ATCO Ltd. (TSX: ACO.X, ACO.Y)
Third Quarter 2018 Results Conference Call Transcript

Date: **Thursday, October 25, 2018**

Time: **9:30 AM MT**

Speakers:

Dennis DeChamplain - Senior Vice President and Chief Financial Officer

Myles Dougan - Senior Manager, Investor Relations

Conference Call Participants:

Linda Ezergailis TD Securities, Inc. **–** Managing Director

Mark Jarvi CIBC Capital Markets– Director, Institutional Equity Research

Robert Kwan RBC Capital Markets (Canada) – Managing Director

Patrick Kenny National Bank Financial (Research) – Director, Equity Research

Operator:

Welcome to the ATCO Limited Third Quarter 2018 Results Conference Call and Webcast. As a reminder, all participants are in listen-only mode and the conference is being recorded. After the presentation, there will be an opportunity to ask questions. To join the question queue, you may press star, one, on your telephone keypad. Should you need assistance during the conference call, you may signal an Operator by pressing star, zero.

I would now like to turn the conference over to Mr. Myles Dougan, Senior Manager, Investor Relations. Please go ahead. Mr. Dougan.

Myles Dougan:

Thank you. Good morning everyone. We're pleased you could join us for our third quarter 2018 conference call. With me today are Senior Vice President and Chief Financial Officer Dennis De Champlain, Vice President and Controller Anthony Maher, and Vice President Finance & Risk Katie Patrick. Dennis will begin today with some opening comments on our financial results and recent Company developments. Following his prepared remarks, we will take questions from the investment community.

Please note that a replay of the conference call and a transcript will be available on our website at atco.com, and can be found in the investors section under the heading Events and Presentations.

I'd like to remind you all that our remarks today will include forward-looking statements that are subject to important risks and uncertainties. For more information on these risks and uncertainties, please see the reports filed by ATCO with Canadian securities regulators.

Finally, I'd also like to point out that during this presentation, we may refer to certain non-GAAP measures such as adjusted earnings, adjusted earnings per share, funds generated by operations, and capital investment. These measures do not have any standardized meaning under IFRS, and as a result they may not be comparable to similar measures presented in other entities.

Now, I'll turn the call over to Dennis for his opening remarks.

Dennis DeChamplain:
Thanks Myles, and good morning everyone. Thanks for joining us today on our third quarter 2018 conference call.

ATCO recorded third quarter 2018 adjusted earnings of $87 million or $0.76 per share, which is $33 million or $0.29 per share higher than the third quarter of 2017. Higher earnings were recorded in all of our investments.

Our Structures & Logistics business recorded $2 million in higher earnings, mainly due to improved margins on fleet sales and fleet rentals, as well as increased activity in Mexico and Chile.

Canadian Utilities recorded $18 million in higher earnings; its higher earnings were mainly due to the termination of the Battle River Unit 5 power purchase arrangement by the balancing pool and the associated availability incentive and operating profit margins. Higher earnings in Canadian Utilities were also due to improved Alberta power market conditions for its independent power plants. You can find further information on Canadian Utilities results on its website in the events and presentation section for its quarterly conference call and in the documents and filing section for the interim financial statements and MD&A. The website address is canadianutilities.com.

In the third quarter, ATCO's corporate operations also recorded $12 million in higher earnings compared to 2017. This was mainly due to the sale of four Alberta properties in our commercial real estate portfolio.

So over all, we had a very good earnings quarter in all of our investments.

We're also active on the M&A front this quarter. Structures & Logistics acquired 264 space rental units in Mexico. This increases Modular Structures' rental fleet to 468 units in Mexico. These units are 100% utilized on existing rental contracts, including a contract for 166 units with the Ministry of Education for schools in the city of Monterrey in northern Mexico.

Perhaps the most interesting M&A development for our investors this quarter was our investment in

Neltume Ports. On September 12, 2018, ATCO invested in a 40% interest of Neltume Ports for approximately $450 million. Neltume Ports is a leading port operator and developer in South America, with 16 port facilities and three stevedoring businesses, primarily located in Chile and Uruguay. Neltume Ports' portfolio is highly diversified across cargo types and volume mix. You can find more information about Neltume Ports in the archive webcast in the events and presentations section on our ATCO.com website.

Neltume Ports' contribution to ATCO's adjusted earnings in the third quarter was $1 million. This amount represents ATCO's share of adjusted earnings from the closing date of the investment on September 12, 2018 to September 30, 2018.

Regarding our financial strength, in August, Dominion Bond Rating Service affirmed its "A (low)" rating and stable outlook for ATCO. In September, S&P affirmed its A-minus rating and stable outlook for ATCO. Credit ratings are important to our financing costs and ability to raise funds. We intend to maintain strong investment grade credit ratings to provide efficient and cost-effective access to funds required for operations and for growth.

That concludes my prepared remarks; Myles, over to you.

Myles Dougan:
Thank you Dennis. I'll now turn it over to the Conference Coordinator for questions.

Operator:
Thank you. We will now begin the question-and-answer session. In the interests of time, we ask you to limit yourself to two questions. If you have additional questions, you are welcome to rejoin the queue. To join the question queue, you may press star, one on your telephone keypad. You will hear a tone acknowledging your request. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question from the question queue, please press star, two. Webcast participants are welcome to click on the "submit question" tab near the top of the webcast frame and type their question. The ATCO investor relations team will follow up with you via e-mail after the call. Once again, anyone on the conference call who wishes to ask a question may press star, one at this time.

The first question comes from Linda Ezergailis with TD Securities. Please go ahead.

Linda Ezergailis:
Thank you. Good morning. Thanks so much for having this conference call.

I'm wondering if you can give us a sense of your Structures & Logistics outlook, perhaps in the form of describing what your project lead list might look like, whether it be in British Columbia, related to LNG, or other major projects there, as well as other jurisdictions, and maybe also as a follow-on just a comment on how you see growth being driven, whether it be organic versus further acquisitions potentially.

Dennis DeChamplain:
Hi Linda. Do you mean growth in Structures & Logistics, or growth at ATCO?

Linda Ezergailis:
Well, why don't we start with Structures & Logistics. Thank you.

Dennis DeChamplain:
Okay. I'll keep it to S&L.

In relation to our lead list, we've seen a kind of a—not an explosion, but a huge increase year over year from last year, call it first quarter to now, it's probably almost a tripling of the amounts that we see. We segregate it by type and by region, and if you take a look at our lead list, probably half of it is associated with the natural resource sector, maybe a third in military and government contracts, and the remainder in education, housing and our other new markets that we're entering.

If you were to look at it by region, it's I'm going to say fairly evenly split between Alberta, British Columbia, and the rest of Canada. That takes up probably 80% of it. The remaining 20% is split between the U.S. and the other international locations.

So, that's kind of where we're at with the lead lists and B.C. is in there and that would include any potential work coming from LNG Canada.

In terms of growth at Structures & Logistics, while we're still ready to capitalize on the large workforce housing contracts, growth in that business is, instead of the one-offs from the workforce housing kind of commodity-driven projects that we've experienced the huge spikes in earnings in the past, we're really going to building a base business in our sales and rental fleet, also through expansion into permanent modular construction, being able to supply different sectors like the education and housing sectors that I referred to earlier.

Linda Ezergailis:
That's helpful. Do you see additional acquisitions similar to what you've done in Mexico recently?

Dennis DeChamplain:
Yes. We've gone along about with structures. The nature of the industry is, with further kind of tuck-in acquisitions in markets where there's demand, we feel that we could increase the service for those markets. Mexico is included with the area for further expansion. United States as well for potential bolt-on acquisitions.

Linda Ezergailis:
Thank you. My second question relates to Neltume. It's a relatively low-risk way to get into a new business platform through partnering with an established operator. But, I'm wondering at what point ATCO might invest directly in ports outside of Neltume, and in what geographies and what would need to be in place for you to be comfortable to do that.

Dennis DeChamplain:
You're bang on with that low-risk entry with an experienced operator like Neltume and provided by the Ultramar ownership. For now, I think we will defer to their port expertise, and learn as we go, so it depends on where we go on that learning curve. Our partnership with Ultramar through the ATCO Sabinco investment that we've done, we are very much aligned in our views, so we would—for right now and foreseeable future, we are with Ultramar and Neltume for port expansions. I can't see us going off on our own in that respect for the foreseeable future.

Linda Ezergailis:

That's helpful context. Thank you.

Dennis DeChamplain:

Thanks Linda.

Operator:

Our next question comes from Mark Jarvi with CIBC Capital Markets. Please go ahead.

Mark Jarvi:

Good morning. Continuing on with Neltume, just wondering if you guys could give us any update in terms of expectations and timelines for completing as your permanent financing?

Dennis DeChamplain:

In our investor day back in mid-September, we said that we were planning to take out some other credit facilities. We're looking to do that in Q4 this year, market conditions allowable, and still with a hybrid instrument.

Mark Jarvi:

And then just, you talked about the strategic review for the power assets through the Canadian Utilities call, but if there wasn't a third-party buyer, what's the openness to sort of ATCO Limited to sort of take those assets out from CU through a transfer of those assets inside the corporate structure? Is that something you guys would consider?

Dennis DeChamplain:

Unlikely. I mean, Canadian Utilities, our 52% ownership in that, they are dedicated to energy infrastructure type investments, and ATCO as a holding company probably would not take a direct investment in there, transfer those assets. That's not envisaged right now.

Mark Jarvi:

Okay. Thanks.

Dennis DeChamplain:

Thanks Mark.

Operator:

Our next question comes from Patrick Kenny with National Bank Financial. Please go ahead.

Patrick Kenny:

Hey guys. Just as it relates to the recent FID by LNG Canada, wondering if you can give us a sense as to what the scope of any workforce housing opportunities ATCO might be pursuing out in Kitimat, or perhaps elsewhere along the coast if other LNG projects are sanctioned at some point over the next year or two.

Dennis DeChamplain:

There's several workforce housing projects associated with LNG Canada, both upstream on the pipeline route and downstream near the site itself. We have been actively involved in the proposal process, but we'll have to see what happens in the near future, so for now I think all I'll recommend is that you stay tuned.

Patrick Kenny:

Got it. And then just on the tuck-in acquisition in Mexico, wondering if you could provide some colour on the duration of the contracts tied to the space rental units, and maybe if possible what sort of transaction multiple we should be assuming here, either on an earnings or an EBITDA basis.

Dennis DeChamplain:

Yes. The initial term for the contract is for a year, and then it's kind of month to month extensions after that. So, that's the nature of those Mexican contracts. In terms of multiples in investments, I mean that's kind of our initial very low cost acquisition entry into that marketplace. A little bit of a one-off, so I don't think it would be fair or indicative with respect to multiples. So it's just a minor investment in Mexico. What it does show is that we are looking afield and we are expanding into further markets like the housing market and school market that we have those contracts for.

Patrick Kenny:

Okay great. And then one last quick one if I could, just any update on how you're thinking about the hybrid market over the near term; are you still looking to tap that market here before year end, or is that being pushed into the new year?

Dennis DeChamplain:

That would be in relation to the Neltume investment and yes, we're still looking for the hybrid instrument and market dependent we're looking to close on that in the fourth quarter this year.

Patrick Kenny:

Great. Thanks, Dennis.

Dennis DeChamplain:

Thanks Pat.

Operator:

Our next question comes from Robert Kwan with RBC Capital Markets. Please go ahead.

Robert Kwan:

Great. Thank you. Just in terms of the commercial real estate starting with that, you had the $13 million of gains, how much was actually the gross amount on the sale?

Myles Dougan:

We had two transactions, Robert, it's Myles here. The gross amount on the first one was $14.5 million, for net earnings of just over $10 million, I believe. We had a second smaller transaction as well; I don't have that gross amount at my fingertips, but it would be the similar kind of tax-affected impact, so we had total impact of $13 million, so gross up another $3 million-ish, call it maybe just under $5 million would be my guess.

Dennis DeChamplain:

A lot of—sorry, Robert, a lot of the properties in the ATCO investments were transferred over the years through the utility operations, and those were assets that were no longer required for utility purposes, generally older, so you'll see that at a relatively smaller book value.

Robert Kwan:

Understood. I guess what I'm kind of wondering is, recognizing look that not all real estate's homogenous, but how do those properties kind of compare to what's in the rest of the portfolio? I don't know if there's kind of you can use like a percentage, but the other thing I'm wondering too is is, how much of what's in the commercial real estate portfolio is actually leased back to ATCO entities?

Dennis DeChamplain:

Well, we've got—if you take a look at the rest of that commercial real estate portfolio, there's about 16 other properties that are in there. There's not much that's leased to ATCO entities. I'm trying to think off the top of my head; it's always dangerous. There's some in downtown Calgary that's leased to Canadian Utilities, but apart from that, not much.

Robert Kwan:

Okay, I'm just wondering, so—because you put out some stats at the investor day and it was 417,000 square feet of salable leasable office space, 90,000 for industrial. In terms of what you sold here, can you give a sense as to the percentage on say square footage?

Dennis DeChamplain:

Those would be in the—I don't know how much of the leasable office space would have been on the Calgary properties. It was kind of like an old gas appliance, or sorry, gas distribution warehousing, and in Edmonton the properties were, my understanding, just bare land.

Robert Kwan:

Okay.

Myles Dougan:

Don't have the square footage on the total assets sold at our fingertips here, Robert, but there's no problem with sharing that, I can follow up with you later.

Robert Kwan:

Perfect. Maybe I can just finish here on financing and, you know, after you get past the Neltume financing, what do you think or how do you think about the amount of additional leverage you can add on your existing asset base, in terms of where you'd be comfortable with, whether it's within the credit ratings or just where generally you'd like to be? Put differently, how much more could you raise to acquire things just by levering up the balance sheet?

Dennis DeChamplain:

At ATCO, it would be kind of—our guide is really maintaining the credit rating, so it would be minimal leverage at ATCO, I think at the investor days I said up to 20%. We incur debt at the holdco very infrequent, and judicious, so the plans right now aren't to lever up that balance sheet at ATCO.

Robert Kwan:

Okay that's great. Thank you very much.

Dennis DeChamplain:

Thanks Robert.

Operator:

Once again, if you have a question, please press, star one. Our next question comes from Linda Ezergailis with TD Securities. Please go ahead.

Linda Ezergailis:

Thank you. Within the context of allocation of capital, can you help us understand how you and your partner at Neltume are thinking of an appropriate dividend policy and pay-out frequency versus retaining free cash flows at the Neltume level to reinvest?

Dennis DeChamplain:

The arrangement in Neltume that we have with Ultramar is that, after CapEx requirements are looked after, dividend out all the free cash flow, so there isn't any amounts being held back beyond what is required, for right now.

Linda Ezergailis:

Is that an annual exercise, or quarterly, or …?

Dennis DeChamplain:

That would be cleared up annually. It excludes the additional kind of growth CapEx that's being held by Neltume. A portion of our $450 million is there to fund future growth. So, absent that, the rest of the cash is dividended out.

Linda Ezergailis:

That's helpful context. Maybe just as a follow-up, to build on some of Robert's questions, could I be so bold as to ask how I might think of a differential or the vintage of the book value of your real estate assets, or how the book value might differ from the market value at this point?

Myles Dougan:

That's a good question, Linda, and I've asked the same question of our real estate folks; the challenge, of course, is that's providing upper market value, if you want to put it up for sale. So, I think at this time, we're probably—just want to just keep that one to ourselves.

Linda Ezergailis:

I can understand, I just felt I could ask. Thank you.

Dennis DeChamplain:

Continue to be bold, Brenda—Linda. Sorry.

Operator:

This concludes the question-and-answer session. I would now like to turn the conference back over to Mr. Myles Dougan for any closing remarks.

Myles Dougan:

Thanks. Thank you all for participating today. We appreciate your interest in ATCO, and we look forward to speaking with you again soon. Bye for now.

Operator:

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