized basis is half of what our steel shipments are so normally that's the requirement 1.2 million ton 1.3 million ton for the whole year. We have got into the discussions on fixing our contracts for next year. And I think it's falling in the same ballpark as you're seeing in that range though the index has gone up 300%, but we know that North American settlements are normally at a – at a discount to that index because that index reflects mostly material going offshore. So – so it's – it's a – it's a reasonable ballpark.

Q

Okay. That's helpful. Thanks. And just one last question for me, for now, the – just a kind of annoying question, but the share count you know with the earn-out rights what – what is the fully diluted share count once those are – those are finished and also actually same question for the – for the warrants?

A

Sure. So – so the – the – it's all – it's all given an F1, which we recently filed, but at a very high level. There is a 112 million shares outstanding currently and that does not include the 37.5 million earn-out shares, which will come sometime early next year. It does not include the 24 million warrants that are – that are out there and it also does not include 3-odd million of management shares that have not been issued. So – so that's – that's the – that's the total amount, 112 million outstanding right now, 3.3 million roughly of management shares, 37.5 million of earn-outs which will come earlier next year and 24 million of warrants.

Q

Okay. Thanks very much. That's it for me. Congrats again on the you know again return to the equity market. Thanks again.

A

Thanks.

A

Thank you.

Operator: Our next question comes from the line of Alex Jackson with RBC Capital Markets. Please proceed with your question.

Q

Yeah. Morning, guys, and thanks for taking my question. I know you've talked with a little bit already, but just in terms of the operating costs, what was sort of driving those higher – those higher costs in terms of which commodities and how would that compare to what we might see in a more normalized environment for an operating cost kind of run rate going forward? Thank you.

A

Sure. So most of the increase that we are seeing is in the metallic side scrap, iron ore and also on the items the variable cost items like refractory reagents and so and so forth. So all the commodities have gone up and that's reflective of the significant increase in steel price as well. On the other side we've also seen increase in natural gas and power to some extent based on what's happening in Europe. So that's what we are seeing. We will see a similar trend in the fourth quarter as well. But on a more normalized basis we expect scrap to flow the same way as the pricing is flowing. So that should correct it. So natural gas and power should correct itself because there is a lot of natural gas availability in North America still and iron ore as we have said that a portion of iron ore is linked to steel revenue and a portion is linked to iron ore index, so that may correct itself in the future as well.

So cost is expected or should come down as things normalize, but it's currently just because of the way where the commodities are currently.

Q

Got it, thank you. And then another one I just had on your volumes you guys guided for a little bit higher volumes in Q4. Sometimes Q4 can be a little bit seasonally weaker. So that's kind of what impacted Q3 shipments. And what the run rate looks like going into started 2022?

A

So calendar Q3 and the shipments in, sorry, let me make sure I understand you're talking just calendar Q3 on the shipments?

A

Yeah, sorry calendar Q3. Yeah.

A

Okay, so our maintenance is, is typically concentrated in the nine months really from April through the end of December. And the issue is really not performing a significant amount of maintenance and I'm talking planned maintenance in the winter months of January, February and March. So this year, we've completed you know our regular maintenance on our DSBC, realigned our number four steelmaking vessel and it should repairs. So it really is an impact of, well, we have CAD2.4 million, CAD2.5 million on an annual basis. We do tend to have you know our strongest quarter in that January through March and again supported by the contracted volumes that we have with our customer base.

Q

Got it, thank you. And then the last one, I had just curious on lead times for your spot sales. What are those looking like right now in terms of weeks?

A

Again, we are you know we're looking to just clean up and finish up at the end of December, so we're out six weeks at this point in time on Hot Rolled well beyond that on, on Coil Rolled. But I think Hot Rolled is the most indicative and looking to close out December now and move into January.

Q

Got it, that's helpful. Thanks, guys, that's all for me.

A

Thank you.

Operator: There are no further questions in the queue. I'd like to hand the call back to management for closing remarks.

Unverified Participant

Listen, our first earnings call as a public company certainly appreciate the attendance this morning. The interest and the questions certainly exciting times the interest in the questions. Certainly, exciting times for Algoma Steel. And we look forward to future earnings calls and sharing our success and progress against the objectives that we set. Thanks very much. Have a safe day.

Operator: Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time. And have a wonderful day.