CUI Global, Inc. Q1 2018 Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CUI Global First Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the conference over to Sanjay Hurry, Investor Relations. You may begin.

Sanjay Hurry – *Investor Relations Counsel*

Thank you, Nicole. Good morning, and welcome to CUI Global's First Quarter 2018 Results Conference Call. A copy of the company's earnings press release and accompanying PowerPoint presentation to this call are available for download on the Events & Presentations page of the Investor Relations section of the CUI Global website. With us on the call today are: William Clough, President and Chief Executive Officer; and Daniel Ford, Chief Financial Officer.

The purpose of today's call is to review the company's (technical difficulty) and to provide you with management's perspective on the balance of fiscal 2018. Following management's remarks, the call will be open to question and answers. A telephonic replay of this call will be made available until May 22. You may also access the archived webcast and the accompanying PowerPoint at any time on the Investor Relations section of the CUI Global website.

As a reminder, this call will contain certain forward-looking statements made within the meaning of Section 27A of the Securities Act of 1933 as amended and Section 21E of the Securities and Exchange Act of 1934 as amended. Such statements are subject to risks and uncertainties that could cause actual results to vary materially from those projected in the forward-looking statements. The company may experience significant fluctuations in future operating results, due to a number of economic, competitive and other factors, including among others, the company's reliance on third-party manufacturers and suppliers, government agency budgetary and political constraints, new or increased competition, changes in market demand and the performance or liability of its products. These factors and others could cause operating results to vary significantly from those in prior periods and to those projected in forward-looking statements. Additional information with respect to these and other factors, which could materially affect the company and its operations, are included in certain forms the company has filed with the Securities and Exchange Commission.

Before starting the call, be advised that management will attend the B. Riley FBR Annual Institutional Investor Conference on May 23 and 24 in Santa Monica and the Craig-Hallum 15th Annual Institutional Investor Conference on May 30 in Minneapolis. Management is available to meet with investors at both conferences. Schedule a one-on-one with management, please contact either a B. Riley FBR or a Craig-Hallum representative.

With that, I'd like to hand the call over to William Clough, Chief Executive Officer. Good morning, Bill.

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Thank you, Sanjay. Good morning, everyone, and thank you for joining us on our fiscal first quarter 2018 results conference call. I'll begin this morning with a brief overview of our performance for the quarter, after which Dan will review our financial results in greater detail. Following Dan's remarks, I will conclude the call with commentary on the momentum we see and our pipeline of opportunities across both Power and Electromechanical and the Energy segments.

To begin, we are very pleased to report higher revenues year-over-year in the first quarter in both of our business segments. We attribute our performance to strong execution across all facets of our business, as we leverage our industry-disrupting technologies to drive topline growth.

Revenues for the quarter reflect continued strength in our Power and Electromechanical segment and growth in our Energy segment as business development activity in prior quarters and the opening of our new larger facility in Houston begin to bear fruit.

As Dan will discuss in his prepared remarks, net loss for the quarter includes an approximate $900,000 royalty payment to Virtual Power Systems, included in cost of revenues. To remind you, royalties to VPS decreased considerably after the first $1.4 million in revenues of ICE Technology products. Therefore, future ICE orders will contribute significantly more to future profits.

Our performance for the quarter also demonstrates execution of our strategy to broaden our base of business and diversify our revenue streams. In our Power and Electromechanical business, we have been moving to expand our market footprint with the addition of new distributors, including Master Electronics, which began in quarter 1 and increase our direct sales business through new design wins and new product introductions to give us a strong foundation for long-term growth.

In our Energy segment, we continued to focus on seeding the market with customers that can scale their orders as their confidence in our innovative gas products builds. I'm very pleased to report that our efforts have yielded a record consolidated backlog of $43.8 million at the quarter end or $11 million higher than at year-end.

I would note that strength in our backlog is broad based across both our business segments and without the benefit of any new orders from our Italian contract.

In our Power and Electromechanical segment, revenues were up approximately 25% due to steps taken during the industry's downturn years to position us for the industry's upturn. Revenue growth in the quarter was driven by increased turnover through our distributors and continued sales to our direct customer base, including the first revenues associated with the ICE Switch order announced in 2017.

As I mentioned, we added Master Electronics, one of largest global distributors of electronic components, to broaden our market footprint and put our product catalog in front of many new potential customers.

Growth in our direct sales channel has been driven by our broad product line as well as the ICE product offering. We delivered our inaugural ICE Switch order in the quarter and also secured our first ICE Block order, a $2.9 million order with a channel partner who is extensively testing the solution over the past 18 months. This order is expected to deliver late this year.

Industry awareness of our ICE Technology continues to grow as we move to promote this disruptive technology in the marketplace following the receipt of UL certifications. In March, we and VPS presented our ICE platform at Data Center World Expo within our integration partner, Sanmina's booth. And I am pleased to report that the attendees' interest in the technology was quite high. Power and Electromechanical backlog was a very strong $26.1 million at March 31, up from $20.2 million at December 31.

Turning to our Energy segment. Energy revenues increased approximately 18% year-over-year due to higher revenue from our Orbital Gas Systems North American subsidiary. With its new larger facility in Houston, Orbital North America is effectively competing for large dollar integration opportunities in this region and we saw that during the quarter. We secured a $2.1 million sole-source integration project with an EPC company because of our larger facility and because we have established a reputation for outstanding customer service and technical excellence in the industry. We also won this project because we can offer the customer turnkey solution that engineers our Energy products into our integration solutions. No competitor can match the scope of our joint offering or pricing.

For us, adding VE and GasPT systems the integration work create significantly incremental value and generates higher gross margins. Energy backlog at the quarter end was $17.7 million, up from $12.6 million at December 31.

Now let me turn the call over to Dan Ford, our CFO, who will take through our financial results in greater detail. Dan?

Daniel N. Ford - *CUI Global, Inc. - CFO*

Thank you, Bill, and good morning, everyone. Before I review our first quarter results, I want to bring to your attention that CUI Global has adopted a new revenue accounting standard known as ASC Topic 606 for fiscal 2018. These new revenue rules are now GAAP for the company. The financials I present for our first quarter today and those that are found in the associated PowerPoint presentation to this call are based on these new revenue rules unless otherwise stated. Please keep in mind that our financial results for the first quarter, under the new revenue rules, are not directly comparable to those of the year-ago period that reported under the old revenue rules, ASC Topic 605.

We utilized the modified retrospective transition method upon adoption of the new revenue rules. Under this transition method, rather than recast prior periods, we are required to report our 2018 financial results on ASC 606 basis. So alongside our new GAAP and to give you an apples-to-apples comparison, we are also providing for your convenience what our first quarter results for 2018 would have been as reported under the old revenue rules. The financial results presented under the old revenue rules are directly comparable to 2017 and can also be found in the PowerPoint presentation.

We expect the ongoing impact to be the option of the new standard to primarily effect the timing of revenue recognition. I refer you to note 2 of our condensed consolidated financial statements found in our Form 10-Q filed a short while ago, for a detailed explanation of revenue recognition, under both the old and new rules. But to summarize, the cumulative effect adjustment recorded as of January 1, 2018, was a net of $1.9 million decrease to a cumulative deficit due to a $2.8 million transition adjustment from the Power and Electromechanical segment, partially offset by a negative $900,000 transition adjustment from the Energy segment.

Turning to our consolidated results for the quarter. Total revenue was $22 million, an increase of 23% from $17.8 million for the first quarter of 2017, reflecting a $3.4 million increase in revenues from the Power and Electromechanical segment and a $764,000 increase in revenue in our Energy segment.

In comparison, under the old rules for direct comparison against our Q1 2017 results, total revenue for Q1 2018 would have been $21.7 million. The variance in total revenue for Q1, between the news and old rules, is $262,000 and is primarily attributable to the timing of revenue recognized on Energy segment contracts.

Largely as a result of higher contribution from our lower margin integration business with our Energy segment, consolidated gross profit margin was 190 basis points below last year at 29.9%, although consolidated gross profit was higher at $6.6 million.

This quarter, as Bill mentioned, we also incurred an approximately $900,000 royalty expense to Virtual Power Systems that is included in cost of revenues. Under our agreement with Virtual Power System, CUI incurs royalty expenses on sales of our ICE products with the royalty rate highest on the first $1.4 million of ICE product revenues and this expense decreases considerably on future revenues.

In comparison under the old rules, gross profit for the first quarter would have been $6 million, a variance of $619,000. This is primarily attributable to the timing of cost recorded on Energy segment contracts.

Consolidated selling, general and administrative expenses for the first quarter were $9.2 million, an increase of $600,000 or 8% compared to the prior year Q1, reflecting increased costs in both of our business segments just for higher sales as well as higher currency translation associated with expenses in the U.K.

While SG&A expenses increased in absolute dollar terms, as a percentage of revenue, SG&A declined to 42% of revenue for the quarter. We expect to realize cost savings over the balance of 2018 from various measures applied in 2017. Adjusted EBITDA loss for the first quarter was $2.7 million, a decrease of $500,000 from last year.

Turning to our segment revenue and gross margin. I'll start with our Power and Electromechanical segment. Revenue for the quarter -- revenues for the quarter were $17 million compared to $13.7 million last year, an increase of approximately 25%. On a sequential basis, Power and Electromechanical segment revenues increased 7% from $15.9 million in Q4 2017, reflecting the continued strong ordering within the segment and their associate delivery as well as the shipment of our first material ICE product order, which was secured in the fourth quarter of last year.

We continue to benefit from the electronics market upcycle, the broader base of business we have established over the past several years with new distribution partners, such as with the addition of Master Electronics most recently as well as new design wins and new product introductions. The Power and Electromechanical segment has continued to see strong ordering through the first month of Q2 2018.

Gross profit for the first quarter was $5.2 million or 30.7%, a 140 basis point decline over last year's 32.1%, reflecting the previously discussed significant royalty expense paid related to the revenues of the ICE product order recognized in the first quarter.

Our Energy segment produced revenues of $4.9 million, an increase of $764,000 as compared to revenue of $4.2 million last year. This increase is primarily associated with higher revenue from our Houston facility and from higher exchange rates on the British pound, as pound has rebounded considerably from its fall -- from its initial fall after Brexit.

Revenues for the quarter were more heavily weighted toward lower margin integration projects. On a sequential basis, revenues for Energy segment declined 6% from $5.2 million in Q4 2017, reflecting the typical decrease we see annually in Q1 related to project delivery schedules. As a result, gross margin for the quarter fell to 27.3% from 31% last year. As a reminder, our Energy segment experiences improved margins when it sells more of its leading-technology solutions, including GasPT and VE sampling systems, which offset lower margin integration-type project work. As Bill noted, we are increasingly offering turnkey solutions to integrate our Energy projects into our project work, which will gene rate higher gross margins for us.

Consolidated backlog was $43.8 million at quarter end compared to $32.8 million at December 31, 2017. Backlog for the Power and Electromechanical segment was $26.1 million, an increase of $5.9 million compared to $20.2 million at December 31, 2017, reflecting the continued uptick in the power market as well as the inclusion of the $2.9 million ICE product order we received in the first quarter, which, as a reminder, we expect to deliver this order in late 2018.

Energy segment backlog at quarter end was $17.7 million compared to $12.6 million at December 31, 2017. Fee increase in Energy segment backlog reflects previously announced orders, including the Orbital U.K. order for $4.58 million to enhance fuel gas metering and compressor efficiency on a U.K. gas transmission network, the Orbital North America order for a $2.1 million sole-source integration project for a major U.S. Energy company as well as the recently announced VE Technology orders also at Orbital North America.

In terms of our balance sheet, we ended the quarter with cash and cash equivalents of $9.6 million and restricted cash of $523,000 for a total of $10.2 million in cash. This compares to $12.6 million as of December 31.

This concludes my prepared remarks. I will now turn the call back to Bill.

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Thank you, Dan. Looking ahead to the balance of the year, we remain focused on developing Energy sales opportunities that cre ate revenue optionality for us even as we continue to build demand in our Power and Electromechanical segment.

Let me take you through each segment in turn and some of the key opportunities we are pursuing. Our pipeline of potential Energy product sales, both GasPT and VE Technologies, continues to expand as major energy companies come to understand the value proposition of these industry disrupting products. Our GasPT analyzer, in particular, takes us to very large market opportunities where we have little or no competition.

We are cultivating new GasPT opportunities across the U.K., Western Europe and North America. In the U.K., Ofgem's recent certification of GasPT opens up that entire market to our solution for biomethane, low-pressure off-takes and high-pressure intake applications as well as for the Future Billing Methodology project.

This certification is timely as Ofgem is incented to put a fiscal monitoring application like ours in the hands of the industry that is more efficient, cost effective and gives users better accuracy throughout the gas distribution system than gas chromatographs. At a time when Energy providers are moving to take advantage of a government subsidy program to build biomethane terminals, Ofgem certification holds the potential to catalyze GasPT sales in the U.K.

The economics of replacing a $250,000 gas chromatograph that needs $8,000 to $10,000 a year in maintenance gas annually with a much less expensive GasPT appeals to all parties, including our competitors who currently utilize gas chromatographs and have approached us to buy GasPTs to include in their integration solutions.

Given our price and technology advantage, we can capture both the product sale and the integration work for the biomethane integrated skids necessary for these terminals. They are currently more than 100 biomethane terminals on the drawing board in the U.K. alone. In the 2 weeks since we secured certification, we have seen an influx of sales opportunities.

To get in front of the decision-makers for this build outs, on May 10, this Thursday, we will be hosting a workshop at our Orbital facility in the U.K. that will be attended by all major gas network companies in the U.K. as well as biomethane producers to help them become more familiar with the GasPT device. In addition, last Wednesday, May 2, we attended and presented our newly certified GasPT device to one of the largest gatherings of the gas-to-grid industry in Europe, the UK Biomethane Day 2018 in Birmingham.

I think it is fair to say that everyone who knew of the GasPT technology were also aware that we have secure certification. Presentations by conference participants also confirmed that the regulatory, statutory and CapEx environments in Europe are driving towards an acceleration in the pace of adoption of renewable sources of Energy.

Biogas is a central figure in this fundamental change in Energy policy, and we believe that it will serve as a tailwind for our Energy business. In Western Europe, we are finalizing a distributorship with an extremely large, well-known German supplier of components for the utility industry. This relationship will complement our direct sales force efforts to the national or large energy producers with a focus on a very broad array of low-volume opportunities that are large uses of natural gas such as glass, ceramic and steel manufacturers. Further, this well-respected German manufacturer and distributer, with facilities throughout Western Europe, Russia, the other Commonwealth of Independent States and China, anticipates opening up new and broader markets for our entire Energy project -- product line.

Staying in Europe. We remain at a standstill regarding our Italy contract. Because no government has been forming at least since the March general election, the regulatory body has been unable to move forward on (inaudible) to consolidate ownership and/or management of all major off-takes on the Italian network. We expect to remain in a holding pattern at least until a new government is formed.

In France, with ENGIE, we await the order of 1,000 GasPT order for biomethane applications, an award for which we have already been spec'ed in.

In North America, we are pursuing a dual-pronged approach to GasPT sales: as a process control application and as a fiscal monitoring solution. Let me touch on process control first. We received a repeat order for our GasPTi device from a leading power and energy producer. This is their fourth order and a rollout that we believe will ultimately extend to their entire fleet, numbering about 400 in total. This customer is implementing GasPTi as they conduct retrofits on their fleet. So while we anticipate no single large purchase order to cover their requirements, we expect the ultimate deployment number to be sizable.

I'm also pleased to report we are seeing forward progress with the global turbine manufacture that represents our most advanced process control opportunity to date. Their new budget year starts in June, when we have been assured that their back and focused on completing their certification process. As a reminder, certification will enable GasPT to be added to the build materials on their new turbines and allow us to sell into their retrofit market for turbines already in the field.

As a fiscal monitoring solution, I have noted on past investor calls we were engaged on a sales cycle with a major gas transporter. We remain fully engaged with its team and have 2 units ready for testing and a few locations now identified. We anticipate that they will finalize testing sometime this year.

Turning to our VE Technology. We are building demand for our VE probes and thermowells throughout North America. Last week, we announced new orders with several Fortune 100 Energy companies that serve as important industry validation and should build further interest and demand in our VE sampling solutions.

And finally, regarding our Power and Electromechanical business, we see continued strong interest in the ICE platform from perspective customers. Our focus this year is on completing proof-of-concept programs with large customers and building a book of orders that will convert into revenues next year.

I hope my prepared remarks have given you a sense of the growing momentum in our business, already making itself apparent in our quarterly results and especially in our backlog.

We expect continued strong performance in our Power business with our ICE platform, direct sales efforts, new product introductions and distribution channel serving as key drivers of growth in our Power and Electromechanical segment.

Our Energy segment offers significant revenue optionality, even as we await a restart to our largest GasPT contract.

With our industry disrupting solutions across both segments of our business, together with the business development foundation and the base of business we have built, we are on the path to ensuring our long-term success.

This concludes my prepared remarks. Operator, please open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Eric Stine of Craig-Hallum.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Maybe just for GasPT process control. Can you just talk about the -- you mentioned, the large turbine manufacturer and imminent restart. Maybe just some thoughts on why that kind of pause? Because I know you're engaged in testing. You had to go back and replace -- I think, it was something like 1,000 or 2,000 hours of that. So may be just what happened there? And then the confidence that you have, that you do see a restart and that there is commitment to doing that on the other end?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, without getting into too much detail, Eric, that was internal complication within their organization. They had a great deal of turmoil going on. They had some restructuring and things happening there that we had no control over. So that's really what happened. And they are -- they have now assured us that they are back in place. The people who were staying are staying. And that they are very committed to the device and to the project. They like the device. It's obviously cheaper, faster, uses less real estate and so it's just a matter of them getting back into the groove of doing their certification, but it was internal. They have -- it had nothing to do with us.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. And in the testing timing, is there -- I mean, any -- and maybe you're not getting this color from them given their process, but any timing? I mean, does it still need some additional testing hours? Or it's more internal as far as their process?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

I will have -- I have team there next week and I'll probably know more then. But frankly, I think there is a combination of both. There are some internal issues that they had that they've got straighten out now and I think there are some hours that they need to rerun it simply because of the wrong gas that was put through it for a period of time.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Got it. All right. May be just turning to Orbital North America. Just -- I mean, you had that new facility open for a little bit here. I mean, how should we think about you going to market? Is it going to be more to EPC firms? Is it more direct to the customer? Maybe it's a little bit of both, but just any thoughts on what -- how the pipeline has expanded? And how you expect that to play out throughout 2018?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, we're expanding quite dramatically in both areas, both EPCs and with direct-to-customer sales. And I think, the reason for that is because it's such a -- it's a -- first of all, it's a very beautiful modern, big facility, which has crane access, which we didn't have before. We also opened it up in late December, had an open house day, where we had several hundred participants come in and view it. And we've seen orders start to pile up from that. We're also seeing excitingly big companies like the Fortune 100 Energy companies coming in and doing vendors audits and certifying us as vendors, which we could not have done in the other facility. So I think as the year progresses, we're going to see more and more orders coming through there. And I think they're going to be, like I say, both the EPCs and direct-to-customers.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Got it. Last one from me. Just in terms of the orders and backlog, I mean, anything -- has that changed given that it's grown in size in terms of being over the next 12 months versus long-term? Anyway we should think about that differently than may be in the past?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

No, I think you -- well, Dan, you want to take that?

Daniel N. Ford - *CUI Global, Inc. - CFO*

Yes, no change in technology mix. No long-term [inaudible] really in there. We expect it all to be 12 months or less with similar turnover periods to what we've historically done, so.

Operator

Our next question comes from Rob Brown of Lake Street Capital.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

On the ENGIE order or ENGIE project, what's your latest thinking on the timeline there? And how that's progressing?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

We have no real visibility of that. It's a contract that was, the tender closed, I believe, last July. Generally speaking, it's anywhere from 3 to 6 months for them to issue a contract. They have not done that yet. There are no reasons that I know of, at least nothing that we're seeing where they have an issue. Yet, they still are very committed to biomethane gas. And we're not part of the contract bidding. We're not -- there are 4 participants in the contract, but we've been spec'ed in. They're going to be using one of our devices for part of the measurement system once it's awarded. So I -- we don't have any visibility other than the fact that the contract is out there waiting to be awarded.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. Okay, got it. Good. And then -- and I guess, maybe the same question on Ofgem certification. I know that gives you an opening to the market. But what sort of the progress and how orders kind of start to flow there...

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

I think we're going to see -- yes, I think we're going to -- the first orders we'll see and I think we'll see them in the next several weeks is biomethane terminals in the U.K. that are starting to get planned and developed. There are 100 -- I think, around 100 to 120 of these units that are planned to be underwritten by the government, almost without exception. All of these are going to use GasPTs because, obviously, that's why the certification was given. And I think we're going to be able to grab a lot of those simply because we own the GasPT technology. We have been approached by competitors who are offering -- or want to offer the GasPT and we are allowing that to occur. Obviously, we want to sell the products as well, but equally as obvious is the fact that our pricing, since we own the technology, is much better than their pricing. So in a competitive bid, we feel we have a leg up. So I think that's where you'll see the first initial impact. The second impact you'll see, I think, over the next probably 12 to 18 months is this Future Billing Methodology project. We've now have identified locations. We're going to set up for the field testing. And we're actually going to go active, go live later this year. I think, it's scheduled for September or in that time frame. And then, they're still focused, Ofgem and the U.K. government are still focused on beginning to roll out the Future Billing Methodology sometime in late 2019 or early 2020. That's a huge opportunity for us. We had to have the certification from Ofgem both for the low pressure and for the fiscal monitoring, and we got that. So I think that's the other area you'll see some movement over the next couple of months.

Robert Duncan Brown - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, great. Good overview. And then last question on the ICE Block or the ICE Switch, what was the revenue in the quarter from that product? And I guess and -- yes, just go with that?

Daniel N. Ford - *CUI Global, Inc. - CFO*

No problem. The revenue was just right around $1 million for the quarter from ICE.

Operator

Our next question comes from the line of Liam Burke of B. Riley.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Bill, first quarter you had a product mix in Energy that held back gross margins. How do you anticipate within backlog some of that lower-margin product working through, will it be this year or do you have some longer projects and lower-margin products in that backlog?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, a lot of that backlog is in the lower-margin integration work. Frankly, we will see the -- I think, the larger -- higher-margin product when we see the bigger projects across Europe with the -- that are pure product based. Italy is a good example of that. That's a pure product-based sale. We're not doing any integration. We're simply delivering to them GasPTs and the associated material that goes with that. Those are going to be the highest margin and those are still pending. I think right now, our biggest part of that backlog is the lower-margin integration work.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. Now within that you've mentioned integrating the GasPT and VE. Are you going to see any less sequentially with those products this year?

Or do you still have maybe typical integration work?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

We have both. There is a mixture of both, but the advantage we have is that now -- especially now in Europe that the GasPT is certified for low-pressure off-takes, we can include that in much more of our integration projects. But we still have both, we have traditional integration without our new products and new product with integration as well.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And then, you announced the new distribution agreement. How does that help on the ICE side of the product sales? Or is ICE primarily going to be an end user sale?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, ICE is not going through distribution at all. It's actually a joint sale process between us and VPS and our channel partners. So that [new distribution agreement with] Master Electronics will not affect ICE at all.

Operator

Our next question comes from the line of Jon Fisher of Dougherty & Company.

Jon Michael Fisher - *Dougherty & Company LLC, Research Division - Senior Research Analyst of Industrials*

Question on the new Houston facility. How would you expect capacity utilization at that facility to exit this year?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

I'm not sure what you're looking for in that question. I can tell you that right now if you go to that facility, it's at a 100% usage. It's filled up with -- I think, there are 6 or 8 very large, like, mobile home-size kiosks and then there is 17 smaller kiosks that are being worked on as people have extra time. So it's fully loaded now. And from looking at the backlog, which increased dramatically quarter-over-quarter, we think for the foreseeable future, it's going to be full up.

Jon Michael Fisher - *Dougherty & Company LLC, Research Division - Senior Research Analyst of Industrials*

So the expansion in and of itself for the facility is not a drag on gross margins for the Energy segment because it's being underutilized due to lack of more revenues from the Energy segment?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

No, it's definitely not being underutilized. In fact, we're seeing it grow. And we've actually been approached by one large company that is asking us to extend the size of that building, actually build a bigger building, so that they can give us multiple projects at the same time. So no, I can tell you -- I can assure that it's actually being used and used quite efficiently.

Jon Michael Fisher - *Dougherty & Company LLC, Research Division - Senior Research Analyst of Industrials*

Okay. And then, SG&A, we saw the absolute number and it was referenced also as a percent of revenues. Just going forward, how should we think about SG&A? Should we think about it from a Q1 reference standpoint more in the absolute spend sense that we saw in this quarter? Or should we think of it more as a percent of revenue sense that we saw in Q1 going forward?

Daniel N. Ford - *CUI Global, Inc. - CFO*

I would say it's going to be between $8.5 million and $9 million a quarter. Some of that is going to be impacted by what the exchange rates are for our U.K. operations, but it's going to be between $8.5 million and $9 million a quarter.

Operator

Our next question comes from the line of Jeff Bernstein of Cowen.

Jeffrey M. Bernstein

Just a couple of questions for you. On the turbine OEM, do you already have the aftermarket sort of hunting license in place?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Hey, we're already there. I'd say right now, we've already made presentations and we are really just awaiting permission certification. We are more than ready to jump into that market, especially in North America, I can say right now, we've contacted a number of big turbine operators and all we're waiting for is that permission.

Jeffrey M. Bernstein

Got you. Okay. So you still are constrained. You are not actually able to make sales there yet?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Well, the question generally comes up, do you have certification from this [OEM turbine manufacturer]. And once we get it, they are ready to go.

Jeffrey M. Bernstein

Got you. Okay. Okay, that's great. And then, just update on the Canadian pipeline operator. What's going on there?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

That's what we talked about with the -- addressing the test. We've got identified locations now that we've got the product ready to go out. It's just a matter of them [getting their ability] to install. So we're ready to move.

Jeffrey M. Bernstein

And so about how long do you think that whole process will take for them?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

It's a 3- to 6-month task, with Measurement Canada on board. So they've already got their certification ready to move, since we have a device out on an active pipeline. So I think it will be somewhere between 3 and 6 months. We expect it to occur next year.

Daniel N. Ford - *CUI Global, Inc. - CFO*

And they [the Canadian pipeline operator] have seen it [GasPT] in lab environments already, so they are familiar with how everything works and are pleased with it. They just have to do the field version of that now. So it's moving in the right direction.

Jeffrey M. Bernstein

Understood. Okay. And then, you mentioned, I think, the U.S. gas processing company -- you had your fourth order. You said, they're retrofitting a fleet of these systems, I guess. Is -- was the number 40?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

400. They have a total need for 400 units.

Jeffrey M. Bernstein

400? Got you.

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes.

Jeffrey M. Bernstein

Okay. Got you. And so you think that will be sort of stretched out over a period of years or whatever?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, I think that's 2-, maybe 3-year project for them.

Jeffrey M. Bernstein

Got you. Okay. And so this is just the first guy. That's big industry with a lot of units. What's -- what else are you seeing out there?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

We're pushing forward. They're actually -- while that we can't use them publicly, they are acting as a reference for us. So we are approaching other large-scale compressor companies. And they are working with the group that's already using it to get data. So we think there will be sales as time goes on because, again, they are acting as a reference customer for us.

Jeffrey M. Bernstein

That's great. And then, any kind of update on ethylene or LNG? I know there is supposed to be another round of ethylene plants that are planned down for the Gulf Coast now?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Yes, we have got a second order. We announced that earlier this year. We did get a second order. I think, it was $2.1 million. So while we haven't received any formal results back, they haven't shared any results with us. They are ordering again. We also have been certified now with our new facility as a preferred vendor for them. So I think those will wrap up as time goes on. So we have -- we've done about 4 million -- a little over $4 million with the business with that customer on 2 of their plants. They have some, I think, 50 or 54 worldwide. So we have -- there is a huge opportunity there, and I think they're going to move forward.

Daniel N. Ford - *CUI Global, Inc. - CFO*

One of the big pushes from our open house was demonstrating the sampling systems. And with the several hundred guests that Bill mentioned earlier that were there, they got to see the VE sampling system working and actually providing feedback on mercury content in the live environment, not on a gas pipeline, but in a lab environment, which was very intriguing to them. So that's generated a lot more interest in quoting going out the door. So it's been a very busy environment down there.

Jeffrey M. Bernstein

Got you. Okay. And then, lastly, every month or so you read about another geography, India now, Korea, South Korea, [for] biogas. I guess, this is now the -- in thing on green energy. How do you see the whole fiscal piece developing, gas quality piece developing in these countries? Are they going to sort of copy Europe? Or how do you think this is going to happen?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Sure. I can tell you that we have presented the Future Billing Methodology through our Korean distributor and in Japan directly to Tokyo and Osaka Gas. And there all of them very interested in particular and this is very public information, so there is nothing new. Japan, over the next year, is talking about widening, broadening their CV envelope because historically Japan has never produced any natural resources of their own at all. Of course, they import everything. Well, they are contemplating -- beginning to produce biomethane in a large scale. And they're going to have to widen and broaden their CV envelope because of that and because of that they're going to need a Future Billing Methodology method of billing much more granularly. So we presented to them. There is interest there. Nothing that I can give any timing on, but I can say we're in front of them.

Daniel N. Ford - *CUI Global, Inc. - CFO*

So just a perspective though on the global opportunity, the U.K. National Grid just hosted essentially 'National Biomethane Gas Day', and it was a discussion about how to get the grid more energy efficient, more green. And their target is to go to 10% biomethane for just the U.K. alone. That's another 3,800 biomethane facilities. So the global opportunity for biomethane should everyone start to adopt is incredible.

Operator

(Operator Instructions) Our next question comes from the line of Mike Wallace of White Pine Capital.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

I just have a couple of questions here. Cash flow from ops for the quarter was negative $2.9 million. Presumably $900,000 of that or so was due to the payment -- the royalty payment in the PEM side. So excluding that, it would be about $2 million, receivables are up about $400,000 from December. Not sure quite how to think about that. But let's say, $2 million is sort of the burn rate of cash and ops for the quarter, how should we think about the cash flow from ops as we go through the rest of the year? And at what levels of margins and revenues do we need to get to, so that it turns positive?

Daniel N. Ford - *CUI Global, Inc. - CFO*

There is a lot in that question. We're expecting to burn cash through Q2. We're looking to start generating cash in the second half of the year. I don't expect it to be a dramatic cash generator in the second half of the year, but we do expect to return to positive in the second half of the year from ops from a cash generation standpoint. We are working to manage all those balance sheet items that are sources or uses of cash as effectively as can be done while growing the business. Margins, particularly the GasPT restarting in Italy, will have a tremendous impact initially on AR going up. But given the terms that we have with the customer, that will turn into cash quite rapidly. 60 to 90 days is what they paid the last orders. So we see that really improving the cash flow from operations. But obviously, the higher margin -- the higher gross margins that we can get to on sales, the better off it will be.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

Is the burn rate for Q2 going to be similar to Q1, Dan, do you think or lower?

Daniel N. Ford - *CUI Global, Inc. - CFO*

I would say, it will probably be very similar.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

And so how do you feel about the amount of cash in terms of funding AR for second half assuming Italy and some of these other gas projects starts to come in?

Daniel N. Ford - *CUI Global, Inc. - CFO*

We're in a good spot. We still have our line of credit. That's $4 million line of credit with Wells Fargo. We got enough cash to get us through there. When we did our raise last year, we did take a look out, "Okay, what are we going to need to get through this period." We did some worst-case scenarios on timing, and we believe we're very adequately positioned for cash.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

It's possible for the year we can be cash flow positive?

Daniel N. Ford - *CUI Global, Inc. - CFO*

I don't think for the full year, no. But I think the second half of the year is turning to positivity and that will be an ongoing go-forward position.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

That will be the turning point second half of the year, yes?

Daniel N. Ford - *CUI Global, Inc. - CFO*

That's what the company is looking for.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

Okay. And then, well, how should we think about gross margins on the PEM business, now that, that one big payment [has been] made going forward?

Daniel N. Ford - *CUI Global, Inc. - CFO*

Yes. So I would say, it's going to go up into the mid-30s for this next quarter is where I would expect it to be, if not, slightly higher than that. And then, as we continue through the year, it should go back up into the higher 30s.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

Okay. So it could be 30 to 35 to 40 by year-end?

Daniel N. Ford - *CUI Global, Inc. - CFO*

Yes.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

And then in terms of Energy 27.3%, we can -- what can we do to get that north of 30%? Is there anything we can do cost wise and things by year-end, excluding any PT orders and things, just the base business?

Daniel N. Ford - *CUI Global, Inc. - CFO*

It's really about winning higher margin business. And some of that comes down to what products we're able to put into it based on what the customer is requiring. So that customer often time specs in what they want in the device and we do the engineering around that. But we are pushing to put more of our technologies in whenever we possibly can and that definitely increases our margins. So that's what we're working towards. Especially in the U.K., we're looking at a lot of biogas opportunities, where we would be just using our GasPT devices and no chromatograph. So we see that as a huge opportunity to helping with margins.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

So reading between the lines there, 27.3% is probably the bottom. From here, we go up?

Daniel N. Ford - *CUI Global, Inc. - CFO*

It's a fair statement.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

And then, Bill, just some thoughts on Italy, what are you hearing up there? And can you give us some...

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Very little. The bottom line is that it’s out of everybody’s control right now. I can't tell you that regulatory-wise if they have not set up a government by -- I believe its May 20, it's 70 days after the election then they have another election. So the bottom line is they're going to have to move forward at some level. They do need a government. They don't have one at this point. And frankly, if you read The Wall Street Journal and some of the other magazines that are commenting on it, there is 3 very large egos involved in this and none of them will give anybody else the prime ministership. And that's what it’s coming down to, and that's what it's sort of coming down to. So I think we have to, along with everybody else in Italy, sit and wait for either these guys to get their act together or for there be another general election, where hopefully somebody wins. I think it's 60% they have to win that -- to actually be the government, and we'll see what happens. But I think that has to occur on or before May 20.

Michael Scott Wallace - *White Pine Capital, LLC - CIO, Managing Partner, Principal and Portfolio Manager*

Yes, that's right too. So we should see something either reconciliation of the power there or they're going to go to another general election process that probably take about another month to conclude. Would that be seen reasonable?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Gosh, Mike, you're asking me something I couldn't answer. It's something we [couldn't] answer that seriously. I'd love to tell you a month, I just don't know.

Operator

Our next question comes from the line of Jon Fisher of Dougherty & Company.

Jon Michael Fisher - *Dougherty & Company LLC, Research Division - Senior Research Analyst of Industrials*

Just a quick follow-up on the PEM gross margin discussion and talking about high 30s margins as we exit this year. Haven't seen those types of margin since going back to 2015. Just wondering if that's driven entirely by the benefits from ICE? Or if there are other things going on in PEM that are -- or would be contributing to gross margin performance at that level?

Daniel N. Ford - *CUI Global, Inc. - CFO*

The roundabout answer is yes, ICE plays a large factor in that. But the way ICE plays a factor in that is by increasing the utilization of our Canadian facility, which is entirely a production facility. So when that production facility is busier, it's more efficient, spreading the cost -- the fixed cost of that facility out over more production. So that will be a dramatic improvement. But backlog is increasing across the spectrum of our product line as well as is increasing the margin as well.

Operator

(Operator Instructions) Our next question comes from the line of Orin Hirschman of AIGH Investment Partners.

Orin Hirschman

Just a question putting together 2 prior questions or few prior questions. With the margin improvements coming, it sounds like they start already -- it's coming in the second quarter. Why would the cash -- negative cash be similar to this past quarter and not so much from level of improvement. They have to do with the working capital?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

So I'm going to say first and foremost, we don't forecast. So I think, Dan said it will be similar. I'm not going to pin that down. Things are improving as we go forward. We believe the second half of the year will be breakeven or maybe slightly cash flow positive. But again, I think I'm going to hesitate to comment much more. We don't give forecast. We don't -- we just don't do that. So again, I don't want to really get into what the second quarter looks like. This is about the first quarter.

Orin Hirschman

Okay. The huge jump in backlog, which obviously is encouraging. Is it less relevant to the near-term quarters? Meaning, it's very long-term backlog? Or is it relevant throughout the year?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

No, it's relevant throughout the year. This was a broad-based increase in business on both segments. And it is -- not much of it is long term. Frankly, it's mostly standard backlog. We say that the backlog in the Energy division is something around 9 months. And the backlog in the electronics division is generally around -- somewhere between 90 and 120 days. So again, it's that type of -- it certainly revenue and business will be seen this year.

Orin Hirschman

And does that give you a much better visibility for the next 3 quarters?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

It starts giving us more visibility. Yes, it does.

Orin Hirschman

Okay. And just -- I know everybody has asked too many questions on Italy already, but I just wanted a recap from an earlier question much early in the call. In Italy, do you feel like you're going to have go through a retesting process? I wasn't clear on that.

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Absolutely not. I can tell that from the perspective of the customer, we are ready to go. They are ready to go. They have roughly 300-some-odd units that they are perfectly ready to install. We have a backlog of somewhere around 400 units. So we're perfectly ready to deliver. And the project is set, funded and ready to move forward. All we are waiting for is this regulatory approval, and that's being held up because there is no government. And that's simply what's happening. So no, there is no testing. No more certification. No more -- no -- we're just got -- in a holding pattern. And I can tell you that both -- I personally and my sales team and my engineering team -- in fact we have an engineering group over there next week talking about biomethane. But the bottom line is, in all regards every contact we've had has been very, very positive. They definitely are very interested in moving this forward. Because for them, it's revenues. It's increased revenues. And so they're as anxious to get going as we are.

Orin Hirschman

And just remind me again how many units they actually have in the field today?

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

Somewhere around 50.

Operator

And at this time, I'm showing no further questions. I'd like to hand the call back to William for any closing remarks.

William J. Clough - *CUI Global, Inc. - Chairman, CEO, President & General Counsel*

I just like to thank everybody for the time and attention. Again, we are pushing forward very hard on both sales and reducing costs. And I think over the next year, you're going to see some real improvements on both end. So again, thank you, everybody. And have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day