FINAL

Bloomberg Transcript

Q2 2020 Earnings Call

Company Participants

- Brad Phillips, Executive Vice President, Chief Financial Officer
- Jim Stark, Vice President of Investor Relations
- John Bullock, Chief Strategy Officer
- Randall C. Stuewe, Chief Executive Officer

Other Participants

- Adam Samuelson
- Benjamin Kallo
- Bill Baldwin
- Carla Casella
- Craig Irwin
- Donald McLee
- Heather L. Jones
- Kenneth B. Zaslow
- Thomas Palmer

Presentation

Operator

Good morning, and welcome to the Darling Ingredients Inc Conference Call to discuss the company's Second Quarter 2020 Results. After the speaker's prepared remarks, there will be a question-and-answer period, and instructions to ask a question will be given at that time. Today's call is being recorded.

I would now like to turn the call over to Mr.Jim Stark. Please go ahead.

Jim Stark {BIO 3022639 <GO>}

Thank you, and welcome to the Darling Ingredients earnings call. Participants on the call this morning are Randall C. Stuewe, our Chairman and Chief Executive Officer; Brad Phillips, Our Chief Financial Officer; and John Bullock, our Chief Strategy Officer. There is a slide presentation available, and you can find that presentation on the Investor page under the Events and Presentations link on our corporate website.

During this call, we will be making forward-looking statements, which are predictions, projections or other statements about future events. These statements are based on

FINAL

Bloomberg Transcript

current expectations and assumptions that are subject to risks and uncertainties.

Actual results could materially differ because of factors discussed in yesterday's press release and the comments made during this conference call and in the Risk Factors section of our Form 10-K, 10-Q and other reported filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

Now, I'd like to turn the call over to Randy.

Randall C. Stuewe {BIO 5497735 <GO>}

Thanks, Jim. Good morning, everybody. Thanks for joining us. When we were hosting our first quarter earnings call in May, we were in the middle of some of the most uncertain times I have witnessed in my career. And I have to say that our global management team pulled together an orchestrated a solid operational and financial performance for the second quarter. The quarters results would not have been achieved without all our essential workers globally doing their part as well. While COVID-19 continues to be a significant threat, our team has adopted operating procedures and tactics that allow us to service our suppliers, ship our customers and keep our employees safe.

For the second quarter of 2020, combined adjusted EBITDA of $195.2 million was admirable given the volatility in our health, nutrient food, fuel and service markets, driving this performance for strong results in our feed segment. The $85.2 million in EBITDA was the best quarter we have had in the last three years and was done on flat round material volumes to a year ago, and volumes 4% lower than Q1 of this year.

For most of the quarter, we had higher fat and protein prices which were mostly the results of disruptions in slaughterhouses. Fat and protein prices have pulled off highs now from the second quarter. The food segment despite COVID-19 causing disruptions to both consumer purchasing and production capabilities, turned in a good performance similar to a year ago period when you remove the gain on the sale of assets in 2019.

As you saw announcement in mid-July, we have commissioned collagen peptide production facility at Ghent, Belgium and commissioned the expansion project that angle in France. We have seen a pickup in collagen peptide or pepsin sales and anticipate a better second half 2020 for this product group. The fuel segment performance was a little better than a year ago, but weaker on a sequential basis. We made the decision to idle our biodiesel plants for the majority of the second quarter in the U.S. and Canada because of the poor margin environment.

Our Ecoson and Rendac businesses were stronger in the second quarter to offset [ph] the biodiesel plants not running. We have sense we restarted our biodiesel production as it is marginally profitable to produce biodiesel. DGD achieved $1.91 EBITDA per gallon margin or $69.1 million, which is Darling share of DGD EBITDA in the second quarter. The energy market had a significant price decline, affecting the selling price of renewable diesel.

FINAL

Coming into the quarter, we have seen prices improved to where the EBITDA stock margin is averaging between $235 to $240 per gallon.

As noted in our release yesterday, the DGD aboard approved and distributed another $80 million in cash distribution to each of the JV Partners in accordance with the distribution policy of DGD. For 2020, Darling has received $205 million in distributions from DGD. And I would also like to add that counting the first dollar we receive from DGD, Darling has the recipient of approximately $413 million of cash distributions.

For the first half of a pandemic year, Darling has generated $408.5 million of combined adjusted EBITDA for the company and we believe that we can contribute to produce solid results for the balance of 2020. Also as we noted yesterday in the release, Darling Ingredients Board has approved the replenishing the company's previously announced share repurchase program back to $200 million of availability and of extended the term of the program.

Now with that, I'd like to hand the call over to Brad to take us through a few financial highlights and then I will follow-up with some additional outlook for the rest of the year. Brad?

Brad Phillips {BIO 4195409 <GO>}

Okay. Thanks, Randy. As a reminder, before we go through our results, Darling did not adjust our results for the blenders tax credit recorded in the second quarter of 2020 compared to the second quarter of 2019 with the BTC being recorded in the fourth quarter of 2019, caused by the reinstatement of the tax credit at that time.

Now for a few of the highlights. Net income for the second quarter of 2020 totaled $65.4 million or $0.39 per diluted share, compared to a net income of $26.3 million or $0.16 per diluted share for the 2019 second quarter. For the first six months of 2020, net income was $150.9 million or $0.90 per diluted share, compared to 44.3% million or $0.26 per diluted share for the same period of 2019.

Our gross margin improved at 25.5% for the second quarter of 2020 compared to 22.1% for the same period in 2019 as net sales increased $21.3 million, and cost of sales and operating expenses decreased $12.4 million. Operating income improved $45.3 million in the second quarter of 2020 as compared to the prior year period, when you exclude the $13.1 million gain on the sale of China land in Q2, 2019. The improvement in operating income was not only result of the gross margin improvement, but also a $25.4 million increase in Darling's equity and net income from Diamond Green Diesel. These increases more than offset a $9.2 million increase in SG&A and the $3.8 million increase in depreciation and amortization.

SG&A increase from the prior period, primarily due to higher compensation related cause -- COVID-19 related cause and certain insurance increases. However, SG&A declines $6 million from the first quarter of 2020, as expected. Depreciation and amortization decline $1.4 million as compared to the first quarter of 2020.

Bloomberg Transcript

FINAL

Bloomberg Transcript

Interest expense decline $2.9 million for the second quarter of 2020, as compared to the prior year period, primarily due to debt reduction as well as lower rates. The company reported income tax expense of $19.9 million for the three months ended June 27, 2020. The effective tax rate is 23.1%, which differs from the federal debt statutory rate of 21% due primarily to the bio fuel tax incentives, the relative mix of earnings among jurisdictions with different tax rates and certain taxable income inclusion items in the U.S. based on foreign earnings.

For the six months ended June 27, 2020, the company recorded income tax expense of $38.2 million, and an effective tax rate of 20%. The company also has paid $18 million of income taxes year-to-date. For 2020, we project an effective tax rate of 20% and cash taxes of approximately $20 million for the remainder of the year.

For the first half of 2020, Darling share of Diamond Green Diesel earnings was $161.3 million as compared to $62.4 million for the first half of 2019. There was no BTC in place of recognized during '19 until the fourth quarter of the year.

Capital expenditures of $123.2 million were made during the first half of 2020. Our CapEx spend was approximately $44.7 million lower than the first half of 2019. We continue to take the disciplined approach on CapEx as a result of the uncertainty surrounding COVID-19, but we continue to prioritize compliance and safety needs of the business in our reduce CapEx spend.

Our liquidity remains very strong with approximately $940 million available under revolving credit facility as of June 27, 2020. And as Randy mentioned, we received $80 million distribution from DGD and early July for the distribution policy at DGD. We utilize the $125 million distribution received in April from DGD to pay-down bank debt, which improved our bank covenant leverage ratio at Q2 to 2.39:1. As mentioned on our prior earnings call, we anticipate this ratio to remain well below 3:1 for the remainder of the 2020.

With that, I'll turn it back over to you, Randy.

Randall C. Stuewe {BIO 5497735 <GO>}

Thanks, Brad. We are past the halfway point of a very erratic year. Our feed segment performed well by processing significant tonnage of depopulated animals during the second quarter. Again hats off to our operations personnel for managing through this unusual event all the while the COVID pandemic was exploding all around us. We believe the commissioning of two collagen peptide production facilities in Europe gives us a solid base of capacity to meet the growing consumer trends in the hydrolyzed collagen products market. We anticipate the facility in Brazil to be commissioned in October of this year by [ph] any further interruption to construction related to COVID-19.

Energy markets seem to have stabilized and are showing some improvement in the back half of 2020. The volatility which took place in the second quarter was something not experienced in over a decade. Ultra low sulfur diesel prices remained 37% lower than they

FINAL

Bloomberg Transcript

were a year ago and 27 -- and 20% lower than during the first quarter. With the resilient spot margin combined with the first half performance of DGD, we are holding to our guidance of EBIDTA per gallon in the range of $230 to $240 for DGD for the full year of 2020. We anticipate selling approximately $280 million to $285 million gallons of renewable diesel for the year with the plant turnaround coming in the month of October.

Our share of the 2020 DGD earnings should be approximately $335 million based on the ranges I just laid-out for you. With the strength we have seen in our feed segment and an improving food segment in the back half of the year, we believe we can produce core EBIDTA of approximately $450 to $465 during 2020. Combining our core estimated EBIDTA with our share of DBG gives us approximately $785 million to $800 million of EBIDTA in a combined pro-forma basis for 2020. That is a significant earnings milestone for Darling, better than 2019 when you remove the retroactive blenders tax credit and particularly in a year there is has been so much upheaval.

We continue to monitor all things that can affect our business whether it's flooding in China, currency fluctuations in Brazil or the effects of a worldwide pandemic. Our focus is to have a steady hand on the controls of this global platform and focus on the long-term growth opportunities in front of us.

I will remind everyone that we are now 16 months away from commissioning $400 million gallons of additional renewable diesel capacity at DGD in Norco, Louisiana. As others have delayed or extended or even abandon their projects in renewable diesel, Darling and our joint venture partner have kept the wheels turning on this new and exciting project.

As I mentioned earlier, Darling has received $413 million of cash distributions from the JV, which is more than 3 times the initial cash outlay we made in the original project. The think that in 2020 to Diamond Green Diesel can produce $675 million gallons of renewable diesel and a conservative $2.25 EBITDA per gallon, this is significant contribution and growth to Darling journey. And don't forget, DGD will reduce -- will produce an approximately $60 million gallons of renewable naphtha, and that will contribute $0.15 a gallon margin to the $675 million gallons already produce.

Now, the rendering of animals doesn't grab headlines around the world or even get people excited to own Darling. But is the key ingredient that makes Diamond Green Diesel in the leader in renewable diesel market today, our ability to be the largest collector and processor of animal fats and oils to provide feedstock to DGD is of high value and is why our vertical integration will enhance DGD's ability to be the best low-cost producer of the greenest fuel on the planet.

With that, let's go ahead and open it up to Q&A.

Questions And Answers

Operator

FINAL

Bloomberg Transcript

(Question And Answer)

We will now begin the question-and-answer session. (Operator Instructions) Our first question is from Heather Jones of Heather Jones Research LLC. Please go ahead.

Q - Heather L. Jones {BIO 4212703 <GO>}

Good morning. Congratulations on a great quarter.

A - Randall C. Stuewe {BIO 5497735 <GO>}

Thanks, Heather.

Q - Heather L. Jones {BIO 4212703 <GO>}

Thank you. So real quickly just want to -- thank you for the color regarding the second half outlook. Just wondering if you could give us a sense of -- I mean, it was an incredibly strong quarter for Feed. So just trying to get a sense of how much of that was due to the help from depopulate the whole hogs? And I know you probably won't give an exact number, but just trying to get a sense of how much that helped?

A - Randall C. Stuewe {BIO 5497735 <GO>}

No. I think number one we want to point out that we have always said that within the business model, as you look at it over the last five years that there was pretty much -- there was significant implied optionality built in that Feed segment. And that optionality exist everywhere, in the U.S., Canada and the Europe rendering model. So while depopulating the hogs, we took in about 40 million pounds of hogs during the quarter. That wasn't all of it. It was -- Canada turned in a very nice performance, Europe had 12 months in a row now of a very strong performance.

What you saw was a combination of alignment issues there. Number one, you saw slaughterhouses that weren't predominantly serve -- that Darling doesn't service the big names out there, that we're having COVID-19 issues in the sense of being able to staff and we talked about those adjustments in several other calls that they would have to make. Well, when -- they reduce the supply of really protein to the market and to a degree the fats also during the month of really May. So we had a little bit of an uptick in the protein markets in the month of May, all around the world. And then you also have the major disruption in the ethanol, the shut-ins or curtailments of those ethanol plants, it took a whole bunch of DGD's off the market during the quarter there. That was -- that's the positive, you had disruptions of trade around the world again between China and Indonesia, but nonetheless, you saw really the markets were driven in the second quarter by a run-up in protein, while fat prices were actually down.

We've now seen as we go forward, protein prices have stabilized, although a little lower than they were in Q2, but fat prices seem to have improved around the world as the world digest how much palm oil there is going to be available, and China seems to continue to replenish their stockpiles. So I mean, while I don't know that, I guess, I'm not totally

FINAL

Bloomberg Transcript

answering your question, hogs played a little bit part of it, but maybe we shouldn't have put it out there as the major driver, it was all those items around the world.

What we're seeing right now in the raw material markets around the world, is we're very strong in Canada. We continue to be strong in the U.S. right now as the slaughterhouses are all running, especially the beef fat [ph] guys are running really hard. The time of the year that we get a lot of breakdown tonnage, they just can't seem to keep their plants in condition to handle it all, and so we're full in the U.S. -- in Europe, margins remain good and spreads remain good in that business, although the tonnage is off a little bit now for us. China has stepped back in and is taking out pig skin and some of the lower grade cuts that were going into the coke rendering process in Q2. So overall, it's a -- we're probably steady when you net it all out, but I would say our breakdown tonnage in the U.S. has pretty much offset most of the hog impact in Q2.

Q - Heather L. Jones {BIO 4212703 <GO>}

But when I'm thinking about Q3 for the core feed business. And now that meat and bone meal prices have come back down, volumes have normalized, but given the tighter fat market, should we see growth in the core feed business in Q3 year-on-year?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Year-over-year, I think the way I would answer that is as I think we put out guidance of $450 million to $465 million for the year, which would tell you that we think that the Q3 the Feed segment could be a little softer than Q2 because of the lower protein prices. And remember Q3 globally for us is always the challenge with hot summer temperatures. You got 10 days in Europe now of record heat going on and the U.S. is not much different. So that's always a little bit of a challenge. What we're trying to telegraph is that we hope that the food segment, that the consumer demand starts to continue to pick up as it has. We've -- and then that's in our Food segment, really with our Rousselot business. I think interesting also then in the Feed segment is where our used cooking oil collection business is? While we said, that hit a low, about April 15. We still have a couple of locations that you can imagine with no eat and dine-in in the Northeast that are off 25%, but for the most part, we're now off around the country between 10% and 15% year-over-year. So that's moved back nicely which should help us a little more within the -- in the Feed segment in Q3.

Q - Heather L. Jones {BIO 4212703 <GO>}

Okay. Thank you for the answer.

Operator

The next question is from Craig Irwin of ROTH Capital Partners. Please go ahead.

Q - Craig Irwin {BIO 6209023 <GO>}

Good morning, and congratulations on a really solid quarter, again. Randy, I wanted to ask about the commodity environment. So many of my clients think we're heading into an inflationary environment, watching all the central banks globally printing money as fast as

FINAL

they can. You've had to deal with the weight on your EBITDA in the core platform from a deflationary commodity environment over the last say over several years. Can you maybe remind us what you did to keep the EBITDA essentially flat now, and now it's inflecting up in that business a little bit? And how this translates forward to leverage if we do see a positive cycle the way it looks like we're fixing one now?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Thanks, Greg. I think it's an academic discussion to a degree, I think, number one, the prices of our finished products and they do compete in the nutrient markets are still well under the 10-year average. So as we said, we still believe there's implied optionality as those improve. We have a fundamental belief in this room that commodities if you want to call them that, all seem to retrace to their 10-year averages over time. So that's number one.

Number two, we've seen weak currencies from the euro side; the Brazilian real, as we look at it. The euro is I think when I look this morning was $1.19, that's up from $1.10 or $1.11 in the first quarter. So that translates back to better GAAP earnings in the U.S. Overall demand, I mean -- and then you look at the weaker dollar, that should incent additional buying of our products, and make them more competitive around the world. I mean clearly COVID-19 has disrupted trade, clearly the tension in China has made it a challenging environment to get permits to bring different products in. But nonetheless we're starting to see pretty nice demand around the world. I mean, the pet food side at the end of the day we've seen it remain strong. It's finally backing off just a little bit. Hopefully, that's not a trend but nonetheless the typical seasonality in the pet food business in Q2 has now carried stronger into Q3.

So overall I think at the end of the day we're seeing a nice resurgence of our business here, I mean if the criticisms that we have taken over the past of capital deployed, we were expanding at a time when we had the capability to expand, to capture the growth in tonnage that now drives our system and our supply chain to Diamond Green Diesel, that's starting to pay off. Number two, we made a conscious effort to look at ourselves in the mirror and say we haven't done as good a job as we should have on recapturing the shareholders monies we deployed, and there's been an initiative all around the world to widen out margins to shut down different processes that don't make sense. And then really I -- while I hate the word optimize, that's what I would use here to try to enhance the margins, and the U.S. team and the North American team, and the European team have done a really nice job in that area; looking at what products we're making? What we should be charging for them? And getting rewarded for being an essential supplier of services.

So to sum it up Craig, we've got -- getting back to the 10-year averages, FX, it's -- that's attractive to earnings, FX, it's attractive to exports and then margin enhancement that we've consciously done to pay for the new capacity, we brought online.

Bloomberg Transcript

Q - Craig Irwin {BIO 6209023 <GO>}

Great. Thank you for that. So on a totally different subject, right, Diamond Green Diesel, COVID-19 was an issue for everybody in the energy markets. Some more than others,

right. So the construction of Diamond II, has there been any impact on the CapEx there or the potential CapEx in the second half of the year and you did reiterate the $220 million to $240 million. But is there anything you can maybe say about potential dividends in the back half of the year given that the cash flows in that business are really fantastic right now?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Yeah, first off, our hats go off to the construction teams down at St. Charles, that we have been fortunate to have construction be uninterrupted for us. We are on time, on budget, on plan. Everything is at this point in time, knock on wood, the hurricanes keep taking right turns. So we're -- but we still have two hurricane seasons to go through. So at the end of the day the construction team has done just a fabulous job down there. We're also blessed that the rest of the petroleum industry has been -- curtailed on their CapEx, which makes a lot of great labor at great values available to us to keep the project moving.

We were down last week, I think on -- Jim put out on our pictures out there, the latest greatest maybe within the last two weeks of the pictures. Steel was coming up out of the ground, the tanks are up, equipment's being set, reactors should be in here, later this fall or later this summer, early fall, and we're right on time. So everything looks good. We gave a margin environment of $230 million to $240 million for the balance of the year. It feels that way unless we get another COVID interruption within the petroleum industry. But as you go back and look at gasoline demand now, it's running 10%, 11% off from a year ago.

So things are more normal than they've been, but nonetheless that right now margins still doable, possibly some upside to them and if we get a little bit of upside, that's number one, we could have a second dividend out of this, although it would probably be small as the second year of construction -- it takes 32 months here magically versus what other people think they can do in a year. But at the end of the day, the big spending will come heavily starting here in fourth quarter and about the first three quarters of next year.

So I think a dividend is probably -- it's hopeful but I don't know that I would predict it out there. However, if in COVID four in Washington DC there's some fund legislation's out there that might send a few additional dollars our way, and if that comes our way then I think a dividend could be likely.

Q - Craig Irwin {BIO 6209023 <GO>}

Excellent. Congratulations again. Thanks for taking my questions.

Operator

The next question is from Adam Samuelson of Goldman Sachs. Please go ahead.

Q - Adam Samuelson {BIO 17060388 <GO>}

Yes. Thanks. Good morning, everyone.

FINAL
Bloomberg Transcript

FINAL

Bloomberg Transcript

A - Randall C. Stuewe {BIO 5497735 <GO>}

Good morning, Adam.

A - Brad Phillips {BIO 4195409 <GO>}

Good morning.

Q - Adam Samuelson {BIO 17060388 <GO>}

So I guess, just my first question is thinking about kind of the preliminary views on Phase 3 in Port Arthur, and just I know that's still undergoing engineering review. But if we think about kind of the base plan from a capital intensity perspective and kind of the investment case margins that you're looking to underwrite. Any way of framing just differences that would be present relative to what you have in the Louisiana? And specifically trying to get a handle on how you -- how feedstock sourcing might be different to the Texas product markets? If it's just California anymore? How you're framing and evaluating the supply-demand of renewable diesel around the world? Maybe we'll start there.

A - John Bullock {BIO 18689026 <GO>}

So Adam, this is John Bullock. We continue forward with our analysis on Diamond Diesel price [ph], heading towards the completion of the Phase III engineering, and the decision on whether or not to ultimately move forward with the plan early next year.

I will tell you everything looks very favorable at this point in time. It's just a fabulous location for renewable diesel plant. As we cite these plants and the citing the renewable diesel plans we've talked about in the past is massively complicated. You have to have your supply chain right. You have to have your capabilities right. You have to have the flexibility to be able to both get the raw material and effectively, and get it out, to the marketplace and have flexibility to go to the various LCFS markets that are currently in place and that are developing around the world. Port Arthur has all of those capabilities. It's just an ideal second location; puts us on the Western Railroads with the UP and BN service to the facility, which is also really good. Currently we have KCS and as we put Diamond Green Diesel II onboard we're going to have CN capability, we'll have water capability through our IMTT deal at St. Charles, so we can bring in both river barges and fat internationally if we want to bring that fat in. We have ability on the outbound side to go by water, by rail and by pipeline at our both facilities.

So excellent, excellent flexibility, and as we think about the marketplace going forward, we have a massively experienced team. As we were -- Randy mentioned we were down at our construction meeting on Diamond Green Diesel II a couple of weeks ago, and if you look around the room, the team is building Diamond Green Diesel II , the team is going to build Diamond Green Diesel III. Built Diamond Green Diesel I, expanded it, put all the logistics capabilities in and are now in the process of designing and engineering Diamond Green Diesel III. It's a massively experienced team. These are massively complicated facilities. If you're just going to start a facility, and say I'm not going to have any pretreatment, I'm not going to have the right logistics capability around it. You're

FINAL

entering the contest with one hand tied behind the back, and so that's going to be difficult to compete.

We say it all the time, we're building Diamond Green Diesel III, to be the low-cost, most flexible, low SCI, most suite of finished products that meet the renewable markets going forward, and if we have that in position with the growing markets that are happening in the United States and around the world, Canada and other places, we feel we're going to be excellently positioned to be able to compete in that market place going forward. We're building Diamond for the long haul, not for a quick buck if we can get it in place and in time to pick up a buck tax credit. We're really trying to do something, that's more for the long haul.

Q - Adam Samuelson {BIO 17060388 <GO>}

That's very helpful. And then just one clarification question as we start thinking about project economic. You talked about $2.25 a gallon in '22 with the blenders credit on the $675 million of renewable diesel. Do we also think on the $60 million of renewable naphtha, that separately is $1.25 a gallon for $60 million on top or how do we think about the renewable naphtha economic on top of the existing renewable diesel economic?

A - Randall C. Stuewe {BIO 5497735 <GO>}

I think for the time being probably include the naphtha in that $2.25 number. I mean, obviously, when we get out to 2022 we're talking about a projection here. But at this point in time, the naphtha helps improve the baseline profitability of the facility, maybe it'll be an additive on top of that, but if you were thinking about it right now, $2.25, probably a pretty good all in number.

Q - Adam Samuelson {BIO 17060388 <GO>}

Okay. That's very helpful. I appreciate the color. Thank you.

Operator

The next question is from Donald McLee of Berenberg. Please go ahead.

Q - Donald McLee {BIO 17941711 <GO>}

Good morning, guys. Just to kick things off. I'm curious to know how comfortable you are with the overall level of capacity additions in the U.S. market that are expected over the next couple of years? And any potential for oversupply? And then within that backdrop of increasing competition, do you think that could highlight some differentiation within the space between Darling and its peers?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Donald this is Randy, first off. Thank you for initiating coverage on us, we sincerely appreciate it. You've done a really nice job for us. So the -- we spend a lot of time thinking about the world and where the demand is going to be and the points, and then we spend no time or little time, thinking about competition because as John highlighted earlier, it's

Bloomberg Transcript

FINAL

really a real estate game, location, location, location. Do you have hydrogen? Are you on the pipeline? Are you on the water? Can you bring in barge? Can you bring in a ship? Can you bring in off to railroads?

So number one, as John said, we're not focused on other people. We're focused on what products we can make around the world to meet the growing needs of both, road fuel, marine fuel, arctic grade fuel, jet fuels that we see happening over the world, and ultimately that's what's going to drive future expansion for us. The supply chain that we build here with the rendering business, with the oil collection, the waste collection businesses gives just a significance, advantage for anybody going forward.

Now all said, we believe that nonetheless if we're correct on these margins which as John said they're predictions, but we also seem to have been able to predict them now for about the last seven, eight, nine years. So I think we got a pretty good feel with our team of how to price products? Where the demand is? Et cetera. It'll encourage people to take a shot at it. Clearly, there's been a lot of announcements out there. I mean every right -- Jim had me read through, three or four petroleum companies and all seemed to have wonderful renewables visions, but there's not one of them that has either got a permit, broken ground or made a customer sale yet or bought a pound of feedstock.

And as I said earlier, permitting is 1 to 1.5 years and construction, to do it right, is somewhere between, 30 and 36 months. And that's proven out by us, by Neste [ph] and by Total in Europe. So nonetheless, I suspect somebody will take a shot at it, given these margins, you're seeing some of these refineries that are in the wrong place if you will logistically for crude oil, now magically think they're in the right place to buy vegetable oil -- high CI vegetable oil to be in the business. Good luck. We welcome the competition, as John says, we're in it for the long haul.

Q - Donald McLee {BIO 17941711 <GO>}

All right. Thanks. That's really helpful. And then just one more on the feed and food side of the business. Just talk a bit about where you think livestock inventory levels ended up, winded up at the end of the quarter relative to historical levels following that round of depopulation in Q2? And is there any concern about a potential headwind from reduced near-term demand to net all that depopulation?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Yes. I mean, good question. I would point everybody just simply if you look at the frozen inventories out there, they've really been knocked down. Somebody's buying everything that we can process out there. Remember you've got slaughterhouses that aren't back to full two half -- or two shifts, 5-day, 6-day a week capacity, and they're still dealing with some labor issues, et cetera. But nonetheless, the beef business is really very strong out there right now. I think it was shared with me and that there's enough cattle on feed or in the feedlots for the process every Saturday for another year or 6-day a year.

The pork side, what's interesting on the pork side and I'll comment both here in North America is, the demand remains very robust for the finished product, while cut-out

Bloomberg Transcript

margins were down; at the end of the day producer margins, et cetera -- at the end of day the demand is really strong and while we even -- while we depopulated animals that really should have gone to the food chain, and it was tragic that they had to be rendered, if you will, but remember we make some great products out of it that ultimately end up in the circular economy again.

But at the end of the day, we weren't depopulating the sow herd. So at the end of the day they were just making room for the next litter to come into the system. So the hog system seems to remain very, very strong right now. The chicken side, at the end of the day you still have -- if you read U.S. Foods foodservice, call, script, you can go look at it, and they're down; they're still saying their distribution systems are down 40% to 46% from a year ago if I remember the numbers right, so it's not back. So you're really packed, you're -- from a chicken side, you're doing a retail pack, and you're still not getting the foodservice. Although wing prices have now come back up to where they were nearly a year ago, but that remains fairly strong.

In Europe, like I said we've seen a little bit of Chinese diversion of the product -- of the cheap cuts, and then if you move all the way around the world to China, what's interesting is, is we're now -- we didn't even have a discussion on African swine fever in our script or call. It's still out there. And at the end of the day what you've now seen is, what I believe, and obviously no data out of China is -- can be relied on here.

But at the end of the day what you've seen is that it appears that the sow heard got hit by ASF in China, because they're Chinese numbers of animals, has not improved from where they were six months ago, a year ago, even though some of the media says, it's up. It may be, but it's not obvious to us. And how do we know that? Well, as we operate three gelatin plants there, pig skin is not available, animal hides that we make a hide gelatin product aren't available. Our five blood processing plants, they are still running limited hours, there's just really not any -- the commercial slaughterhouses don't have any availability to pigs or maybe a few more in the backyard, but they aren't in the commercial system yet.

So overall, I know I gave you a little too much color there, but at the end of the day meat supplies around the world and in South America, everything seems very robust still and I don't see any changing of that as we go forward here. We're in the middle of barbecue season in North America and in Europe, and we'll keep moving forward here. And the numbers to produce an animal are very attractive right now, also.

Q - Donald McLee {BIO 17941711 <GO>}

Okay. Thanks. That's really insightful. I'll stop there. And I appreciate you taking my questions.

Operator

The next question is from Tom Palmer of JP Morgan. Please go ahead.

FINAL

Bloomberg Transcript

FINAL

Q - Thomas Palmer {BIO 20130502 <GO>}

Good morning, and thanks for the question. You talked earlier about some tweaks to how you think about capital deployment. I know this year's CapEx is lighter given the uncertainty. But going forward, how might we think about your CapEx plans? Were you suggesting CapEx might be lower than in past years? Or is it more that you're changing the types of projects that you're investing in or maybe how you're thinking about the project that you would invest in?

A - Randall C. Stuewe {BIO 5497735 <GO>}

I think it's all the above, Tom. This is Randy. I mean, number one, we came into a very uncertain erratic year, clearly, we were responding to our board and looking at doomsday scenarios, and then we were -- at the end of the day, these are very capital intensive businesses to be in, both from a truck fleet, where we have to haul our own material in most cases to the plants where it's just very corrosive. So essentially we came into the first half of the year and said we want to watch and make sure that our business model works in this environment.

And so I think for the first half of the year, 120 million to 125 million. I see about the same thing. Maybe just a little bit more in the back half of the year. We're finishing out the two Peptan plants that are commissioning, the Epitacio, Brazil is in those numbers. But now we're taking a cautious approach still to the balance of the year. Also trying to make sure that our operations and management team understand that we're kind of moving the bar on them a little bit to make sure that we get a return on the capital, and we're doing -- that's part of the margin enhancement program. So going forward, I really look for a number closer to the 275 and that's all in going forward, would be my target as we go forward. We've always said that it really takes about a 175, 185 to maintain the business, and really when you got 215- or -18 plants now around the world, when you do the divisor on that, it's not a lot of capital per plant. And then the trucking fleet if we try to maintain a seven, eight year age on that trucking fleet, it takes 50 million. The rest has been competition for good projects that will meet the 15% to 20% internal hurdle rate for us. So that's how I look at it going forward.

Bloomberg Transcript

Q - Thomas Palmer {BIO 20130502 <GO>}

Thanks for that. I also -- I wanted to follow-up on the new collagen plants opening. Could you just remind us how much your production capacity of collagen increases? What you're assuming in terms of volume growth as we think about the second half of the year, including the ramp? And then just what you're seeing on the demand side to support that supply growth? Thank you.

A - Randall C. Stuewe {BIO 5497735 <GO>}

Thanks, Tom. I'll take a stab and if John wants to jump in and help me here if I -- number one, what we're adding is a process to an existing process around the world. We have the Peptan plants, the two Peptan plants in Amparo, Brazil today, that are running near capacity. We just commissioned Ghent, Belgium, and are commissioning the -- and expanding Angouleme, France, that's a fish Peptan plant. Predominantly, geared towards the Asian countries. And then we're bringing on another plant in Epitacio, Brazil.

FINAL

Bloomberg Transcript

So we're trying -- what we're trying to do is capture a trend or a move within the global collagen market. If you say gelatin is collagen and Peptan as we call it is hydrolyzed collagen or a fancy word is saying it's spray dry. So you can either send the gelatin down or the collagen down a belt dryer, and you have gelatin, or you can divert it to an enzymatic process and spray dry. So it's a balancing of production capacity force. It's obviously being driven by the margin structure in it. It's also optimizing our product mix around the world where maybe we were making too much of a lower grade collagen that can now be spray dried and moved into a different market.

Remember that the absolutes within the business for us are that, this is a water soluble product that goes into health, and nutrition, and beauty. And that's what's key about it for us. And it really as we embark on a multi-year strategy in a Rousselot business, that this is the next processing step for us in collagen, in a sense as we talk about collagen peptides, and that's where the brand Peptan came out of. And you will see additional health and beauty nutrition uses as we isolate the different peptides and find the markets form.

I think we've also made an announcement during the quarter of our X-Pure product, which is a low endotoxin product. It's very, very exciting for us. And clearly we're putting these products out here competitively. We're not going to tell you the margins on them. We're going to show you the results here over the next coming quarters. But really for us, the system is going to run the same amount of tonnage in it. It's just going to be which markets it goes to and that's going to be allowed us to move our product mix around relative to the market.

And if you think through the second quarter here. We made less Peptan because that's a little step closer to the consumer, the consumer that's a big-box retailer. The customers had to move that to an online system. It took a most of the quarter to get there. It's now there. But conversely we saw significant growth in demand of basic gelatin to go into the gel cap business, and that was really a positive thing, as everybody staying at homes looking for that magic pill to take now to keep them safe and so, we'll see that happen and I suspect we'll probably move a little bit of that capacity back to the U.S. and Europe, away from China over time. But nonetheless, it's an optimization of product mix for us.

Q - Thomas Palmer {BIO 20130502 <GO>}

Okay. Thanks for all that detail, Randy.

Operator

The next question is from Ben Kallo of Baird. Please go ahead.

Q - Benjamin Kallo

Hey, good morning, and congrats on the quarter. So just to clarify the last question. It's to say, -- you're basically -- it's same process for gelatin and your collagen? Is that what I heard? You just said that you're adding a different processing line?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Yeah. It's an additional processing line to existing plants. That's why we could build four plants for whatever it was, a 125 million, 160 million.

Q - Benjamin Kallo

Okay. The only reason I asked about that is, because there's a worry if that it gets more commoditized or the fad goes away, that we have some capital there. So we get that question. I'm just wondering what your thoughts are on that front?

A - John Bullock {BIO 18689026 <GO>}

Yeah. So this is, John. So what -- it was very interesting as the Peptan opportunity came up, because it was a rapidly rising trend. In the nutraceutical markets, nutraceutical markets have a tendency to have products that become very hot, and they become very cold. We wanted to make sure that we took advantage of the opportunity without spending a tremendous amount of capital and that's what we did by modifying essentially the back end of some of our assisting units.

So while we spent a fair bit of money on this, if we would have tried to develop entirely new facilities to do this, we would have spent 4x the amount of money that we did spend. So we went into this on relatively a low capital approach. We are extremely excited because we believe that Peptans and hydrolyzed collagens are now mainstreaming into the marketplace. And I think the proof positive on that, is when we saw Nestle invest in vital proteins. They are now going to be able to take the hydrolyzed collagen and move that out on many more platforms into many more marketplaces and quite frankly, if you've got the stamp of a great consumer product, have a company like Nestle say, we want to be in that business.

And so we are extremely excited. We think we've seen a validation of hydrolyzed collagen. There's going to be a lot more utilization in a lot more categories out there, and that's going to really help drive the growth in that category of those products. So we win it -- relatively modest capital for the capability that we got, and we really think now we received the stamp of validation for the product category.

Q - Benjamin Kallo

Okay. And then I had just two more. Just, Randy you talked about the core being $450 million and $475 million. I think the last call you kind of walked down to $425 million, so I'm just wondering what the changes are there -- the big drivers?

A - Randall C. Stuewe {BIO 5497735 <GO>}

I was just really being conservative, I mean on the back half of the year, I mean -- and there's still some risk there. I mean, it is a resurgence and some of the economy shutting down. But it really at the end of the day, it feels like meat demand, food demand, fuel demand is just very solid for us, so it's really an improvement of back half of the year. I think, food pricing for us or the Rousselot system, also with palm oil improving and then really our tonnage remaining strong. And it's really all those things combined.

FINAL
Bloomberg Transcript

FINAL

Q - Benjamin Kallo

And then lastly, just kind of follows other people's questions on Diamond Green. As you move forward on Port Arthur, if you do or even with your current expansion. The logistics that we are getting feedstock, I guess get more complicated. How do we think about your -- and you deleveraged nicely, how do we about your thoughts around you controlling more of feedstock, whether North America or elsewhere? Is that a priority for you? Or do you already have kind of what you need in the core business for both of those expansions? Thanks.

A - John Bullock {BIO 18689026 <GO>}

Yeah. This is John. I mean, we are the -- I think, we publicly say, 10% of all slaughtered animal by-product parts around the world go through a Darling facility. So we have a significant ability to source and supply fast to Diamonds Green Diesel. We will always continue to look at new opportunities to add additional capacity as Randy talked about.

But one of the things we also do is we show I think great restraint on when we invest. We've been buying companies, but when the multiples got too high to buy companies, we didn't chase. We look to put new capacity on place, and we look at what it will make on a 10-year average price -- commodity price and if commodity prices are a little lower, we know we might not make quite as much in the short-term, but we're building that supply base for Diamond Green Diesel. So we're going to continue to be aggressive out there, to build our vertically integrated platform. But we will show financial restraint and just not throw money to buy stuff at high multiples that we don't think we can make a good return on processing that material. But absolutely we will take advantage of more growth opportunities if they become available in the market. But today we have a tremendous supply base already for Diamond Green Diesel.

Q - Benjamin Kallo

Okay. Thanks, gentlemen.

Operator

The next question is from Ken Zaslow of Bank of Montreal. Please go ahead.

Q - Kenneth B. Zaslow {BIO 5641218 <GO>}

Hey, good morning, everyone.

A - Randall C. Stuewe {BIO 5497735 <GO>}

Good morning.

A - Brad Phillips {BIO 4195409 <GO>}

Good morning, Ken.

Q - Kenneth B. Zaslow {BIO 5641218 <GO>}

Bloomberg Transcript

FINAL

Bloomberg Transcript

Just one quick one. When you think about your leverage, where do you want to get it to? And then once you get it to a certain level, what do you plan to do with the capital? Is it more of a dividend strategy? Is it more of a share repurchase? How do you think about it? Because it's starting to get to a point where you're generating significant cash. And what are you going to end up doing with that? Is there any thoughts on that longer term?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Yes. Ken, this is Randy, and I'll let Brad chime in if I don't say it right. I mean, two words, investment grade is where we're headed. We're -- we've had some challenges at the rating agencies recognizing DGD as part of the whole system. Then we've had some challenges there of being big enough to be investment grade. But I think we're getting there with them. Clearly we set out all the conferences we did over the last two years, we kept telling you a number of 2.5 ratchet 2.39 now is where we're at. Clearly as DGD II or number III comes on or DGD II comes online, we still have to fund a little bit of DGD III, whether that we're clearly still open and in discussions with our partner on outside finance there.

And clearly the market is readily available to us to do that if we so choose. At which time then there's significant amounts of cash that will start to pour into Darling as you know then there's three tranches of our debt structure that are out there, the Term B and then a couple of bonds, a euro bond and a U.S. bond, still aren't callable today, but eventually they will be. But that obviously the first use would be to pay off the Term B, and then after that, I think you're going to see us, look, seriously, and this is a Board decision. So I have to defer to my bosses that then you would look at a dividend and a repurchase programming. Obviously, we put the repurchase reauthorization out there, just from an opportunistic standpoint as we go forward.

But clearly we're in a different position here in about 16 months, as Jim Stark said in the script to be a net cash generator, delever, and then to put a meaningful dividend under it and then hopefully with that comes a recognition of long-term value and a shareholder that they couldn't hold the day, they can hold once there's a dividend.

Q - Kenneth B. Zaslow {BIO 5641218 <GO>}

Great. Greatly appreciate it. Thank you.

Operator

The next question is from Carla Casella of JP Morgan. Please go ahead.

Q - Carla Casella {BIO 2215113 <GO>}

Hi. My question relates about collagen and the other new businesses. I'm just wondering, what's the magnitude of those today? And how big do you see those getting over the near-term?

A - Randall C. Stuewe {BIO 5497735 <GO>}

FINAL

Hey, Carla, can you repeat the question? You were really loud there, so.

Q - Carla Casella {BIO 2215113 <GO>}

I'm sorry. I'll stop yelling. I'm just wondering, how big those collagen and the other ancillary businesses are today and how big they could become?

A - John Bullock {BIO 18689026 <GO>}

Yeah. This is John. I don't know, that we release specific information about Peptan or what our gelatin sales are. What we see is, is we see the gelatin segment now showing some fairly good growth because quite frankly a lot of nutraceuticals and a lot of medical pills are being taken by people as the COVID crisis is upon us. So we've seen that segment show some real resilience here. And then we think the hydrolyzed collagen market, the Peptan market is a market that is really just beginning its process to growth, as it mainstreams into the large international marketing companies.

We will see how far that goes, and we'll see what type of growth that entails for us. But we believe that the -- in essence what amounts to tailwinds, as we get through the COVID crisis? And as Randy talked about, there's no doubt about it. Peptan is a little closer to the consumer and it got hit a little harder upfront with the COVID crisis. But as we work through the COVID crisis and we will get out of this at some point in time, relatively soon, when we do, we think we're going to see really, really good growth in that Peptan collagen business.

Q - Carla Casella {BIO 2215113 <GO>}

Okay. Great. Thanks.

Bloomberg Transcript

Operator

And the last question is from Bill Baldwin and Baldwin Anthony Security. Please go ahead.

Q - Bill Baldwin {BIO 16861485 <GO>}

Yes. Thank you very much. Good morning, folks.

A - Randall C. Stuewe {BIO 5497735 <GO>}

Good morning, Bill.

A - Brad Phillips {BIO 4195409 <GO>}

Good morning, Bill.

Q - Bill Baldwin {BIO 16861485 <GO>}

I wanted to just get a feel of -- on the used cooking oil collections. Are there any regions of the country that are more important to you than the others here in the U.S. on that business, Randy?

FINAL

Bloomberg Transcript

A - Randall C. Stuewe {BIO 5497735 <GO>}

Yes. Yes, Bill, I mean, it's clearly the -- with -- we have a strong presence in the Northeast and a very high concentration of population in that New York tri-state area. That's the part that's down 25% right now, just because dining is not open but clearly in the Southeast, the home of fried food is clearly an important part for us and it has for the most part reopened and the high producers or your drive-through's, you're fast food QSRs versus your sit-down dining. So yes, as we said we saw that business come back to I don't know 10%, 11% off now versus last year. And I suspect it'll hold there as we go forward.

The thing about it is we always talked about there's limited seasonality in there, but when the ballparks open, it seemed that the cooking oil demand picked up or used cooking oil supply kicked up. And clearly -- and I -- those virtual fans out there aren't really eating any french fries or corn dogs now, and -- and so but, so I suspect we'll probably hold it at the off 10% to 15% for the year before it reopens.

Q - Bill Baldwin {BIO 16861485 <GO>}

And I guess that business is probably what pretty heavily weighted towards the national chains, the McDonald's or Burger King, people like that?

A - Randall C. Stuewe {BIO 5497735 <GO>}

Clearly it's weighted towards the heavy deep fryers which are the chicken guys, if you will.

Q - Bill Baldwin {BIO 16861485 <GO>}

Right. Okay. And then on the food ingredients segment, can you give us just a rough breakdown on revenues between the Rousselot brand, your edible fats, and your sausage casing businesses? Just --

A - Randall C. Stuewe {BIO 5497735 <GO>}

We have not ever -- we have never really broke it down Bill. What we've said is, Rousselot is a significant portion of that, and we try to leave it there. As John was answering, the competitive market for Carla, the gelatin market is roughly 400,000, 425,000 tons globally. So it's a micro market, and we prefer to keep that pretty close to the best there.

Q - Bill Baldwin {BIO 16861485 <GO>}

Okay. Fair enough. Thank you so much, and good job.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Randy Stuewe for closing remarks.

A - Randall C. Stuewe {BIO 5497735 <GO>}

Thank you. We appreciate everyone's time today. Look forward to talking to you soon. And if anything happens during the update or the next quarter in November, we will be

the first to let everybody know. Thanks again.

Operator

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

FINAL

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2020, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

Bloomberg Transcript