From Producer to the World

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AGT Food and Ingredients Inc.
Second Quarter 2017 Financial Results Conference Call Transcript

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Speakers:

Murad Al-Katib
President and Chief Executive Officer

Lori Ireland
Chief Financial Officer

Omer Al-Katib
Director, Corporate Affairs and Investor Relations

OPERATOR:
I would now like to turn the conference over to Omer Al-Katib, Director of Corporate Affairs and Investor Relations. Please go ahead, Mr. Al-Katib.

OMER AL-KATIB:
Thank you. Good morning, and thank you for joining us on our Second Quarter 2017 Conference Call. On the line with us today we have Murad Al-Katib, President and CEO of AGT Food and Ingredients; Lori Ireland, our Chief Financial Officer; and Gaetan Bourassa, our Chief Operating Officer.

Before we get started, I would like to remind everyone that today's call may include forward-looking statements. Such forward-looking statements are given as of the date of this call and involve certain risks and uncertainties. A number of factors and assumptions were applied in the formulation of such statements and actual results could differ materially.

This call may also include references to certain non-IFRS financial measures. For additional information with respect to forward-looking statements, factors and assumptions, as well as a reconciliation to IFRS measures, we direct you to our news release, our website, as well as our recent filings on SEDAR.

With that, I'd like to ask Murad to make some comments and then we'll go to questions. Murad?

MURAD AL-KATIB:
Good morning. Thank you for your interest in AGT Foods.

We are right at the start of harvest in Western Canada, with harvest in some parts of Saskatchewan already under way. It's expected that farmers should be in the fields over the coming weeks getting their products into their bins earlier than they typically would. This is coming after a hot, dry growing season.

We've had a challenging quarter with margins constrained and metric tonnes invoiced reduced, and a return to traditional cyclical global commodity markets resuming imports at a slower pace than in past years, where local production is being consumed first before imports will fill local demand.

Global pulse markets have been closely watching a number of factors with regards to harvest timing, production volumes and quality, import volumes to key consumption markets, and resolution of non-tariff trade barriers as markets advance to the start of a traditional shipping period for pulses and staple foods in the late Q3 and Q4 2017 and Q1 2018 periods.

Even with all of these factors, I remain optimistic in the future prospects for our business in the coming quarters, as cycles in our business develop quickly but also resolve relatively swiftly. Staple foods are fast-moving consumer products.

I would like to discuss some of the market dynamics and developments in our business and outlook for the periods ahead, where we see an expected resumption of traditional purchasing and import patterns, but first I'm going to ask Lori Ireland, our CFO, to go over the results for the current quarter. Lori?

LORI IRELAND:

Thanks, Murad. Quarter Two of 2017 presented some challenges for AGT. Total tonnes invoiced were down by approximately 10% for the second quarter compared to the first quarter, with lower invoiced tonnes in the Pulse and Grain Processing and in the Bulk Handling and Distribution segments. The gap between the price at the producer level and the sales price was a contributor to the reduction.

Although tonnes invoiced in the Food Ingredients and Packaged Foods segment increased in Quarter Two compared to Quarter One of 2017, adjusted gross profit and Adjusted EBITDA decreased. The new pasta line in Turkey was commissioning during the quarter, and pasta that was produced during this time was sold to various price-sensitive markets at lower margins. In addition, margin pressure related to high-priced remaining old crop stock and current drought conditions in North Dakota and Montana caused producers to demand higher prices. Product and customer mix also had an impact on earnings.

However, net debt did improve and decreased by $18.4 million at June 30, 2017, compared to March 31, 2017. The ratio of net debt to trailing 12-month EBITDA, however, increased to 5.37 compared to 5.23 at March 31, 2017. This is due to the lower volumes this quarter, coupled with the high fixed costs component of AGT's operations, and resulted in lower earnings.

Net working capital also improved when comparing $361.4 million at June 30, 2017, to $389.3 million at March 31, 2017. Net working capital as a percentage of trailing 12-month revenues decreased to 17.37% at June 30 compared to 18.97% at March 31, and compared to 20.96% the same period last year. We will continue to monitor this metric throughout the harvest season and we will continue to strive to maintain a ratio of net working capital to trailing 12-month revenue of between 17% and 18%.

General and administrative and marketing, sales and distribution costs increased for the quarter ended June 30, 2017 compared to the same quarter in the prior year, and were slightly higher when comparing to the six months ended June 30, 2017 to the same period in the prior year. This is due to specific marketing campaigns related to the Food Ingredients and Packaged Foods segment. Reduction of this expense as a percentage of revenue will continue to be an area of focus, and we will work with each subsidiary to lower the ratio and ensure that discretionary expenditures are kept to a minimum.

Non-cash foreign exchange includes a snapshot of outstanding foreign-denominated accounts receivable and accounts payable, as well as outstanding foreign exchange contracts, and includes the contract relating to the bonds. This is a non-cash item and fluctuates depending on the strength or weakness of foreign currencies when compared to the Canadian dollar, and is excluded from Adjusted EBITDA calculations due to its non-cash nature. AGT has treasury processes in place to ensure that the need to purchase foreign currencies to settle debt will be minimized if it will result in cash losses on foreign exchange.

AGT tracks adjusted earnings per share as it is reported exclusive of the non-cash foreign exchange effects of our global business, whether that means a gain or a loss, because Management feels that inclusion of both gains or losses that result from snapshot non-cash IFRS effects do not accurately reflect the cash flow generating ability of the business.

Adjusted earnings per share were $0.10 basic and fully diluted for the quarter ended June 30, 2017, which was a decrease over the prior quarter and the same quarter in the prior year.

This quarter we have included our June 2017 covenant requirements and the results, and it's all in our MD&A. You will see that three of the covenants are at the APP operating company level, and two of the covenants are at the AGT consolidated level. Our credit agreement defines the calculations required for our covenants and in certain cases there are carve-outs and adjustments for certain activities. AGT continues to have a positive relationship with our lenders and we are in compliance with our syndicated facility covenants at June 30, 2017. Thank you.

MURAD AL-KATIB:

Thanks, Lori. As I mentioned at the start, harvest is getting underway. It's expected to be earlier than we've seen in a few years. Overall, we expect average production volumes on lower yields but with quality in the top grades. Acres are reduced in Canada and the U.S. over 2016, and environmental conditions are reducing the yield, but the projected production volumes in 2017 are still some of the highest on record when adding production and carry-in stocks from the 2016 harvest. There are still lots of peas and lentils expected in Canada, potentially over 7.75 million metric tonnes or more of specialty crops overall. Stocks are viewed as ample in all origins that AGT has operations in.

With anticipated better average quality with the new crop cycle, we expect these supplies will allow us to meet consumer demands in traditional shipping periods as consumption market demand is needed to be filled and we expect better utilization of our assets going forward, allowing for a gradual return to more normalized margins and volumes.

In the current quarter, we reported margins as continuing to be constrained due to market transition from North American old crop to new crop. Expectations of farmers with remaining stocks in the period did not match the purchase price that local markets would bear and that importers were willing to book forward. With ample local stocks, importers were delaying purchases, working through local production and waiting for the new crop to come. There was an expectation that the new crop would be better quality with potentially similar or better price levels than old crop stocks.

In the longer term, we see a consumer demand for pulses and vegetable protein they provide in traditional diets as unchanged as a result of population growth, income growth and demand for food. Lower prices may also stimulate more consumption, fuelling the need for imports to fill the gap between available local supply and demand in the near term.

We forecast demand for pulses and staple foods to remain strong. These are products that people need as basic staple foods. They're relatively non-discretionary consumption items; however, supply and demand balance has become a key part of the market dynamic. This is the result of markets like India and Turkey where pulses are produced and consumed, working through their own local production before commencing their imports. This is how the global pulse sector has operated for decades, with the past few years being an anomaly with the high levels of import in non-traditional periods. As the market dynamic moves from consumption of local production to build demand to imported products, we expect a resumption in later 2017 of periods where imported products will make up the bulk of the supply in deficit markets like India and Turkey, however it may just happen at slightly a slower pace than in the past few years.

India is the story that we see in global pulse markets today, as they are the largest producer and consumer of pulses and their actions are a key driver of the market globally. Indian government has taken a number of steps in recent months to support their local market with elections and messaging surrounding food security, agricultural policy, anti-hoarding regulations, import of safety stocks to ensure availability, and non-tariff trade barriers such as their fumigation of agricultural products.

However, the market developments in India require monitoring. It's something we do as a management team every day. For example, to illustrate how quickly the developments can change, recent policy changes in India to restrict the import of pigeon peas and to impose a modest quota of 200,000 tonnes were announced on August 5, 2017. It's a measure that we see may have a positive effect to clear up surplus stocks of pigeon peas and may have the effect of stimulating India's local market. This was rumoured for only days and became a decreed policy change on August 5 with no phase-in period and validity until March 31. Local production is stabilized to a degree, providing more local stocks to fill near-term demand, although it's uncertain that Indian local production volumes will continue at their current rate.

Should production trends in major consumption regions revert back to insufficient local production levels, imports could again increase as they have in the past four or five years. The current policy of India regarding prices and supply levels may have had an opposite to the intended effect. There are high levels of supply and prices have fallen dramatically, which may drive farmers to other crops in the upcoming planting season.

Added to this are non-tariff trade barriers that the markets have appeared to have a relatively slower move towards a return to shipping volumes. We expect that the evolving Indian government intervention in pulse markets to build prices back up, reduce stocks and may result in the return of more normalized imports. Overall, the short-term flows of imported products to markets are impacted; however, there's no change in demand fundamentals. Markets are expected to resume traditional purchasing, import patterns later in 2017, and 2018 looks to be a positive year.

We also believe margin constraints seen in this quarter will be moderated by new crop supplies coming on stream.

In our Food Ingredient and Packaged Foods segment, we see our pulse ingredient business continue to advance with incremental volume gains, however, margins decreased due to product mix in the Packaged Foods side of our business. Food manufacturing customers have provided feedback they are pleased with the functionality of our pulse ingredients; the product development cycle for human products is one that's long; but we continue to see traction and movements with less pressure from lower corn prices with constrained crop supplies in the United States. Human food and pet food sales programs continue to advance, as seen by the volume gains in this segment.

Product and customer mix had some impact on AGT's Ingredient and Packaged Foods business unit, with fibre, flour and starch sales continuing to develop to complement the growing book of sales to both customers in human and pet food markets as they ramp up their requirements for protein. This continues to be the core focus for AGT: the building of the starch, flour and fibre sales that complement the protein. All starches and flours and co-product streams are being sold out as produced, and Management is seeing a gradual stability and increase in the average price for its starch fractions, which has the long-term potential to positively impact margins in our segment overall.

The balance of product mix to customers continues to be a focus within this business unit. It's essential to maintain uses in markets for all fractions to ensure that as the subsequent production lines are added in the future that AGT is not only able to market all the product streams but to realize the return it expects on each product stream of production.

Currently, AGT's Minot facility is operating at 95% capacity—really, full capacity over the three production lines. The newly commissioned fourth production line is ramping up commercial production. Sales are going out the door; production is going as planned. Overall volumes in the Q2 period at Minot were up approximately 20% when comparing Q2 to Q1, and pea prices in North America were firm as old crop stocks were depleted to nearly sold out.

Higher priced residual stocks and farm levels remain firm due to drought conditions in North Dakota and Montana, and margins were under pressure. However, new crop stocks began to arrive in July 2017. Harvest is in full swing, and early indications are that yields may be better than projected.

New crop contracts are being negotiated with large customers, and demand forecasts in all segments of Food Ingredients are for additional volume in 2018, boding well for new production capacity from the fourth line, and margins are expected to gradually recover later this year as new crop stocks are purchased.

The Packaged Foods business continues to grow as market opportunities and sales and distribution efficiencies are realized, and the units contribute positively to this segment. Similarly, raw material pressures were seen in the business unit, in particular with tight durum wheat stocks later in the quarter prior to the new Turkish harvest in June, and of course the new North American harvest for durum that is upon us. We feel the pressures will be alleviated with new crop harvests, and we feel that the segment and its business units are advancing as expected. Our strategy aimed at further margins and volumes in this segment will yield success in our coming quarters as we enhance the products available to meet consumer requests and demand.

Pasta volumes were up over 50% when comparing Q2 to Q1. Margins were reduced slightly with that durum wheat input cost, and the commissioning related to the sixth production line is largely under way and commencing well.

As the pulse ingredients business ramps up and the Packaged Foods business ramps up, Management's evaluations of opportunities and investments for additional infrastructure of production of pulse-based or blended pulse ingredient pastas are ongoing; however, we have provided no timeline yet for announcement of completion of these projects.

Markets were healthier in gluten-free or reduced gluten pastas and North America, Asia and Europe are continuing to grow, and our management team continues to investigate production, co-packing and sales opportunities in this important future business line.

Our Bulk Handling and Distribution segment, including our Distribution business unit for non-core commodities, as well as our short line rail operations, continues to grow as a contributor to earnings in a steady and regular fashion. It provides opportunities to augment our earnings with little capital deployment other than working capital to finance the business unit. With the upcoming production volumes from North America and volumes to be moved to market, our investment in logistics like the Mobil short-line railway and West Central Road and Rail loading locations, as well as our port and terminal investment like CanEst we announced during the quarter, will provide efficient modes of transport and the necessary infrastructure for loading, handling, and cartage and access to port facilities that are necessary to monetize this business unit.

In the quarter we were also pleased to announce our partnership with Fairfax as a strategic partner that provides numerous advantages for AGT and its business across all segments with regards to emerging market growth strategies, particularly India and Africa, de-levering of our balance sheet providing necessary liquidity for current and future growth needs, including the possibility of future strategic investments and acquisitions. We're pleased to have them on board and confident in our ability to grow our business as we go forward.

Let me be very clear: the process for this decision to undertake the transaction with Fairfax was a long process that involved a significant due diligence process on both sides to identify the management alignment on our views of the world, and particularly the role that Canada and AGT may play in building a global champion in a supply chain integrated strategy in pulses and staple foods. We believe that Prem Watsa, Paul Rivett, the Fairfax team, and its affiliate investee companies provide us with exceptional partnership opportunities.

Before we go to questions, I want to conclude by stating that the past period has been challenging; however, the conditions further demonstrate our strategy of balance sheet initiatives, investment in logistics infrastructure and diversified operations and segments is the correct one. In the first two quarters of 2017, almost half of our Adjusted EBITDA came from businesses that were not in existence within AGT eight years ago. We're optimistic that our business will continue to grow and develop with strong fundamentals, long-term trends and our short term position will be solidified by our recent investments in Packaged Foods, Food Ingredients, Bulk Handling and Ports.

We're going to stay the course with our strategy, focused on disciplined capital allocation, focusing on costs and efficiencies in our current production systems, and focus on the utilization of our processing and bulk handling infrastructure more efficiently, growing value-added opportunities for our products globally.

I want to thank you for your interest in AGT Foods and I'll go to questions.

OMER AL-KATIB:
Operator, we'll take the first question, please.

OPERATOR:
Thank you. The first question comes from the line of George Doumet with Scotiabank.

GEORGE DOUMET:
Just two big ones, Murad, if I can. Firstly, can you maybe share your views on this year's kharif season in India from a pulse seeding standpoint and where you see it relative to last year? The second one, should we expect a continued reversal in working capital in the next two quarters?

MURAD AL-KATIB:
Yes. With regards to India, there're a lot of mixed reports coming out of India related to the kharif season. The monsoons were actually quite uneven, so while you can read reports that talk about an average monsoon, you actually had drought conditions in certain areas and actually surplus conditions in others, which have a number of analysts in India predicting that the harvest will not be as large as government forecasts had projected.

We're also looking at the effect of low prices and the current lower minimum support levels on commodities like lentils, where with the current depression of prices, the seeding of the crops that will be harvested in March, which is really the harvest that affects AGT's business, we expect that to be much more of a profound effect in terms of the effect on our business.

I think that what we're going to see is a depletion of local stocks over the near term and a resumption of imports as we go forward in the year. I think that this oversupply scenario, I mean the monsoon variability is something that I think is going to become normal course and I don't think we're going to see much different this year.

George, you'll have to just repeat your second question, if he's still in the queue.

GEORGE DOUMET:
Yes, sure. I was just wanting—we saw pretty healthy reversal in working capital this quarter. I think seasonally in Q2 we get those, but I was just wondering if there's any chance we get more of that in the back half of the year.

MURAD AL-KATIB:
I think that, again, our demonstration of the reduction of the working capital as a percentage of 12 months trailing revenue show that these working capital initiatives are working. I mean we've managed to reduce that. Two years ago we were running at around 27% working capital as a percentage of trailing 12 months revenue. We're actually in our target zone now of 17% to 18%, and so we expect again that as commodity prices have normalized and that as we continue to sell out our stocks, collect and then re-stock again, we could see stable to potentially declining working capital.

Certainly I don't project that working capital is going to be a consumer of cash as we go forward in the near term, which I think is really positive. As earnings recover, we'll start to show the free cash flow that we projected coming along.

OPERATOR:
Our next question is from Steve Hansen with Raymond James. Please go ahead with your question.

STEVE HANSEN:
Good morning, guys. Just very quickly on sort of the infrastructure footprint that you have today, you've done a lot of work, Murad, on building out the origination side, both through Processing initially and then more recently on the Bulk Handling side. I'm just curious about the downstream footprint that you might want or that you would aspire to have over time, given, I guess, one, the Fairfax investment, but then and again the recent macro turmoil we've been seeing of late. Is there any desire to have a downstream footprint into some of your end markets like India?

MURAD AL-KATIB:
Good question, Steve. Certainly, we have been already vocal a little bit about the need for port infrastructure within our Canadian platform. The small strategic investment in CanEst in Montreal, it is the only handling facility in Montreal, right in the port, that's able to receive a full 10,000 tonne unit train and it can actually take it into containers for export with 60,000 tonnes of onsite storage. This provides us with a tremendous opportunity off of our East Coast side, coupled, of course, with our Thunder Bay terminal that we have, Mobil Ex, that has been built out and licenced over the course of the last 12 months. So, our East Coast infrastructure is done.

West Coast terminal agreements and terminal handling agreements, long-term agreements, are currently in our focus. In order to monetize the very impressive bulk handling system and origination system that we've built out and acquired, we'll need that port agreement and infrastructure to happen. We think that there are opportunities where we do see currently the repurposing of certain assets that were utilized for other dry commodities, whether it be the forestry products or coal or other type of dry agricultural or bulk commodities, coming available for grain. So, from that perspective, you can expect that we'll make those types of moves.

With regards to India: I do think fundamentally that we're going to see long-term opportunities to link the bulk supply chain that we have in Canada through a port agreement on the West Coast into some modest infrastructure in India on the port side, to be able to receive vessels, offload vessels into warehouses, into the silos, and put them into milling and distribution in India. We'll have our eye on that as we go forward and implement our strategy in the 2018, '19 and '20 periods. I think that that will be an essential part of the long-term strategy. But again, the Fairfax partnership helps us.

Fairfax is one of the largest owners of private warehousing and distribution services in India, so they currently have a large investment in that particular area. The synergies and opportunities between Fairfax investee companies and AGT was one of the big draws that we had in the strategic investment that we've undertaken with them.

OPERATOR:
Our next question comes from Jacob Bout of CIBC. Please proceed with your question.

JACOB BOUT:
Good morning. Can you talk a bit about any changes that you're anticipating to happen as a result of Fairfax and PointNorth involvement, either from a corporate governance or strategy perspective?

MURAD AL-KATIB:
Well, you know, I think that, again, both partners are great partners for us. We have a long-term relationship with the partners at PointNorth. Barry Goldberg and Phil Evershed are long-term friends of the firm. We worked with them very extensively at their time at Genuity Capital Markets. They've expressed their support for Management and support for the strategy.

At the end of the day, the focus with Fairfax and PointNorth—and all our shareholders, really, and of course, we remain a very large shareholder in this company—is to focus on recovery of utilization of our assets, focus on costs and efficiency, focus on margin improvement, and that will generate the free cash flow with the stability that we have in our working capital currently. Our cap budgets are going to be very modest. In fact, when I look at the 2017 cap budget, it's heavily weighted in the first half of the year, so we've expended a lot of the funds that were allocated, as these projects were started in 2016 and finished in 2017, and I think that, from a go-forward basis, we'll go there.

From a corporate governance side, we added two independent directors that were new over the past year, and that's going well, and we're going to be—assuming that we close the Fairfax transaction, we'll be adding an independent director nominee from their side. We'll be focusing again on taking a look at opportunities to improve our governance QuickScores and to continue to focus on corporate governance. We made some good strides this year with the appointment of an independent lead director, formulization of our committees. We've appointed committee chairs on all of the different committees from our independent director groups. We're optimistic that, from the corporate governance side, we're certainly not only sophisticated and compliant, but we're moving in the right direction.

OPERATOR:

Thank you. Our next question is from Joel Jackson with BMO Capital Markets. Please proceed with your question.

JOEL JACKSON:

Hi, good morning, Murad. I had a couple questions. My first question is, in going through all your disclosure and some of your commentary, you talk about a number of issues that affected margins in Q2 in the pulse business, and what I could pull out was you talk about higher freight costs, container shortage, you talk about crop mix shift to add more peas. You, of course, talk about low utilization and you, of course, talk about a delay from purchasers, importers purchasing, because of the higher inventory in places like India and Turkey. Can you walk us through those issues, and any other ones you want to add? Maybe more concisely, talk about how each of those issues is going to get better, worse or stay the same in Q3 and Q4?

MURAD AL-KATIB:

That's a great question, Joel. Let me start with freight. I mean, our commentary on freight was very much related to our Australian business. We were looking at the mix of business units that contributed and performed and those that may have under-performed in the quarter. As a result of a later harvest in Australia in 2016—one of the things that is a dynamic in Australia for us is we're a container shipper, and container dynamics are such that Australia actually has surplus ports and deficit ports. The Port of Adelaide in South Australia, which is one of our biggest operations, is actually a deficit port, and it's a deficit port because they have very strong South Australian wine exports. So, all of us like Australian wine. From that perspective, wines also use containers, along with grains and everything else.

With the later harvest period, the shipping periods were quite constrained into quarter one and quarter two, and so we had to constrain, you know, longer shipping windows into shorter timeframes, which led to container shortages and container freight rate increases. It was a supply/demand issue. Those have largely resolved themselves, so we don't foresee that. In fact, we're seeing, as a result of North American stocks being relatively more moderate this year—you know, North American freight is actually going to be quite competitive this year, we're seeing container rates quite stable. So, we think that the freight pressure on our margins is largely alleviated.

We think, as well, that the CanEst investment that we've made will provide us with a good Montreal balance to our Vancouver freight option, in particular, when we look at the Indian subcontinent and Asia. We actually load via Montreal and we go by the Suez Canal even into the Indian subcontinent. So, I think that the freight side is relatively resolved, when we look at a Q3/Q4 period.

The products mix side that we discussed was really relative to—available green lentil stocks weren't there. We were sold out. That's a market where we make margins, okay? So, that wasn't available to us, and the red lentils that were available were relatively poor quality and demand was relatively constrained as a result of full markets and really a reluctance to buy the old crop, relatively not good stocks.

So, we looked at what was available to buy, and that was peas. So green peas, yellow peas, flaxseed, different types of commodities that went through our system, that utilized our assets, but may have generated lower margin. I can tell you on a percentage basis, we shipped more peas in the second quarter than we usually do, because, again, demand was there and product was there, and we took the demand to generate cash flow. That's largely resolving itself, as well. The new crop is upon us. So, we'll be back to a mix of green lentils, chickpeas, beans, red lentils, peas, flaxseed. We'll do the full product mix back into our Q3/Q4 season. I think those constraints are going to be resolving themselves as we go through Q3, into Q4, and into Q1. Again, the supply constraints and the transition side, we just talked about the new crop.

So, my commentary is, look, we went through two quarters of relative constraint. I think that from that perspective we will certainly start to see an easing of that and go from there.

Did you have another question, Joel?

JOEL JACKSON:
If I can follow up on that—I know you don't give guidance, but can you help us out? Is Q2 likely the lowest earnings of the year? Similar to 2016, should we see Q3 better than

Q2, or would something drastically, your worst-case scenario for Q3 have to happen to see earnings below Q2?

MURAD AL-KATIB:

Yes, I can't really give you much guidance, but I can tell you that our commentary was that we see gradual improvement in Q3. I think we're kind of giving you the answer already in our disclosures.

JOEL JACKSON:

Okay. Thank you very much.

OPERATOR:

Thank you. Our next question comes from Kyle McPhee with Cormark Securities. Please proceed with your question.

KYLE MCPHEE:

Hello. Can you comment on Minot Line Four utilization during Q2? Your statement about volume at Minot being up 20% quarter-over-quarter to just Line Four ran at about 60% utilization throughout the whole quarter, on average. Is that accurate? What's going on here?

MURAD AL-KATIB:

Yes, you know, I guess you've done the math the other way based on capacity. We'd say it probably wasn't that high, Kyle. You probably had some spillover from Q1 to Q2, in terms of production and invoice. I mean, remember, we don't—just because it's produced and it's put into a shipping unit, depending on where it's being shipped, it may be transitioning to a port, so if it was produced in Q1, invoiced in Q2. I don't think utilization was quite that high on our fourth line. But, what I can tell you is that we started commissioning it in April, by May it was running, and by June it was really running. So, you know, we're in a position now where we're happy with the volumes, the productions went well.

We continue to demonstrate our ability to do what we call plug-and-play, where we have the system done, we plop in a line, we pipe it in, we can commission it within four to six weeks, and we could be up and have the notional production capacity increased dramatically in a very short period of time.

So, we're quite optimistic again that the Q3/Q4 period—in particular, later in Q3 and Q4. The summer period, July and August, are really quite predictably a lot of scheduled shutdowns for a number of our food manufacturing clients and pet food manufacturing clients. So, they would have, on average—let's say the pet food side, because they handle a lot of meat and other things, they have some very stringent clean-down processes that they'll do once a year. So, again, I think that the volume utilization was material and we're quite happy with it.

OPERATOR:
Thank you. Our next question is from John Chu with Laurentian Bank. Please go ahead with your question.

JOHN CHU:
Good morning. I've got a couple of questions here. Can you just comment on the marketing and promotional expenditures you're doing on the pulse ingredient side and how long do we expect to see that continue going forward?

MURAD AL-KATIB:
Yes, you know what, John? These were just seasonally—you've got both in your Packaged Foods business and your Pulse Ingredients business certain expenditures related to larger show presences, and things like that. The IFT, International Food Technologists Show was in the second quarter; that's a very big pulse ingredients presence for us. We had the new pasta lines coming on in Turkey, which would have had us incur some promotional and listing fees related to the new production volume. We've added in Turkey roughly 25% to 30% capacity. These are kind of—I don't want to use the word "one-time," but they certainly were largely falling in the quarter, just from a timing perspective, so we don't foresee all of them on a recurring basis, but they did happen to fall in the quarter and they were one of the reasons why G&A were a bit higher. We expect G&A to normalize again.

I can tell you in a time of some constraint on margin every cost is being examined. That is something that is in Management's control. So, whether it be production costs, maintenance costs, in particular G&A costs, we're scrutinizing every penny and we're going to make sure that we do what we can to tighten our belts up and make sure those costs don't escalate. On a percentage of revenue, we're actually seeing G&A costs as stable again, or declining. So, we want to see that continue, as well.

JOHN CHU:

Okay, and then just another question. The last couple quarters, you had some, I guess we'll call it liquidity issues, facing some of the importers. Can you tell us if that's been mostly resolved, or is that still an ongoing issue?

MURAD AL-KATIB:

You know, John, as they crystalize their losses and they move through them, and markets stabilize, liquidity improves. I made in my comments about the nondiscretionary nature of staple foods? Staple foods, a large base is our cash, right? They're like cash. They're almost cash-equivalent, because they can move through the system, if you choose to market them. From the perspective of our importers, what we saw is the reluctance of some importers to crystalize their losses and hope for the best. As markets have troughed and started to come back up, we are seeing importers liquidate stocks and even start to think about rebuying, which again is why we believe that maybe it might be a bit slower paced, but we're optimistic about the resumption of imports.

OPERATOR:

Thank you. Our next question is from Anoop Prihar with GMP Securities. Please proceed with your question.

ANOOP PRIHAR:

Good morning. Just a point of clarification. On the Q2 income statement, there's $2.5 million in non-recurring expenses that are included in EBITDA and the year-to-date number is about $4.2 million. For the quarter, can you tell me what exactly those charges related to?

MURAD AL-KATIB:

Yes, the compensation expenses related to stock-based comp are always in there, Anoop, so they're always a part of what we would put in those costs, so that's a normal—every quarter, those go in. Then, it would be a combination of costs. A big one in this period was some demurrage, detention and ancillary costs related to two programs. One was related to the Syrian Refugee Program. So, with some conflicts, the United Nations had to change the way we distributed some of the products and parcels, which led to some ancillary costs, so these would be viewed as non-recurring ancillary costs related to, you may argue almost a force majeure-type event because of the war in Syria. So, that would have been a material cost in that segment.

The second thing would have been related to Indian government tendering on pigeon peas from Africa. So, there were some ancillary costs related to that, again, we judged as one-time costs related to non-tariff phytosanitary issues. So, those are in, but we expect those costs to come back into line. When we look at a global business, we usually have somewhere in the range of around $1.5 million, or so, that we kind of judge into that non-recurring side. We're watching that really carefully.

OPERATOR:
Thank you. Our next question is from the line of Westley Nixon with National Bank Financial. Please proceed with your question.

WESTLEY NIXON:
Good morning. We see margins tend to jump around quarter to quarter in the Ingredients division. We saw it this quarter with product mix and the input costs, but when we think longer term and plans for ramping up, how should we be thinking about the margin progression in the Ingredients division longer term?

MURAD AL-KATIB:
Yes. I definitely, Westley, think that as we said when we look at overall—the big effect of this segment over the last two quarters has really been the non-Food Ingredients side. It's been more the Packaged Foods side our business. So, you know, the African business unit had had some constrained margins as a result of the drought in Africa. That's largely resolved itself, so we'll start to see that improve in Q3 and Q4.

The product constraints in terms of the North American side have also been resolved with the new crop harvest. I think that we should start to see—with our starch monetization initiatives related to marketing our starch, we should start to see a progression back to improved margins in that segment. Of course, that's a focus today. It's not only about utilizing that fourth line, but it's about extracting more margin out of the current production system we have on four production lines, plus the deflavouring line. So, I have some optimism that that's going to happen.

The same thing on our pasta business. We had more volume. Pasta is a fixed-cost manufacturing business. Any time you can increase capacity by 25% to 30%, you're going to see a margin improvement as long as you've got the retail clients to sell to, and we do have that. So, I've got some optimism there.

OPERATOR:
Thank you. Our next question comes from Steve Hansen with Raymond James. Please proceed with your question.

STEVE HANSEN:
Yes, Murad, just one follow-up. I'm not sure if I missed it in the opening remarks, but just any clarification you can provide on the fumigation issues. The current exemption I think we have today extends to the end of September. Other jurisdictions, I think are in until December. Just any clarification on the update for the program to find some sort of permanent resolution there and how that might impact Q3 shipments if it's not resolved.

MURAD AL-KATIB:
Yes, right now, the Canadian exemption is only until September 30th. Every other market in the world has an exemption until end of December. So, from that perspective, one of the things that we'll be watching carefully is whether or not Canada secures an extension to the end of December. There would be a view by many in the market, you know, just the trade view, and really the view that we're getting even from our government here in Canada. This is at the highest levels, being discussed between senior levels of the Canadian and Indian governments. We see no reason not to be optimistic about an extension of our deadline in Canada to at least match the December 31st.

One of the things that we're hearing through the government sources is that Canada has presented what we call our systems-based approach. We don't have the pests of concern. Therefore, our position is that with our weather conditions being effective fumigation, we don't require fumigation. Therefore, the Indian government should allow us a long-term exemption. In the absence of that, what we're going to see—you know what? U.S. origin is able to be shipped. So, we have our U.S. processing plants that could make up some volume. Australia is able to ship. Turkey is able to ship. So from that perspective—and then Canada can ship in bulk vessels. Then, we can also pay out the five times penalty, Steve.

Just so we're clear on that, I think we put some clarification in our—maybe we didn't, actually, okay. To clarify what a five times penalty means is, if you don't fumigate here, you can ship and you'll pay around a $12 a tonne penalty. Again, $12 a tonne isn't great, but it's not the end of the world. The supply chain may have an ability to bear that in some fashion.

So from that perspective though, I remain optimistic. It's in the interest of India and Canada to have a long-term resolution. I expect that to happen.

STEVE HANSEN:
Very helpful. Thanks.

OPERATOR:
Thank you. Our next question is from the line of Kyle McPhee with Cormark Securities. Please proceed with your question.

KYLE MCPHEE:
Just two quick follow-ups here. So, on the total food segment, your volume was up 30% quarter-over-quarter, but your gross profit per tonne came down a fair bit. In other words, it sounds like this incremental volume coming in came in at materially lower margin. I know the input cost is an issue, you talked about that in your MD&A, the input cost inflation, but that was also an issue in Q1. What's going on here to drive kind of that margin decrease quarter-over-quarter?

MURAD AL-KATIB:
Like you just said, I told you in the MD&A we had product availability constraints. We talked very clearly about the fact that the pasta volumes were up. When you're commissioning a pasta line, you produce and you stop, you produce, you stop. You're commissioning a large line.

Many of you as analysts have been to our production facility. A pasta production facility that's producing in the range of 5.5 tonnes per every hour of production, you get what you would call second-quality product when you're producing and commissioning. So, that second-quality product would have been sold into food-aid markets, would have been sold into Africa. This is a normal part of commissioning. So, now, you know, when that product is now running on a full-time basis, we're producing into our regular markets, we should see margins improving.

But, you know, again, I think that what we have to do is focus on the positive. The positive is sales are there, right? Our production systems are functioning appropriately; we think margins are going to improve. We think that sequentially we should start to see improvements, and we think that 48% of our earnings coming out of that segment provides us with a strong base in which to weather the storm in our pulse business. We think, overall, it's a great result and we're optimistic that the food Ingredients segment is going continue to be a good, strong growth in balance for us as we go forward.

KYLE MCPHEE:
Okay, thanks for that, that makes sense, and then really quick, your corporate eliminations line items, revenue and volume was down in a big way in Q2. What's going on there? Can you just quickly remind us what's feeding those numbers?

MURAD AL-KATIB:
Corporate eliminations are just tonnes that are shipped from one company to another. They have to be eliminated. It just shows on a seasonal flow, we don't ship a lot of product from Canada to Turkey during the Q2 period because Turkey is harvesting. So, those numbers down is a normal seasonal side. We just have less inter-company shipments, which leads to less inter-corporate eliminations. That's just a balancing thing on revenue recognition.

OPERATOR:
Thank you. Our next question is from John Chu with Laurentian Bank Securities. Please proceed with your question.

JOHN CHU:
Hi, Murad. I just had two follow-up questions here. Do you have a utilization rate for the Pulses and Grains Processing segment?

MURAD AL-KATIB:
Yes, we're running right around 51%, or so, John, so it was very constrained. On our pulses side, this was about as low as utilization has got, even in the 2011 period. When the sun's not shining, we still have to make hay. We maintained our plants, we did our

scheduled maintenance shutdowns, and when demand resumes we're ready to roll. That's what you do in a time where you've got some low utilization.

JOHN CHU:

Okay, and then the follow-up question is, on the Pulse Ingredients side, we keep seeing new data coming out showing more new products coming out that have pulse ingredients in them, and you mentioned in your MD&A that the pace of ingredient option is expected to increase in the back half of this year and 2018. So I'm curious, when you say that, are you saying that your adoption should be increasing at a similar rate or should we start to see it accelerate based on all these new products in North America and globally that are coming out now?

MURAD AL-KATIB:

John, I don't know what data you're looking at, but I can tell you that this business—you know, I characterized it to somebody recently like it's like a freight train. You've got to get a lot of power to get it rolling along, but once it's rolling, it's hard to stop the train. From that perspective, we've put a tremendous amount of dollars into R&D, application development, product development, process development, construction, engineering and production facilities, and now we're going to start to see the pace of adoption increasing. I would like to think that we, as a first mover, will probably accelerate above the trend. I mean that's obviously what you want to do when you're that first mover.

OMER AL-KATIB:

Thanks a lot, Murad. That brings us to the end of our time allotted for questions in the session. I'd like to thank all of you for joining us on the call this morning. I'd like to remind anyone still on the call that if you have any follow-up questions, you can feel free to contact us at our Regina head office and we'd be more than happy to follow up with you. Again, thanks for attending the AGT Foods Conference Call this morning and I wish you all a good day.

OPERATOR:

Thank you. Today's conference call has concluded. You may disconnect your lines at this time. Thank you.