Just Energy Group Inc. [JE]
Q3 Fiscal 2018 Conference Call and Webcast
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Company Participants:
Deb Merril; Co-CEO
Pat McCullough; CFO
James Lewis; Co-CEO
Rebecca MacDonald; Executive Chair

Analysts:
Carson Sippel; B. Riley FBR, Inc.
Nelson Ng; RBC Capital Markets
Raveel Afzaal; Canaccord Genuity
Endri Leno; National Bank Financial
Amit Dayal; H. C. Wainwright & Co.

Presentation:

Operator: Good morning and welcome to the Just Energy Group fiscal third-quarter conference call. (Operator Instructions) Please note that today's event is being recorded.

I would now like to turn the conference over to Deb Merril, Co-CEO. Please go ahead.

Deb Merril: Thank you very much. Good morning, everyone, and thank you for joining us for our fiscal 2018 third-quarter earnings conference call.

My name is Deb Merril. I'm the Co-CEO of Just Energy. With me today are the Executive Chair, Rebecca MacDonald; my Co-CEO, James Lewis; and our CFO, Pat McCullough. Pat and I will discuss the results for the quarter, as well as expectations for the future. We will then open the call to questions.

Before we begin, let me preface the call by telling you that our earnings release and potentially our answers to your questions will contain forward-looking financial information. This information may eventually prove to be inaccurate, so please read the disclaimer regarding such information at the bottom of our press release.

Today I'd like to begin with a perspective on market trends of our industry and Just Energy's progress on our strategic initiatives to achieve long-term sustainable growth. The energy industry has only recently begun the transition from being stagnant to one driven by the need for technological innovation and increased focus on customers.

Energy plays a significant role in the changing home ecosystem. We are firmly focused on addressing growth opportunities around the rapidly changing ways that consumers use energy.

Commercial and residential customers have come to expect reliable service and to have greater control of their energy consumption.

Evolving technology and empowered consumers are the most influential factors in our business today. Just Energy was an early adopter in recognizing the change to a consumer-driven industry and we have a broad value-based product portfolio that customers can access.

For example, four years ago we began offering a smart thermostat through ecobee, a company which Just Energy holds a 10% equity interest. Not all customers are aware of products like ecobee that brings real efficiency and savings to their bottom line. As the energy expert, we are in the best position to make consumers aware of these opportunities and deliver them to their homes.

Further, we teamed up with Skydrop one year ago to offers smart sprinklers to promote both environmental preservation and cost efficiency. Similar to ecobee, Smart Irrigation Controllers contribute to significant water conservation while also saving customers' time and money. By bringing these products together with energy, we are able to deliver a better solution for customers.

We also reward our customers for their adoption of our products. In 2017, we launched Just Energy Perks, a comprehensive rewards program that strengthens our relationship with customers. Today, we have hundreds of thousands of customers on the product and the response has been overwhelmingly positive. With Just Energy Perks, we have seen a positive correlation to customer retention and net promoter score.

At Just Energy, we fully understand that we must not only keep pace with consumer needs, but learn to anticipate the future and deliver unparalleled value. Our product pipeline to meet the growing market opportunities is robust and remains a top strategic priority for our organization. To ensure we are on the right path we use independent sources to measure net promoter score, a leading customer loyalty metric. We use this data to optimize the customer life cycle process.

Today we are able to reach more customers in more ways than ever before in our history. Our growing product offering, combined with our expanding sales channels, resulted in significant growth of 45% in gross additions year over year. We are having great success with our retail channel expansion efforts and remain on track to achieve our goal of being present in 500 stores by fiscal year end.

As we noted in our press release last night our largest retail partner, Sam's Club, recently awarded Just Energy with an additional 48 stores to add to our portfolio of stores across North America. This partnership exemplifies how Just Energy is expanding our channel opportunities to further reach potential customers.

Furthermore, by building a sustainable distribution network with our leading brand retail partners, we can efficiently grow our business while proactively managing any risk of changes in the regulatory environment and consumer buying preferences. Expanding retail partnerships is a critical and relatively new growth area for us, and demonstrates why we must continue to explore and invest in new sales channels.

On the commercial side we are also making investments into growth channels that will allow us to help businesses be more energy efficient. Just Energy offers LED retrofit products to our commercial customers. Through this platform we offer commodity, as well as savings, through our energy-efficiency devices. In a relatively short period of time our sales of this product have been strong and acceptance has been high. And we're expanding to US markets to further grow the business.

Earlier this week we announced our agreement to acquire EdgePower, a leading provider of lighting and HVAC controls, as well as enterprise monitoring system. EdgePower has hundreds of commercial buildings in North America that they provide service to. Adding their capabilities to our product suite for commercial customers only further sets us apart from our competition as a leader in energy management and at a larger scale.

We understand that businesses are looking to their energy experts to deliver both cost savings and energy efficiency. Just Energy is poised to deliver on that commitment and will continue to grow our offering of products and services to our customer base and ultimately drive profitability.

As we look to our overseas markets, our geographic expansion efforts remain on track. The UK continues to perform very well. In Ireland we are setting up new customers every day and fully expect that market to contribute to our growth. During the quarter we officially launched operations in Japan under the Just Energy brand, marking the Company's first expansion into Asia and our third new geographic launch outside of North America in the past 12 months.

In summary, as a leader in the retail energy space, our strategic initiative to continue investing in value-added products, profitably expand our sales channels and geographic reach remain our top priorities. As a result of these ongoing efforts we are already delivering meaningful, measureable results.

Our business demonstrated this with a strong operating performance during the third quarter. Our positive customer trends continued as we have now achieved positive net customer additions in each of the last two quarters of fiscal 2018, and our attrition rates remain at historic lows. We believe these trends demonstrate the importance of our strategies and our efforts to attract and retain customers that align with our growth initiatives.

With that, I would now like to turn the call over to Pat McCullough, our CFO. Pat?

Pat McCullough: Thank you, Deb.

During the third quarter our business performed very well, rebounding from the challenges we faced in the second quarter and truly displaying the underlying health of our core operations that are supporting our growth. First I'll begin with a few highlights from the third quarter and then provide some added color in certain areas of the business.

The third quarter was a strong quarter for the Company, as evidenced by improvements in net customer growth, bottom-line profit and cash from operations. Funds from operations of CAD 37 million was CAD 16 million better than prior year and reinforces the stability of our dividend.

Our third-quarter base EBITDA improved 2%. A strong operating performance offset planned strategic growth investments and foreign exchange. Gross margin for the quarter declined 2% to CAD 171 million due to foreign exchange impact from the weakening US dollar.

Looking more closely at gross margin, there's a very positive story within our Consumer Division, where we are adding or renewing customers at an average gross margin per RCE well in excess of those lost. In fact, during the quarter we achieved an average gross margin per RCE for the customers added and renewed of CAD 225 per RCE, which is an all-time Company record for Just Energy.

Couple this exciting accomplishment with the fact that our average aggregation cost for the Consumer Division continues to decline as a direct result of the strategic shift in the Company's sales channels from door-to-door to online broker and other sales channels. These developments demonstrate the long-term value in our Customer First strategy and our growing suite of value-added products and long-term loyalty programs.

In line with these focused efforts, we drove year-over-year customer attrition improvement of 2 percentage points during the quarter, and we remain near historically low levels. We believe our improving combined attrition rate was the result of our focus on becoming our customers' trusted advisor and providing a variety of energy management solutions to drive loyalty. These efforts are evident within each division, as Consumer attrition of 22% decreased 2 percentage points year over year and was flat sequentially, while Commercial attrition of 5% decreased 3 percentage points from a year ago and was also flat from the prior quarter.

Commercial renewal rates declined by 7 percentage points to 48%. The Consumer renewal rate also declined by 7 percentage points to 72%. The decline in Commercial renewal rates reflect a very competitive market with aggressive pricing. Just Energy remains focused on improving retained customers' profitability rather than pursuing low margin growth. The Consumer renewals in Canada have decreased mainly due to regulatory changes in Alberta and Ontario, which prohibit selling energy products door to door, ban contracting with consumers at their home and disallow the automatic renewal or extension of expiring contracts.

Finally on the income statement, we controlled sales and marketing costs as they remained flat during the quarter despite growing our customer base. Administrative expenses increased by 13% due to the necessary expenditures to support our growth initiatives.

Total finance costs decreased 48% as a result of the redemption of the 6% convertible debentures and the senior unsecured notes in fiscal 2017. That was partially offset by the finance costs from the issuance of the 6.75% convertible debentures.

We remain focused on sustainable cost reduction through cost efficiency initiatives that were underway in the third fiscal quarter. We expect benefits to be realized in the fourth fiscal quarter and into subsequent quarters.

Now turning to some of the other key financial metrics and balance sheet items, base funds from operations increased 85% from the prior year due to lower tax and interest payments. The payout ratio on base funds from operations was 57% for the quarter, improved from the 90% reported one year ago. On a trailing 12-month basis, the payout ratio was 90%, improving from 106% last quarter and overcoming the weak nonrecurring Q2 earnings.

Cash and cash equivalents of CAD 99 million improved CAD 21 million, or 27% year over year, primarily as a result of the withdrawal of CAD 20.8 million on the credit facility this quarter to support seasonal cash requirements.

The enactment of the Tax Cuts and Jobs Act of 2017 in the US resulted in a reduction in the federal corporate income tax rate effective for January 1, 2018, and other tax measures. The enactment does not have a material impact on Just Energy, as no deferred tax assets were recognized on our significant loss carryforward in the US. As further clarification and guidance on the new legislation is provided by the IRS and Treasury Department, Just Energy will assess its impact on our financial position. However, no material impact is expected.

Managing our balance sheet remains a priority. Our long-term debt increased to CAD 586.5 million due to the credit facility withdrawal. This resulted in a book value net debt of 2.6x EBITDA on a trailing 12-month basis, which is in line with the figure we reported last quarter and lower than the 2.9x reported one year ago. We remain committed to improving our debt ratios. Our repositioned business model has improved our ability to drive profitability and cash generation to meet our financial obligations while pursuing future growth.

Moving to our outlook, we are reiterating our previously issued guidance for fiscal 2018 base EBITDA in the range of CAD 175 million to CAD 190 million. This range reflects the impact of the significant one-time weather events in the second fiscal quarter and the Company's efforts to improve profitability.

The Company is making significant investments to cultivate international operations, further invest in product and other growth initiatives, and pay up-front commissions related to customer growth in fiscal 2018.

With that, I'll turn it over to Deb for her closing remarks.

Deb Merril: Thank you, Pat.

I'm pleased with the strong results that we delivered this quarter. We delivered growth in customers, profit, as well as cash. The improvement in all these metrics demonstrates that our strategy is working.

With that, I would now like to open the call for questions.

Questions & Answers:

Operator: We will now begin the question-and-answer session. (Operator Instructions) Carter Driscoll; B. Riley FBR.

Carson Sippel: This is Carson Sippel speaking on behalf of Carter Driscoll. For my first question, in regards to debt, can you please address how you're thinking about debt refinancing in the face of the global rising interest rates?

Pat McCullough: Yes. Thank you for the question, Carson. This is Pat. We are looking at refinancing our short-term debt maturities in the near term. You'll see announcements coming from us in the not too distant future. But we have gotten after that. There's a great deal of planning that's happened in the Company and we expect a very successful outcome there in the short term.

Carson Sippel: All right, thank you. And then for my follow-up question, in regard to the competition for the retail sales channels, could you shed some light on the competitive landscape for the newer retail channel and discuss the success you've had, like. for instance Sam's Club? And what do you think the average long-term customer additions per day is? Do you think it's in the two-per-day range? Thanks.

Deb Merril: This is Deb. I'll take that question. We're building retail relationships with not just Sam's Club, but we have many companies we've been working with. So we've got I believe north of a dozen partners right now. So as we talk about competition we're not all going after one. And I believe that as I look at our team, as I look at the value proposition we're bringing to our partners and how we're executing, I think that that is contributing a lot to the success that we're having on the retail channel.

So we're going to continue to go after a lot of names to make sure that we have some diversity in that portfolio as well. We don't want to be highly concentrated anywhere, just like in any sales channel. But we definitely are driving that sales channel through execution and through being good partners with our retail partners.

Pat McCullough: And this is Pat. To add one thing to that, we have a competitive advantage over our competition in that we have the broadest geographic footprint in North America. We also are in the gas and electricity business, and we're very broad in energy efficiency devices. So as we compete with our direct competitors for retail attention and ultimately partnerships, we do have a big advantage there.

Carson Sippel: Right. And then, so do you think you'll be able to present a financial metric soon to gauge the success?

Pat McCullough: We'll certainly be talking in more detail as it becomes a material channel to us. As you probably know, we've reported sales by channel in the past. And you'll see us break retail out in fiscal '19 because it will become significant enough to make that materiality cut on a sales basis.

Carson Sippel: Great. Thank you. I'll get back in the queue.

Operator: Nelson Ng; RBC.

Nelson Ng: And just a quick follow-up on tax. Pat, you mentioned that the tax reform shouldn't have a material impact. I guess it helped during the quarter, and I was just wondering whether you have some rough guidance in terms what your expectation is in terms of a current income tax expense for fiscal '18, and I guess directionally where it will go for fiscal '19.

Pat McCullough: Thank you for the question, Nelson. As we think about current income tax expense, we're going to be in a $25 million to $30 million range. And we'll probably hold in that range for multiple years until we expire the net operating loss in the US and become a US cash taxpayer, which we're expecting about 2.5 to 3.5 years from now. And obviously the US tax reform is beneficial to us relative to the old tax regime once we get out in that 3-plus-year period.

Nelson Ng: Okay, got it. And then just a quick question on EdgePower. Can you give a bit more color on the strategy there? Like, are you essentially, I guess, offering monitoring and management capabilities? And then do those customers typically also buy the commodity from you as well? Or do you try to cross sell them? And what's the success rate there?

Deb Merril: Well, we just -- the reason we bought EdgePower is, one, they've got really good products. They've been around for a long time and they've refined their product over several years. And as we look at the ecosystem for a commercial customer, you think about it, they're dealing with lighting. They're dealing with HVAC. They've got commodity. And all of those things, you start to pull those together you can start to show real savings for the customer.

So between our LED retrofit business, where customer saves 20%, 30% based on when they install the LED more efficient product, and then when you couple that with the ability to control those LED and make sure you're monitoring and you're turning them off and on at the right time and you do that remotely, as well as commodity, and you've pulled all those things together, that will be the value product that we're offering.

And, again, we've talked before, Nelson, where commercial customers are about price and efficiency and savings. So we want to make sure that we're able to deliver that to them so that we can then continue to get those high-value customers, be able to grow our commercial base as well.

Nelson Ng: Okay, thanks, Deb. And then just one last question. Can you talk about gross margin expectations per RCE for the new geographies in, I guess, Ireland, Germany and also Japan? I believe the UK margins are pretty high and I was just wondering how the other countries compare to the UK or the US.

Pat McCullough: Sure. Thanks for the question, Nelson. So as you probably know, the North American households are larger than many of these foreign nations. So if you think about a residential customer equivalent on a North American scale the way we report, it's not very conducive to how to think about a British household, which is maybe half the size.

So as we think about profit per electron, or profit per MMBtu, we're thinking about it on a rate basis. So, fundamentally, if our cost of goods sold is X, can we hold a higher markup? And that margin ultimately is driven as much by the supply and demand in our volume power and customer pricing as it is the value that we can deliver and maybe change customer thinking on what pricing or value actually is.

We have experienced better than average profit on a molecule basis in the UK. We think Irish market is similar to that. The German market is extraordinarily different because the vast majority of the bill's actually a tariff from their former solar and wind installs. So if you think about commodity and markups on commodity, it's not really the game there. The game there is energy efficiency and conservation to reduce the overall usage-based tariff, which is the biggest part of the bill. So it's really hard to say what margins can be in Germany until we get through a full piloting of energy efficiency and whether the market's ready to accept some of those new technologies.

And Japan is a tough market to understand right now because wholesale liquidity is not fully in place. Price volatility is not allowed yet by the government. So I think we'll understand margin potential in Japan in the next year and a half or so, but that's a hard one to call at this point. We're attracted to the market, though, because of the open plan and the 85 million meters.

Nelson Ng: So just on Japan, so I guess sounds like you're going to take it slow, given the uncertainty then. You're not trying to really kind of ramp up there. Are you just kind of opening up an office and seeing how things go? Or what's the approach in Japan, given that certain things are still kind of very uncertain?

James Lewis: Nelson, it's Jay here. What we're looking at in Japan, we're going to pilot like we do everyplace else and make sure that systems are in place. We're making sure we've built our customers there. So we've started growing. We're billing now. We're going through the collection process. And so what we'll find (inaudible) over the next quarter or two here and then go full scale on our marketing approach.

Nelson Ng: Okay, thanks.

Operator: Raveel Afzaal; Canaccord Genuity.

Raveel Afzaal: So first with respect to weather, the weather has been quite volatile this quarter. Can you please speak to your hedging strategy and whether you think it's going to provide you with some consolidation opportunities in the marketplace?

James Lewis: Great question. You're right. January has been extremely volatile. We do a great job, our risk group, with our hedging. We put a lot of hedges on, as we talked about. So as of right now, yes, we right now guiding -- we feel comfortable.

Pat McCullough: And to the second part of your question, Raveel, around consolidation opportunities, we're keeping a keen eye on this, because if you remember after polar vortex we saw companies trading at 1x to 2x earnings after getting hit with liquidity and working capital pinches. So we do expect there's going to be some companies that have trouble with January weather, maybe February, based on how it's pointed. But it will be interesting to see how the pure retail folks that don't have the proper weather hedges in place fare, given we saw tremendous volatility in January.

Raveel Afzaal: Thank you. And then with respect to the gross customer adds for the Consumer division, very impressive growth coming out of the kiosk channel. But when I look at the gross customer adds, 105 versus 169 in the previous quarter, why were they down sequentially? And how should we think about this? Was there some seasonality? Why were they down this quarter?

Pat McCullough: Yes. If you think about door-to-door channel, which is becoming a very small part of our channel mix, it's a tough quarter for door to door. If you think about the digital transition we're making to new partners and selling ourselves, it's a smaller quarter than you'll see us do on a go-forward basis. And obviously we did have retail step up, but retail is still in the scaling process. So as we think about retail in the future it's going to be a large segment for just. It's just not overtaking some of the bigger legacy segments yet.

Raveel Afzaal: Thank you. I'll get back in the queue.

Operator: Endri Leno; National Bank.

Endri Leno: Congrats on the good quarter, first of all. And first question that I have is, will you be impacted at all by the Sam's Club closures that were announced earlier this year? And will the new additions, the 48 store awards, will they be completed in fiscal 2018 or are they going to spill into 2019?

Deb Merril: We'll roll those out over the next several weeks, so it might spill into some '19. But we did have some of the stores that Sam's Club closed that impacted us. But the new stores that we got more than offset that. So overall the number is increasing.

Endri Leno: Great. Thanks. And my next question is, in Japan as you're preparing for this sort of a soft launch for the next couple of quarters, what kind of incremental expenses do you expect there? Are they going to be significant?

Pat McCullough: No, they won't be significant. As you probably know, there is no CapEx required for us to enter these new markets. They'll be modest OpEx. And we'll actually be gauging the amount of OpEx that we're willing to spend based on those marketing opportunities that Jay was talking about. But you can imagine the very low single-digit millions of dollars Canadian as the potential annual OpEx in a market like Japan until it's proven and ready to scale.

Endri Leno: Okay. Great. Thanks. That's all my questions.

Operator: (Operator Instructions) Amit Dayal; H.C. Wainwright.

Amit Dayal: In regards to this recent acquisition, can you talk about the impact on the financials as an annual run rate level maybe for fiscal 2019 margins, revenues?

Pat McCullough: Yes. Thanks for the question, Amit. It's not material to our bottom line, but it is profitable in cash flowing. So from a credit and an EV perspective there's a very, very small amount of accretion for us. But it's not material and it won't fundamentally impact fiscal '19 until we fully integrate it inside of our company, coupled it with the LED retrofit business, and had a chance to take that to all of our several hundred thousand commercial customers.

Amit Dayal: Yes. So my next question is actually going to be about what's the plan to deploy this. Is the offering scalable at that level already, or do you need to sort of put in some work to get there?

Deb Merril: No, it's scalable right now. So, I mean, it's a cloud-based software system. And there's some local installation that you do in order to get the controls in place. So we are building out the plan associated our existing customers, which ones will be most likely to benefit the most from this kind of thing. And we'll go after that kind of on a very methodical basis over the next several quarters.

Amit Dayal: And is this something you can maybe in the future leverage with your residential clients as well? Or are you just going to limit this to the commercial side?

Deb Merril: It really is a commercial application. It's a pretty sophisticated product. We do have other things with residential for energy efficiency and smart home that we're doing that probably apply more to the residential side.

Amit Dayal: Understood.

Rebecca MacDonald: This is Rebecca. I just would like to add to what Deb said. I think it will be important for analysts to start looking at Just Energy as a trusted advisor that wants to provide energy solutions to the customers. An acquisition like this is more focused toward commercial customer, but there are numerous products that we want to have in our bag to be able to offer either commercial or residential as a part of that energy solution that we want to provide.

Amit Dayal: Right. I think it makes a lot of sense. I am fully in agreement with you guys on that.

Just a question on the RCE trends of the margin levels for the commercial side. Year over year it looks like that those margins are lower. Is this just competitive environment in the industry, or is it something else that we should be aware of?

Pat McCullough: It is. You're talking about the incoming margin of CAD 73 per RCE and the outgoing of CAD 77. Yes, the challenge as you look at the outgoing margin on the commercial accounts is that CAD 77 is the design margin we've held at the point of previous sale. And when it comes up for renewal, some of those larger customers are really pushing pricing down. They're doing a good job at negotiating and commoditizing the retail energy space. Hence you hear us talking so much about management solutions which provide more value. So that CAD 77 margin that's falling off of our book is probably being quoted at near breakeven. And that's the reason that we're letting that customer go to our competition and not renewing them.

Now, with the volatility we're seeing in the markets in January and potentially February, that could change. The pricing power may come back to us as the bottom feeders get shook out of the space a little bit.

Deb Merril: And, Amit, I'll just add a little bit to that. That commercial margin coming in per RCE kind of depends on the size customers we're adding. Obviously smaller commercial customers have higher margins; bigger commercial customers have lower margins per RCE -- but overall, very profitable. So as we fluctuate and maybe -- this last quarter we actually saw some really good traction with some of those medium to medium-large customers. So that weighted down the average a little bit, but all very profitable customers. So we'll see that fluctuate a little bit, but the discipline is still there around ensuring we're getting the right return.

Pat McCullough: And then I should have added as well, Amit, if you look at the trailing-12-months actual margin per RCE, it clicked up for us to CAD 88, which is very strong and it's near the high point that we've reported on an actual basis. And the reason we've been running with a slightly higher actualized margin versus that incoming design margin is, frankly, the folks have done a better job with these customers or the supply and trading desk has made a little bit more money than we had conservatively planned in the design margin.

So we actually feel very good about margins right now in the commercial business because of our selectivity with customers.

Amit Dayal: Understood. That was actually really helpful. Just one last one from me. In terms of customer additions you're seeing from this presence in the retail channels, I know you provided numbers like 1 to 2 customers potentially from these channels per day. Are you seeing similar levels of signups? Or has that improved for places you've been in for a longer period?

Pat McCullough: Yes. As we think about that channel and what we can do, I think we've said publicly before that we'd like to see one sale per store per day and then it meets our return needs. That was our original conservative expectation. We've seen better than that. And I think the question for all of us is, when we get into full scale in fiscal '19, can we hold the number significantly higher than that? We certainly hope so. We're certainly working on that. But right now it's really hard to say where we'll be at when we're in several hundred stores and fully scaled, which should take a few months.

Amit Dayal: Okay. Thank you. That's [a pass].

Operator: This will conclude our question-and-answer session. I'd like to turn the conference back over to Deb Merril for any closing remarks.

Deb Merril: All right. Thank you much, everybody, for joining us. We really appreciate your questions and your interest in the Company.

I also wanted to extend our deepest gratitude to Just Energy's employees. These are the people who, in four countries and several offices around the globe, make all this happen. So we want to make sure that they understand that they're the ones who make this thing run. So we really appreciate their commitment and their loyalty.

And we look forward to updating you on our fiscal fourth quarter in May. We'll talk to you then. Thank you.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.