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Q1 2021 Earnings Call

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Company: **Darling Ingredients, Inc.**

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COMPANY PARTICIPANTS

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- Randall C. Stuewe - Darling Ingredients, Inc., Chairman & Chief Executive Officer
- Brad Phillips - Darling Ingredients, Inc., Executive Vice President & Chief Financial Officer
- Sandra Dudley - Darling Ingredients, Inc., Senior Vice President - Renewables and Strategy

OTHER PARTICIPANTS

- Ben Bienvenu - Analyst
- Manav Gupta - Analyst
- Thomas Palmer - Analyst
- Sam Margolin - Analyst
- Ryan M. Todd - Analyst
- Craig Irwin - Analyst
- Benjamin Joseph Kallo - Analyst
- Matthew Blair - Analyst
- Kenneth B. Zaslow - Analyst
- Adam Samuelson - Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to the Darling Ingredients Conference Call to discuss the company's First Quarter 2021 Results. After the speakers' prepared remarks, there will be a question-and-answer session, 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.

James E. Stark

Thanks, Tom. Welcome to the Darling Ingredients Q1 earnings call. Participants on the call this morning are Mr. Randall C. Stuewe, Chairman and Chief Executive Officer; Mr. Brad Phillips, our Chief Financial Officer; and Ms. Sandra Dudley, our Senior Vice President of Renewables and Strategy. Mr. John Bullock is attending college graduation today and family comes first. 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 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

Thanks, Jim. Good morning, everyone. Glad you could join us on the call this morning. A year ago, like many other management teams, we all had the deer in the headlights stare happening as a result of the pandemic. Today, we see a very clear future for Darling Ingredients as our dedicated global team of 10,000-plus employees continue to execute our business strategy in a safe

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and efficient manner. Our earnings for the first quarter of 2021 were certainly energized by rising commodity price environment, which undoubtedly had a positive impact and enabled Darling to report a record $284.8 million of combined EBITDA for the quarter. The feed segment's EBITDA was $124.4 million, which was $34 million better than the fourth quarter of 2020 and $54 million higher than the first quarter of 2020. Protein and fat prices averaged in the range of 40% to 60% higher than the year-ago period and have continued to move higher into the current period.

Our food segment turned in a solid performance to start 2021 with an EBITDA of $46.4 million, which was approximately 18% higher than a year-ago. We continued to see solid growth in our collagen peptide sales and look forward to our biomedical products having an impact in the future on this segment's earnings. In the fuel segment, we continued to see solid results from our European bioenergy business, which reported another solid quarter, producing $20.5 million of EBITDA in Q1. Diamond Green Diesel generated another outstanding quarter with a $2.77 EBITDA per gallon on 78 million gallons sold. Darling's half was $108.2 million of EBITDA plus our bioenergy results produced a strong $128.7 million of combined EBITDA in Q1 for our fuel segment.

As we noted in the earnings release yesterday, both DGD expansion projects remain on time, on budget and on target. We continue to experience a favorable commodity pricing environment as the US economy recovers with more and more states lifting COVID restrictions. As travel increases, we are seeing energy prices go higher as ultra-low sulfur diesel is trading above $2 a gallon in a NYMEX spot for the first time in a couple years. Higher levels of economic activity here and abroad we believe will support continued strength in the demand driven commodity cycle that I'll discuss a little later on the call.

Now, I'd like to hand it over to Brad to take us through the financials and then I'm going to come back and discuss the outlook and our increased guidance for 2021. Brad?

Brad Phillips

Okay. Thanks, Randy. Net income for the first quarter of 2021 totaled $151.8 million or $0.90 per diluted share compared to net income of $85.5 million or $0.51 per diluted share for the 2020 first quarter. Net sales increased 22.7% to $1.05 billion for the first quarter of 2021 as compared to $852.8 million in the first quarter of 2020. Operating income increased 62% to $199.5 million for the first quarter of 2021 compared to $122.8 million for the first quarter of 2020. The 62% increase in operating income was primarily due to the first quarter of 2021 gross margin improving approximately $68 million over the prior year and increasing from 24.1% to 26.2%. This is primarily the result of higher protein and fat prices in our feed segment during the first quarter as Randy mentioned earlier.

Depreciation and amortization declined $6.1 million in the first quarter of 2021 when compared to the first quarter 2020. This reduction was due primarily to certain assets in our food segment, which became fully depreciated and amortized by the end of 2020. SG&A increased slightly by $1.2 million in the quarter as compared to the prior year and there were $778,000 of additional restructuring and impairment charges related to the biodiesel facilities shut down in the prior quarter. Lastly, regarding the improved operating income, our 50% share of Diamond Green Diesel's net income was $102.2 million as compared to $97.8 million for the first quarter of 2020. Interest expense declined $2.7 million for the first quarter 2021 as compared to the 2020 first quarter.

Now turning to income taxes, the company recorded income tax expense of $28.7 million for the three months ended April 3, 2021. The effective tax rate for the first quarter is 15.8%, which differs from the federal statutory rate of 21% due primarily to the biofuel tax incentives, the relative mix of earnings among jurisdictions with different tax rates and excess tax benefits from stock-based compensation. The company also paid $15.6 million of income taxes in the first quarter. For 2021, we are projecting an effective tax rate of 20% and cash taxes of approximately $30 million for the remainder of the year. Looking at the Q1 balance sheet, our total debt declined $63.5 million to $1.44 billion, and the bank covenant leverage ratio ended the first quarter at 1.6 times adjusted EBITDA. Capital expenditures were $60.8 million for Q1 2021 and is in line with Darling's planned CapEx spend of approximately $312 million on capital expenditures for fiscal 2021.

As you saw at the end of March, Diamond Green Diesel successfully entered into a new $400 million senior unsecured revolving credit facility. The new revolving credit facility matures March 30, 2024 and is non-recourse to the joint venture partners. Use of funds of this revolver are for general joint venture purposes, and as we have indicated in the past, any potential distributions in 2021 wouldn't be considered until the expansion in Norco, Louisiana is in production in the fourth quarter later this year.

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

Randall C. Stuewe

Thanks, Brad.

I'd like to touch on our updated guidance we provided in our press release yesterday and it can also be found on slide 5 of our investor presentation. We feel comfortable with the increased range of $1.075 billion to $1.15 billion of combined EBITDA as the increase is coming from two segments: our feed segment and our fuel segment. The feed segment is certainly benefiting from the rising commodity price environment for both proteins and animal fats and waste oils and the question you are thinking is how long does this higher price environment last? Darling, just like every other commodity producer, is watching this like a hawk. Our view is that we got into the current situation because of a demand-driven event, which started with China and unlike a supply shortage, driving commodity prices higher, higher prices from a demand-driven event can take multiple growing seasons to rebuild feed inventories.

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Yes, commodity prices have steepened versus on the futures curve, but that futures price is still 30% to 50% higher than the historical price when you get to that future period. For now, we think the feed segment will perform well for the rest of 2021. We remain disciplined in our evaluation of the volatility this segment can experience and continuing to reduce our expenses and improve efficiencies to enhance the margin environment we are experiencing today. The other increase in our guidance is the fuel segment. DGD turned in a record EBITDA per gallon in Q1, and with that, the Q2 margin is averaging in the current environment, we're putting a potential range of $2.25 to $2.40 EBITDA per gallon for DGD for 2021.

As our joint venture partner announced several weeks ago, we believe the start-up at Norco expansion will be in the middle of Q4 that DGD will ultimately sell 365 million gallons of ***renewable diesel*** in 2021. Those higher gallons and the range of EBITDA per gallon provided puts Darling's half of the EBITDA from DGD between $410 million and $435 million for 2021. The DGD Port Arthur project continues to make excellent progress and we did include a picture of that site on slide 10 of the investor presentation. We are targeting this facility to be operational in the back half of 2023, but the team continues to evaluate if we can improve the timeline and start up Port Arthur earlier.

For Darling, we continue to investigate multiple avenues to expand our feedstock footprint and we believe that we are on a solid pathway to achieve this objective in the very near future. We are encouraged to see more and more states in the US and other countries passing and preparing legislation for low carbon fuel standards. In our view of the ***renewable diesel*** supply and demand equation, we continue to believe that ***renewable diesel*** demand will outpace supply for the next three to four years. Then we believe that ***sustainable*** aviation fuel market demand should begin to develop and have demand pull for DGD somewhere in that timeframe. We think our DGD joint venture is a highly innovative platform and employs one of the most advanced processes for turning waste animal fats and oils into the greenest hydrocarbon in the world.

And it goes without saying, DGD is one of the best investments we can allocate capital to for high returns for our stakeholders. But we have other areas of innovation as well. Since the beginning of 2020, Darling has had 100% ownership of EnviroFlight. EnviroFlight is a leader in sustainable insect ingredients designed for animal and plant nutrition aiming to drive transformative change in the global food supply. We have made several recent announcements on expanding our operations of EnviroFlight earlier this year. And we believe this project will position us as the leading developer of proprietary technologies with the first commercial scale black soldier fly larvae manufacturer in the US.

We are also pleased with the development of work going on in Europe with our biomedical technology team. Our X-Pure or GelMA is our latest addition to our biomedical range of ultra-pure gelatins and collagens to the medical industry. And we anticipate that the product offerings will grow as we move forward and the new products bringing added value to our industry. Our X-Pure products are unique on the market as they come with ultra-low levels of impurities and fully validated traceability of raw materials. Our innovative spirit grows as we continue to look for ways to improve our product offerings across the spectrum of the markets we serve.

We view our efforts to add innovative products as well as the ongoing investments we have made to build new and expanded rendering capacity over the past several years as key to improving long-term shareholder value. Sometimes, the cycles may not line up for us, but when they do, Darling can generate solid returns and strong free cash flow. I'd like to note that we are proud to be selected by Bloomberg and TB Media Group (sic) [TBD Media Group] (13:09) as one of the 50 sustainable (sic) [Sustainability and] (13:11) Climate Leaders in the world. Darling is the original recycler and to us, that makes Darling Ingredients the greenest company on the planet. Thank you for all of the 10,000 employees for making Darling the company it is today.

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

QUESTION AND ANSWER SECTION

Operator

Thank you. We will now begin the question-and-answer session. And the first question comes from Ben Bienvenu with Stephens Incorporated. Please go ahead.

Analyst: Ben Bienvenu

Question – Ben Bienvenu: Hey, good morning everybody.

Answer – Randall C. Stuewe: Good morning, Ben.

Answer – Brad Phillips: Good morning.

Question – Ben Bienvenu: I want to ask, maybe starting on your guidance, and in particular, the margin per gallon guidance for DGD. Can you just help us think about what's embedded into your outlook there and where you think elements of variability or obviously, we had very strong margins in the first quarter. We've seen some components of the margin pressure things a little bit in 2Q. But still as you said supply demand looks favorable and some – I just want to kind of better understand what's going into your output?

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Answer – Randall C. Stuewe: Hey, Ben, this is Randy and I'll tag team with Sandy here a little bit on this one. The margin environment in Q2 is very similar if not better than Q1 right now. And what's driving it is really the biodiesel industry, which obviously, we don't participate in is having to pay substantially more for feedstock than we are. As you know, a majority of biodiesel made from soybean oil and then you can see that's in the – at least on the board of trade is at $0.65 on the non-deliverable option here in July. And those that are running refined, bleached or refined, bleached deodorizer paying somewhere between $0.75 and $0.85 a pound delivered their locations today. You take that and you have to – in order to produce those gallons, you have to drive marginal profitability.

And the green premium that we refer to, which is a combination of the RINs and the blenders tax credit forum (15:39) or having to do the work the blenders tax credits fix. So, therefore, it comes down to the RIN and we've seen some pretty strong escalation in the RIN that has been provided with lower feedstock cost of DGD because of waste fats and oils and our pre-treatment technology plus the RIN, plus the LCFS has come back a little bit here in the last 30 days, we've set up a Q2 now that I think will impress. The balance of the year, I think it'd be easier to take guidance up there right now than where we're at, but we're going to watch from here and see where we're at and I think that's fair enough. Sandy, anything you want to add to that.

Answer – Sandra Dudley: Yeah, I think we're very pleased with the margin environment that we're in. I think that historically you've seen that our margins have been very good regardless of the environment that it's in. But there's some things that we're going to continue to watch especially as we get farther out into the year. So, there's a Supreme Court ruling on small refinery exemptions, there's RVO, there's how feedstock prices are kind of progress, but that said, again, you've seen very solid performance out of DGD for an extended period of time regardless of the environment.

Question – Ben Bienvenu: Okay, perfect. And then, when we think about the feed ingredients business, kind of two-part question here, it seems like the outlook there is I guess just a reflection of what we see in the futures strips, is there a point at which you foresee any sort of demand disruption or price resistance? I know the demand backdrop for the feed environment is quite good, all the protein processors continue to consume at high margins, ethanol is coming back online that's supporting corn. So, it does seem like there's a great demand backdrop for the grain environment. But I want to get a sense of how you think about that, that unfolding through the year relative to your guidance and then kind of understanding what's in your guidance if it is reflective of the current futures.

Answer – Randall C. Stuewe: Yeah. Ben, this is Randy again. I mean clearly, the optionality that is built in the feed segment we've talked about for the last three or four years, as we've said, well, if the pricing comes back finished product pricing to the 10-year average, everyone will be pleased with the investments we've made. We've now driven past the 10-year average on these in the feed segment, the core rendering business and the derivatives from the slaughtered animal by-products. They're benefiting from the corn pricing, the soybean meal pricing around the world. And it's really pretty fascinating to me. You could probably take our guidance up from the feed segment performance here even, because prices have continued to improve here in the near-term will probably be a conservative. We benefit in these times when corn and soybean meal rise up because we're an alternative ingredient in many of the rations around the world. And so, we become an alternative out there and probably never receive full nutritional value whether we're at a discount or a premium.

So, I think we're pretty well set. I think that our fats and oils will – we're trading today delivered – Diamond Green Diesel delivered feed customer in the mid-50s, while the bean oil boards at 65%. And so, that's a historical discount that we've seen. So, at the end of the day, anybody that has fears for us having enough feedstock, there's plenty of feedstock here for us, and then the proteins have now moved up to where soybean meals in the mid-4s, it's slightly inverted. It's not a giant inverse from – to new crop. So, we'll continue to see that spring. The interesting thing on this is and we've had a lot of internal discussion and narratives about it. Every time – I guess I'm approaching 39 years, almost 40 years in the business now, and when we've ever seen price spikes in the past or cycles if you will, they've been driven because of some crop shortage, usually a weather event somewhere in the world or in multi hemispheres as it was in whatever 2011, 2010-2011.

This is a demand driven event, where the combination of meat production to feed animals and fuel production to produce green energy has now made the lines get very narrow to the point where even what looked like massive stocks of corn and soybeans six months to nine months ago, now as a stocks or percentage of use ratio, you're down in very low levels. And so, if you get any disruption in crop production, those lines will cross, and you could have $9 corn very quickly here. At that point, you're going to ration something.

What's interesting to me is as you look at the price of chicken, the price of pork and the price of beef year-over-year, the marketers and the producers have gotten ahead of the curve there and have retail prices at a point here, where they're still profitable even with the higher feeding economics. It doesn't mean that there's not going to be some compression in the margins of the livestock producer here with the higher input cost, but there's enough to keep it. There's enough profitability in the chain itself than to keep it producing versus contracting as maybe we've seen in the past year or so. Overall, it looks pretty darn good around the world for us. Raw material volumes aren't up as sharply as they were a year ago, but they're still up again. Population growth around the world this year and I just don't see much, much change in that here in the near term.

Question – Ben Bienvenu: Okay . Very helpful. Thanks, and good luck.

Answer – Randall C. Stuewe: Thanks.

Operator

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The next question comes from Manav Gupta with Credit Suisse. Please go ahead.

Analyst: Manav Gupta

Question – Manav Gupta: Hey guys, congrats on the beat and excellent raise. My question here is we have seen a number of small players out there who have never actually done this, come out and sign sustainable aviation fuel contracts of fuel they are nowhere even close to producing and have never actually produced. And then we look at you guys, the best in the business, who has not announced anything major in sustainable aviation fuel as of yet. So, my question is why are the two best guys in business holding back and while some of the other players out there are announcing these contracts, which we are not even sure are executable.

Answer – Sandra Dudley: Hi, Manav, this is Sandy. So, I think in terms of next steps in SAF, first, our immediate future is really completing the St. Charles expansion and the Port Arthur greenfield. We know that these facilities will provide significant carbon reduction opportunities for our customers, and both projects will be completed before we know it. And of course, we've talked about what's next. We've left space at the Port Arthur facility in anticipation that there would be something next, and that's no coincidence. As the market develops both in terms of transportation and aviation, we'll have more for you. And be assured, when we do move, we'll move swiftly and that's in line with our first mover reputation.

We're well aware that SAF is of extreme interest to a lot of folks. We believe that there is a real push by the current administration and their significant support in general for reduced aviation emissions. SAF will happen. It's just a matter of time, but what we need is, we need the mandates, and we need the incentives to turn this nascent industry into a real one. We're really in the stages of preliminary engineering on that at DGD as we speak and we're running all the financial models that you normally would and as the economics pencil out, of course, we want to be a part of it.

Question – Manav Gupta: Okay, great. My follow-up question here is and I think you mentioned this a little bit in the prepared comments. We saw a little bit of pullback in the carbon prices in California. I think it's seasonal, but I would like to know your view and also, do you think as Washington, Canada and other places open up, do you think there's a sustainable support for carbon prices whether it's California or Washington or even in Canada or do you think the supply that is building is a little too high, so the carbon price can trend down.

Answer – Sandra Dudley: Yeah. So, the first thing with regard to California, I think what you're seeing there is it's just really a matter that they got hit really hard by COVID. They're starting to open up. Things will get better I think as we move further into the summer and we see the transportation, the summer transportation pick-up, you'll also see that LCFS pricing pick up. In terms of demand worldwide, I think you had asked about that and what we're seeing out there, obviously, there are a number of programs that exist today, there's your California, Oregon, DC. Now we can expect to see Washington join the list of jurisdictions with the CFS. We also recently saw New Mexico make a run at the CFS and it came so close but just ran out of time. And so we think that there's significant momentum going into 2022 as well. And we know that New York continues to work to get a CFS in place with hopes that one will be included in the Climate Action Council's draft recommendations later this year.

Obviously the Canadian CFS final regulation will be out at the end of this year and implemented in December of 2022. And now we're seeing provinces like Quebec which are enacting their own provincial mandates. And then of course there's RED2 which is slowly becoming RED3, we're early stages of that but we expect those targets will become more aggressive. So as we look to the outlook in terms of demand we see great things. And as we look at – really at our sales deck which is kind of an indication of that, we're very pleased. Obviously, we have two facilities that are going to be coming online in the not too distant future. And I think that there was probably a point where we looked at ourselves around the room, we said wow, are we biting up a pretty big piece of apple and filling up these facilities. But the fact is that as we look at going forward, we're probably not going to have the gallons for everyone that wants them. And so, I know that it's not demand related but at the same time we're also seeing things on the supply side. So we're seeing projects getting pushed back. And I think you had alluded to something like that and we're hearing less and less about other projects that we want – that were once widely mentioned. And so, I think what we're seeing setting up is there may be less supply than some would estimate in order to build increasing demand that we're seeing. So all-in-all I think we think that there's a lot of demand out there and we're really excited about that.

Question – Manav Gupta: Thank you for taking my questions.

Answer – Randall C. Stuewe: Thanks, Manav.

Operator

The next question comes from Tom Palmer with JPMorgan. Please go ahead.

Analyst: Thomas Palmer

Question – Thomas Palmer: Good morning and thanks for the question, guys. So you've seen a big step up in feed segment EBITDA over the past couple of quarters. I know this has been covered various times over the years. I just had a couple of questions to clarify your pricing model. You've given us some helpful detail in the past on how $0.01 of higher fat prices translates to $8 million to $10 million EBITDA in the feed segment. Has there been thought about providing similar figures for the other

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products in the segment like protein, used cooking oil?

And then I just wanted to clarify the timing of your revenue recognition in that segment. If we see spot prices at a certain level today, should we be thinking about that. Is the price you're recognizing immediately or do you pre-sell and does higher prices today flow through on a slight lag? Thanks.

Answer – Randall C. Stuewe: Yeah. Good questions, Tom. I mean obviously the feed segment has a whole bunch of businesses built in that, some have price exposure and optionality, others don't. When we said before $0.01 a pound is $10 million annual in EBITDA, that's all fats and oils globally. You've seen Europe be at a higher price on fats although they've moved up above a $1,000 or €1,000 a ton now. So we're starting to get some more momentum back out of Europe reacting to this. But overall that model is in intact as we look around. Our proteins have been lagging a little bit of what's going on in the world. There's limited uses at times for some of the animal based proteins out there.

And then the final question is that you were asking is the lead lag. The biggest impact of that is the – if I want to say is the pipeline, the in-transit to Diamond Green Diesel. We came into the first quarter with a very, very short book on – meaning, we didn't have much sold out in front here. We had beliefs where the market was going at that time and convictions. And so we have now moved on and we keep in a strong inverse trying to be sold up. So what's that translate to in common language means that there's probably a 40 or – 45 to 60 day lag in recognition of these higher prices flowing into our P&L now. So that's where second quarter as the fat prices moved up late and first quarter they came back down. They've gone back up. We'll start to flow through again in second quarter. And the question will ultimately be how far – how long does this inverse roll forward. I think we're very comfortable, it's going to roll through all of third quarter.

And then the question is, how much does it really back off if any in Q4. And really, we're already as I said earlier, we're such a substantial discount to palm oil and bean oil today on the fats, that I don't see much downside there. And the proteins were fairly priced and you're seeing actual protein price now come back up, while the oil share is backing off a little bit. So into the day, I think you'll see – as we're saying in our improved guidance obviously that comes through a belief that the feed segment which carries the new capacity, which carries the optionality will continue to improve for the next several quarters.

Question – Thomas Palmer: Thanks for all that color. And I just had a follow-up on the fat side. You talked last quarter once Port Arthur is up and running about the possibility of sourcing from other parts of the world. In your view is the animal rendering industry in areas like South America built out to the extent to ensure the supply you would like or is that a strategic opportunity for Darling to explore establishing rendering operations.

Answer – Randall C. Stuewe: Well, I think the first thing, I'll have Sandy help me a little bit on this here. As I would say, none of our strategy or investment is built on global origination. We believe that there's adequate feedstock today in North America to support our investments. We've said secondarily that we believe that feedstock will be displaced from generation one technology in the biodiesel industry as we bring the capacity online, that's number one. Number two, we sit on a 0.5 million tons of fat in Europe today that can move in here if the euro, the freight rate are in right position. And yes, South America, Australia, New Zealand, Latin America, China to a lesser degree have developed industries that can arbitrage fat in here as necessary.

Answer – Sandra Dudley: Yeah. This is Sandy. So, I think we feel very comfortable about our ability to secure feedstock both for St. Charles expansion and for our Port Arthur facility. Feedstock's always been a significant part of any investment thesis that we've done for any of the facilities. And keep in mind that – the build out of our facilities is really centered around feedstocks, which I think makes us unique compared to many other projects. Our locations are where there are a lot of agricultural products that naturally funnel into it. And that's no coincidence. We like the US in terms of the supply of feedstocks. And needless to say, Darling produces a significant amount of low carbon feedstocks in the US.

And finally, we do see growth in feedstocks down the road. In general and then specifically within Darling as we continue to enhance our collections and expand our control of various low carbon feedstocks. So I guess in the end, the feedstocks supply chain has always been a differentiator between DGD and other projects.

Question – Thomas Palmer: Thank you.

Operator

The next question comes from Sam Margolin with Wolfe Research. Please go ahead.

Analyst: Sam Margolin

Question – Sam Margolin: Hi. Good morning, everybody. Thanks for the call.

Answer – Randall C. Stuewe: Good morning, Sam.

Answer – Brad Phillips: Good morning.

Question – Sam Margolin: Just a follow-up on DGD margins and strength. So look as you know, a lot of people focus on unit cost spread between the byproducts and sort of fresh vegetable oils. Is there anything else going on on the operational or technical

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level that's worth calling out, maybe a yield outcome that's generally better than modeled or something beyond just what people see on the screen on a price per pound basis?

Answer – Sandra Dudley: Yeah. I think we're always trying to improve our DGD facilities. Really, what I think the most important thing is with regard to our pretreatment facilities that gives us a huge advantage at DGD. It allows us to source the lowest cost feedstocks and you're seeing that show up in our margins today.

Answer – Randall C. Stuewe: Yeah. And I think, Sam, this is Randy. I think that's well said. I think the secret sauce is the flexibility of our origination that comes into the pretreatment. Clearly there is never ending operational efficiency targets that are happening. Valero's, they're just awesome people in the world of optimizing the unit down there between yield – there, collectively we work on CI scores, and then ultimately customer mix, and then we've talked in the past about Arctic-grade and what were the product mix that we're making. So you put all those together and it's quietly a very definable and unique in a sense to us advantage that you're starting to see out there.

Question – Sam Margolin: Okay. Thanks for that. And then just switching gears to the base business and maybe I'd ask you to expand a little bit on your thoughts on demand and how this is a unique cycle. I mean, just how would you characterize, what you're seeing in demand. Is this a special year for growth on just a rate of change basis or is what we're seeing sort of also like the cumulative effect of two decades of China in the WTO and all the people in the world moving out of poverty. And therefore is – and that sort of adds to the structural duration of what you're seeing? Thanks.

Answer – Randall C. Stuewe: No. It's a great question and hopefully my crystal ball doesn't have a fog in it. But for us as we looked around the world, our thesis has always been very simple, population growth, wealth creation and two things happen once there's wealth created. You use a lot of energy and you like to eat better. And all those confluences are coming together now around the world. The pandemic probably interrupted that for a better part of a year. But we're seeing appetite for protein around the world like never before. I mean, when you look at China and I have been absolutely paradoxical on my belief that China has to de-risk their food supply. They don't have water. They don't have land. They're at full production on what they can produce. And then you take the animal disease risk that they've experienced and it's really put into the fore-light and foresight here of what they have to do on the world market.

So six months ago, we thought they were replenishing the hog herd. And I think they were. I mean, we would tell you – how do we know that. Well, we had pig blood coming into our five blood processing plants in China and then we had pig skin coming into our Central China gelatin factory for the first time in almost two years, so that's pretty good indicator. That has slowed down again tremendously, almost 50% of what it was in November if not less. So, China lost a portion of their hog herd again and the question will ultimately be how do they – is this a cycle that they'll really industrialize, institutionalize, commercialize, the bigger farms? I think the answer is, yes and China has a magical way of making things happen faster than most people in the world understand. But we've never seen – this type of demand in the world all-around. Every one of our plants in the world is full today to produce meat and I don't see anything slowing down that part of the picture in the near term – here in the near term. I can't even put years on that. I just think once that appetite is there, it doesn't go away.

So, that's where we said and try to characterize this as demand driven versus a crop shortage in North America or South America or the wheat crop got interrupted in the Balkans or the Ukraine. So this is very different. All said, I talk both sides here, I mean China has a magical way of being one of the best traders in the world and they can change on a dime with policy and put a halt on some of this. But I just don't see them doing that this time, they've got such a severe shortage of meat. And the way you look at that is you look at cold storage of products here in the US and they're really at historical low. So quietly the meat is moving out of the country, it's feeding the demand and I don't see anything slowing down.

Question – Sam Margolin: All right, thanks everybody.

Operator

The next question comes from Ryan Todd with Simmons Energy. Please go ahead.

Analyst: Ryan M. Todd

Question – Ryan M. Todd: Great. Thanks. Maybe just a follow-up on one of your comments during the prepared remarks on distributions and capital management. I know, you had talked in the past about external financing for the DGD expansion. Do you have a revolver that you got there DGD, I think in March, but I think you commented that you wouldn't be likely to see distributions until Q4 when the expansion starts up. Is that how we should think about it. Well, you looked at half the revolver over the course this year or you look to hold out until the expansion starts before we would see kind of distributions to the parent accelerate?

Answer – Randall C. Stuewe: Yeah. Ryan, this is Randy and Brad now and Sandy, we'll all – we'll tri-team this a little bit here. From a macro perspective, we are now what is this May, so June, July, August, September. We're four months away from starting up the second machine. At that time, then you're going to be at a 700 million-plus gallon run rate, maybe $250 a gallon (40:29). So dividends become really possible as we start that new machine up here and start to pull back. I don't think pulling from the revolver does much for any of our capital structures today as we're not in any risk of that or have anything to really push on.

The timing of DGD III as Sandy referenced and as we referenced in our comments, clearly, we're looking at ways to bring that

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online as quickly as possible. Slated for second half 2023, but as we complete number two, clearly we will turn our focus to that. We're blessed right now at the – with the kind of the troubles if you will in the petroleum industry or the reduced capital programs there. It's made great labor and really the mechanical and pipe fitting shops available rather than sharing them with somebody else for a percent of their capacity. We've got access to them, so.

Ultimately, the timing and the size of the dividends, when you – if you say, even 225 million to 250 million gallons for next year 700 million gallons. That's a 1.750 billion gallons. That's 875 million-plus gallons. We don't see much change in the core business next year given the demand driven cycle. You're paying with this here (41:50). You're six months from a pretty significant cash coming over the transom.

Question – Ryan M. Todd: Thanks. I really appreciate that. Maybe since you're talking to expansions, a follow-up there, I guess first on DGD II any color on how you think about like how much time that takes to ramp up volumetrically. How much you'll see kind of in the fourth quarter of this year and into the early part of next year.

And then as you were talking about the capacity on the pipe fitting and on some of the construction side, we've obviously seen a lot of significant inflation in the market right now on raw materials including steel pricing. Is there any risk to DGD IIIs capital budget or did you price these contracts before a lot of the stuff kicked in?

Answer – Sandra Dudley: So, this is Sandy. What we told you, as we've given you guidance in terms of total volumes for this year. Those include volumes from DGD II coming online as well and we expect to be fully up in 2022 and obviously we're saying that it's prior to that. So I think you can draw your conclusions there. In terms of construction costs, obviously we're nearing the end of St. Charles expansion and everything appears online and on budget there.

And with regard to Port Arthur, we've driven (43:22) foundations. We've ordered all of our major equipment and we did that early on. I know Randy and John Bullock often talk about our first mover advantage. And I think when it comes to this, this is clearly an example of that. We moved quickly and we hit the market right in the right window in terms of when we made our purchases.

We've also done this before and we have a great model that's been fully engineered and it's working. It's always easier when you have the blueprint than when you're having to make changes on the fly. And we've seen other projects report 20% to 25% increases in cost due to things like that like you've mentioned. We're not – and so I think everything looks very positive.

We are not projecting any increases at this point in time. So we're very proud of both of our projects and the progress. And I know that Jim had mentioned earlier that we have some pictures in the deck for you on this.

Question – Ryan M. Todd: Yeah. Thank you.

Operator

The next question comes from Craig Irwin with ROTH Capital Partners. Please go ahead.

Analyst: Craig Irwin

Question – Craig Irwin: Hi. Good morning. Congratulations on the really strong results.

Answer – Randall C. Stuewe: Thanks, Craig.

Question – Craig Irwin: Randy, I wanted to ask if you can connect the $1.1 billion in EBITDA give or take in the guidance. If you connect that back to free cash flow this year, I know there is uncertainty around exactly how much cash you're going to get from Diamond Green, but what do you expect the core operations to throw off. And is it fair for us to expect cash flow to strengthen in the second half?

Answer – Brad Phillips: Hey, Craig. This is Brad. On free cash flow this year, we've got the $300-plus-million which we more or less the last several years had on CapEx, although our interest expenses is coming down, we'll still see that probably in the $60 million, $65 million range, $45 million of cash taxes, we'll see kind of how working capital ends up for the year right now with the higher prices, there's obviously a little bit of pressure on changes in working capital.

But we're in pretty good shape there in Q1 which is typically our toughest working capital quarter. But really when you put that all together with the guidance and where we expect the base business to be and you disregard dividends for the moment in that discussion which we just discussed would be the tail end of the year, and meaningful ones certainly next year from Diamond Green.

We do expect to have noticeable reductions in our debt level this year. We're at 1.67 times on our leverage ratio and I think really for the year even without dividends, we expect that to remain at or below 2 times.

Question – Craig Irwin: Great, thank you. So this is a very similar environment today to when you did the acquisitions of both Griffin and VION. I've heard you explain in the past how environments like this tend to increase the appetite of families that control some of these very large rendering competitors of yours, obviously much smaller than you, but large for the market. The question

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is, are you guys elephant hunting again, is North America attractive for you or would you be looking more for elephants maybe grazing in South America or Asia.

Answer – Randall C. Stuewe: Hunting for zebras, we own all the elephants.

Question – Craig Irwin: I love it.

Answer – Randall C. Stuewe: Now, Craig, it's a great question. And for the first time we completed a board meeting here this week. And for the first time the opportunities around the world are starting to surface again post some pandemic recovery depending on which continent you're on. So yeah, I mean, I think number one, the balance sheet is in order, number two, the free cash generation between now and 2023, 2024 is pretty well predictable.

And yes, we would like to grow but we will do it smartly and it'll be driven around building the moats around the kind of the four platforms I talked about being that our renewable energy platform, which is a sustainable aviation fuel and our green energy businesses in Europe around EnviroFlight, around our collagen peptide business. And then we love any bolt-on core rendering businesses that give us number one, a presence in a geography. Number two gives us the arbitrage of feedstock. So we're actively looking around the world and for the first time we're starting to see some stuff move that may come to market here this year or later this year.

Question – Craig Irwin: Hats off. Well, you guys are definitely executing the long term vision. So congratulations. I'll hop back in the queue.

Operator

The next question comes from Ben Kallo with Robert W. Baird. Please go ahead.

Analyst: Benjamin Joseph Kallo

Question – Benjamin Joseph Kallo: Hey, good morning, guys.

Answer – Randall C. Stuewe: Good morning, Ben.

Question – Benjamin Joseph Kallo: Good job in the call.

Answer – Sandra Dudley: Thanks.

Question – Benjamin Joseph Kallo: Randy I had to look up transom. I didn't know that word. So three questions, two big picture and maybe one (49:05). Big picture, the inflation environment, you talk about it lasting for the foreseeable future I think is what I heard. But you've been in a lot of these environments over those 39 years.

And so I guess, like, how do we get confident around that, into your predictability? The second thing, I get a question quite a bit, we saw the ADM facility coming on with the soy crush, the announcement yesterday. You guys knew about it before. But the question is like does the returns go to ethanol business as everyone comes into this business and what separates that.

And then the third, the minutia (49:52) question is how do we think about SG&A, I see it ticks up a little bit here and obviously there's some leverage in the business. But how do you think about you could – controlling costs even though you're high in the hog period, let's say? Thank you.

Answer – Randall C. Stuewe: Lots of embedded questions there. And clearly the business has some tailwinds right now that it's faced headwinds for the last five years. I'll break these down for you. Clearly the crushing industry both here and in the US and in Canada for North American canola are responding to the increase in demand or the anticipated demand for feedstock to feed ***renewable diesel*** investment in the near future. And I think that's all well and good.

The crushing industry will take three years probably to build out. And you've seen the scale of some of these announcements, whether it's North Dakota crushing plant for ADM or it's Sidney, Ohio expansion for Cargill or canola for Richardson's in Canada, and Viterra and Cargill and et cetera, et cetera. And at the end of the day those are for 1 million ton crush plant, that's a $350 million to $400 million investment today US dollar.

The other thing that you've got to look at is, is that any of the rene***wable die***s***el stu***ff that's been announced out there. It requires refined bleach deodorized vegetable oil and that capacity is also needs to be expanded today. I think then it's pretty simple and then I'll turn it over to Sandy is Marathon has proven the great experiment true. They used up all of the refining bleach and deodorizing capacity in the United States by starting up a plant.

And so today, I'm hearing that RBD is trading somewhere between 15 and 20 over – that's 1,500 and 2,000 (51:57) over. And so clearly that capacity is going to have to be expanded too as we go forward and Sandy do you want to talk about ***renewable diesel*** capacity in your views.

Answer – Sandra Dudley: So ***renewable diesel*** capacity. Yeah, I think we touched on this maybe in an earlier call. Obviously,

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there are projects that are moving along and moving along well, probably like ours. But then there are projects that we're seeing kind of fall behind in terms of timelines. There are ones that we used to talk about, but that we don't hear much about anymore today. And so while we probably saw this what – some people think is, this aggressive amount of gallons coming out on the market, I don't think that we see it as aggressively as some other people do.

Answer – Randall C. Stuewe: And then SG&A, Brad, do you want to take that.

Answer – Brad Phillips: Yeah. Ben. This is (52:52)...

Question – Benjamin Joseph Kallo: My question too was just upon the ethanol front as we had this boom bust cycle. And then maybe you answered this. But just spell it out for me because I'm slow. Why is it different than that?

Answer – Randall C. Stuewe: So, Jim why is RD different than ethanol since you're ex-ethanol, I saved you from that business.

Answer – James E. Stark: Okay. Thanks Randy, hey, Ben, it's different because of the boom that you had with ethanol build out was to meet a certain level of the mandate driven by the renewable fuel standard is different from renewable diesel because low carbon fuel credit – or low carbon fuel standards around the world are about reducing carbon. So you've got more opportunity and demand for lower CI scoring products like what DDD makes versus ethanol in its reduction, so the element of the backdrop is, two, it comes from the fuel side itself, renewable diesel is 100% fungible with petroleum and diesel today, you don't have limitations on what you can blend in in the amounts, it doesn't have to be handled separately, can get moved in the pipeline when it's back up and running.

So you've got a variety of just differences from that standpoint and also to cost if you remember back in the day, when they could get the 20% GHG reduction, they were spending $1.65, $1.75 a gallon to build, we're looking at plants that, at least the way DDD is built, around $3 or higher. So it's the capital limitations and the advent of just the overall market is different from the standpoint of an RFS versus LCFS around the world.

Answer – Brad Phillips: Ben, this is Brad. Just to circle back on the SG&A, yeah, we were up a little tick there about $1.2 million versus a year ago. We did have a multiemployer $1.3 million additional accrual that we made on a withdrawal liability on the pension side. But when you strip that away, we're flat. Really there you had some increases of several million due to FX, when you got the Euro USD at 1.2 versus 1.1, insurance as we've talked about before the last couple of quarters is up year-over-year. And then we're actually, this year and as Randy and we've talked about the guidance up and the performance, we are accruing more on the compensation incentive side instead of playing catch up maybe on a good year later in the year. We've upped that. So that'll be smoother during the year. And then on the flip side, we've obviously had travel offsetting that, with travel down, and the stock awards expenses down versus last year, just the difference in the plan and the cadence of that. So, I expect SG&A to run right in this range, absent something extraordinary, which many things run through SG&A being around this level or a little lower there in the following quarters.

Question – Benjamin Joseph Kallo: Thank you, guys. I know that was a lot of questions.

Answer – Brad Phillips: Okay.

Operator

The next question comes from Matthew Blair with Tudor, Pickering, Holt. Please go ahead.

Analyst: Matthew Blair

Question – Matthew Blair: Hey, good morning. Thanks for taking my question and congrats on the guidance raise. My question is with the volatile pricing that we saw in the quarter, were there any significant shifts in your RD feedstocks fleet. And I guess on a similar note, are you seeing any improvements in UCO or DCO availability.

Answer – Sandra Dudley: All right. Thanks, Matt. This is Sandy. In terms of our feedstock plays and I think you're asking, have we changed our mix based upon what we were seeing going on in the market. And really, it's – no, I mean, I think, you – everybody knows the three products that we typically use, and that's UCO, DCO and animal fats. And at any one time, one of those could be higher or lower priced than others. And we're going to take advantage of that because we have the machine that can do that. And so, I don't – that really wasn't a major thing for us. We just took advantage of what we could in the market. In terms of, UCO – and I'm sorry, DCO, were you asking if we were seeing more supplies come online. And I think that we never really experienced an issue with either one of those supplies. In general, I think that you're seeing more and more restaurants coming back online. And so, within the market in general there's probably more pounds out there. But I don't think that we've seen any substantial.

Answer – Randall C. Stuewe: Yeah. Matt, this is Randy. I always smile a little bit with – given the number of conversations that I have on UCO in this country. It's not a material amount of the entire feedstock as we've always said, there – there's 2 billion pounds of it. Darling has 40% to 50% market share in the United States. We're still down about 8% to 10% versus let's call it 2019. And that's predominantly in the East Coast, West Coast, Northeast and California to be exact, where they're still not open. So, it's really not a material discussion for even the RD business. You would never build an RD plant. And say your lead feedstock is going to be UCO, because there really isn't any, and 50% of it is already going to our location. I can't use the word control, like Sandy

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does, but I'm not allowed to. But that's where we see it. But at the end of the day, I think, you're going to see more and more restaurants opening up, with food service comes bigger and better demand for protein, which should make additional rendering and animal fats available, as we go forward here.

Question – Matthew Blair: Sounds good. Thanks for all the details. And then my follow-up is for the 30 million gallons of renewable naphtha that's coming off the Norco expansion. What market does that go into, does that go into the chems market, does that go into gasoline, and can you talk about how the economics on renewable naphtha stack-up versus RD?

Answer – Sandra Dudley: Yeah. So, I think, renewable naphtha is a new product for us, which we're just going to be able to produce once the expansion is online, and – but like rene***wable die***s***el, we*** view naphtha as a worldwide market and we're seeing potential opportunities out there around the globe. And it may be in different forms, whether that's in terms of green gasoline or possibly used as a feedstock in another process. I think that there are a number of options, but we're just not quite there yet. We still haven't (1:00:12) actually produced it and stripped it. So...

Question – Matthew Blair: Got it. Thank you.

Operator

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

Analyst: Kenneth B. Zaslow

Question – Kenneth B. Zaslow: Hey, good morning, everyone.

Answer – Randall C. Stuewe: Good morning, Ken.

Question – Kenneth B. Zaslow: Can you dimensionalize how each new policy would create demand relative to the California because there seems to be some real runway here in terms of the policies that are coming down the pike. And it would be helpful if we could get some idea of – because that's going to be the lead to continue the momentum, I think. So, there's two parts there. Am I right that there's continued momentum, and can you dimensionalize how much incremental demand there would be with each new policy that comes down the pike?

Answer – Sandra Dudley: So, yeah, I think, you're right, we had mentioned earlier that there is an awful lot of momentum. We're seeing a lot of new programs out there and potential new programs out there. Obviously, we now have Washington State, which is in play and we're so excited about that. And that's about an 0.8 billion gallon market per year. New York is also on that horizon that we're looking at, and that's probably a 1.4 billion gallon per year. New Mexico which we think has a decent amount of momentum going into next year is about a 0.5 billion gallon to 0.6 billion gallon market per year. And then obviously Canada is going to be coming online and they're about an 8.5 billion gallon market per year. And then I think I'd also mentioned Quebec early on as well, and that's probably close to a 1.2 billion gallon market itself. And so, there are significant volumes out there, there's a lot of demand being created, and these are just what we're seeing today. And so, I think that there – the future looks really bright.

Question – Kenneth B. Zaslow: Great. And then Randy in terms of cash deployment, you did obviously mention the acquisitions. What – the amount of cash that you're going to have is going to be very hard to spend. Would you think about reallocating that to either one-time dividends, share repurchases, anything like that because again I think it's going to be just hard to spend all the cash you are going to bring in. Any thoughts on that?

Answer – Randall C. Stuewe: Yeah. I was, as I said clearly, in the boardroom in the last couple days that was put on the screen as the – as we always call it the cigar box starts to build cash here pretty strong in 2022 and then just massive in 2023. At the end of the day, Brad has around $250 million of term B to pay down. Then we're sitting with a summertime callable or fall callable 3.625% euro bond that's out there. And then we've got a 5.375%...

Answer – Brad Phillips: 5.25%.

Answer – Randall C. Stuewe: 5.25% US bond in the 2022. Long term I suspect we'd like to keep that – some of that debt out there if not the most of it and extend it out when the time is right before inflation moves these rates back up. And then at the end of the day the opportunities that we're looking around the world. Hopefully, we'll find some that makes sense that are fair priced that we follow our model on. And then Ken, you said it outright, the Board is eventually going to have to evaluate a one-time dividend, a regular dividend or buybacks of some magnitude going forward. And as we call that in the boardroom, it's a high-class problem. Don't want to say we're kicking the can down the road, but at the end of the day we still got a little bit of time on our hands before we have to make that call.

Question – Kenneth B. Zaslow: Great. I appreciate it.

Operator

And our final question today comes from Adam Samuelson with Goldman Sachs. Please go ahead.

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Analyst: Adam Samuelson

Question – Adam Samuelson: Yeah. Thanks. Good morning, everyone, and thanks for squeezing me in.

Answer – Randall C. Stuewe: Good morning.

Answer – Brad Phillips: Good morning

Question – Adam Samuelson: Good morning. So, a lot of ground has been covered. Maybe didn't hear much about the food business both on the quarter and the forward outlook, which was unchanged. I know you've been very confident Randy on the growth on collagen peptides and some of the new capacity there. Just help us think about some of the dynamics in play in that business this year and how we should think about exiting the year into 2022?

Answer – Randall C. Stuewe: Yeah. No. Great question, Adam, and a fun one to kind of conclude with the feed segment clearly because all the optionality in there looks like the shining star. But the reality is the growth in the annuity side and then the strong cash flows have been always in that food segment that have been very predictable. And two years ago we laid out a plan to add three or four new spray dryers out there and then an enzyme conversion unit to capture the growing collagen peptide world which essentially for those that are listening in is a water soluble use versus an emulsifier type of application in regular gelatin. And really, we – not only the DGD ever that we hit a homerun there, we are hitting a homerun in the collagen peptide world right now from a demand perspective. That capacity is all coming online right now when I say coming online, it's running. The sales ledgers are building, Nestlé's investment or Nestlé Health and Nutrition that invested into Vital Proteins has clearly given kind of a great turbocharge to the Vital Proteins brand and allowed us to grow with that. The number one brand in the world is the – as we call it the blue jar that's out there now. And that's Rousselot Darling product that that's in there. And so, we see that continuing to grow very nicely. It's been led by Jennifer Aniston and she has quite the following out there. She was reintroduced recently in some Dutch commercials. And the sales are now 5 times to 10 times higher than what they anticipated. So, we're excited about it in that area. You know all said in the segment, you know Brad and I watched that segment in the 125, 140 range for years and years. And then we said, 160 last year. And then we said we would probably be in the 180s this year and then we would be in the 200s. I think we're still on that trajectory as we changed the product mix here and get the capacity sold out.

And then we're working on that the biomedical device area right now. And that's probably two or three years out. But that in our world as we talk in the boardroom about the next big thing is in that – those applications for collagen peptides as we look around the world going forward. So, the Rousselot model as we took it back in 2014 was a 100% gelatin driven model on. And then we've rationalized that and refocused it to now where it's both a gelatin and a collagen peptide business, and soon it'll have a third leg to it in the biomedical health and nutrition area.

So, hope that helps.

Question – Adam Samuelson: It does, and kind of, if I could just squeeze one quick one in.

Answer – Randall C. Stuewe: Sure.

Question – Adam Samuelson: I don't think I heard this earlier, what is the CapEx expectation both at the parent, but also what's Diamond Green CapEx this year?

Answer – Brad Phillips: On the base business, we're looking at about $310 million, $312 million. And we did $60 million here in Q1.

Answer – Randall C. Stuewe: And Sandy, do you want to comment about DGD a little bit?

Answer – Sandra Dudley: Yeah. So, this year and next year really are two big CapEx years. So, we're finishing out DGD II this year and starting our – working on DGD III as well, so you're talking probably close to $800 million.

Answer – Randall C. Stuewe: In both years?

Answer – Sandra Dudley: In both years.

Answer – Randall C. Stuewe: Yes.

Question – Adam Samuelson: All right, great that's really helpful. Thanks so much.

Answer – Randall C. Stuewe: Yup.

Operator

This concludes the question-and-answer session. I would now like to turn the conference over to Randall Stuewe for any closing remarks.

Thanks, Tom, appreciate everybody's time today and hope you all stay safe. In our IR deck, there's a list of upcoming events that we'll be speaking at and look forward to talking to everybody in August and stay safe. Thanks for all the questions today.

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Operator

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

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