CUI Global Inc. Q1 2019 Earnings Conference Call - Transcript
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PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for your patience. Welcome to CUI Global's First Quarter 2019 Results Conference Call. (Operator Instructions) As a reminder, this conference may be recorded.

I would now like to turn the call over to your host, Sanjay Hurry, Investor Relations Counsel. Sir, you may begin.

Sanjay M. Hurry ***Investor Relations Counsel***

Thank you, operator. Good afternoon, and welcome to CUI Global's Transaction Discussion and First Quarter 2019 Results Conference Call. A copy of the company's earnings press release and accompanying PowerPoint presentation to the transaction 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 provide you with management's viewpoint on the transaction at hand and to review the company's financial results for the first quarter. 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 31. You may also access the archived webcast and 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 other things, 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 turning the call over to management, please note that both Bill and Dan will be in attendance at the 20th Annual B.Riley FBR Investor Conference on May 22. To schedule a one-on-one with management, please contact your B.Riley representative.

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

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

Thank you, Sanjay, and thank you, everyone, for joining us on our call this afternoon. It is fitting that, Dan Ford, our CFO, and I are hosting this call from our Orbital facility in Houston, the city that sits at the heart of the U.S. energy industry.

In concert with the publication of our first quarter financial results a short while ago, we announced a transformative development for the company, our intent to acquire 100% of the outstanding stock of 4 privately held companies for consideration consisting of cash, seller debt and CUI Global equity. The combined entity, which on today's call I will refer to as *Pro Forma* CUI, will be led by Jim O'Neil as its CEO. Jim is the former CEO of Quanta Services, a well-respected New York Stock Exchange-listed, mid-cap company focused on infrastructure solutions for the electric power, oil and natural gas, telecommunications and renewable industries. Over Jim's approximately 8-year tenure as Quanta's COO and then CEO, Quanta Services grew into a Fortune 500 enterprise, with about $8 billion in annual revenue at its peak through a combination of both organic growth and numerous strategic acquisitions.

For my part, I will remain in a leadership role as President and General Counsel, partnering with Jim to take CUI Global to the next level. With this proposed transaction, we are rebooting CUI Global and creating a diversified energy infrastructure services company that span the midstream and downstream energy companies and power and telecommunication infrastructure industries.

I will begin today's call with remarks on the strategic rationale for this transformative transaction and why I believe it is a truly win-win proposition for the company, our shareholders and our employees. I will also give a time line of next steps. Dan will then provide you with a review of our financial results and operational highlights for the first quarter, and we will open the call to your questions. We have Jim O'Neil with us today, and he will be available to answer questions as well.

Over the past several quarters, our Board of Directors and the management team and I have been assessing the growth strategies and market opportunities for our Power and Electromechanical and Energy segments with an eye towards unlocking the potential of our extensive portfolio of technologies and products and our engineering expertise.

In evaluating and acting on our opportunity-set, we have been guided by an unwavering commitment to improving shareholder value. Step One was acquiring 21.4% of Virtual Power Systems. As I discussed in our fourth quarter call, taking an equity stake in the category leader in Software Defined Power enables us to monetize growing adoption of VPS' platform far beyond power utilization to other areas within data centers while also continuing to supply ICE Switch and ICE Block to data center operators. This was a good outcome for our shareholders and maximally monetizes the strong relationship we have built with VPS for the long term.

Transforming CUI Global to the acquisition of 4 target companies and adding Jim O'Neil as CEO is Step Two of the transformation. The proposed transaction, and with Jim at the helm, positions us to capitalize on midstream and downstream energy companies' capital spending, estimated by the Oil and Gas Journal to be almost $190 billion this year, to meet the needs for new transportation, storage and processing assets along the Gulf Coast. This spend coincides with the U.S.' emergence as a top global exporter of oil and natural gas. To give you a better sense of the market opportunity ahead of us, capital expenditures for new oil and gas infrastructure development are expected to total an average of $791 billion from 2018 through 2035 in the U.S. and Canada according to a 2018 report by the Interstate Natural Gas Association for America. Midstream opportunities are expected to be plentiful.

The components of the transaction are as follows: the issuance of approximately 160 million shares of CUI Global stock; $30 million in cash; a $45 million 1-year unsecured sellers note; the assumption of $15 million of sellers outstanding secured debt; and an earnout payable over 5 years of up to $200 million depending on certain specific performance criteria. We expect to finance the cash contribution of this transaction through debt financing. We will be assisted in this transaction by our investment banking partner, B. Riley FBR.

Upon the close of the transaction, Pro Forma CUI will have aggregate revenues of $350 million and EBITDA of more than $40 million on a pro forma basis for 2019, of which CUI Global will contribute approximately 1/3 to the total revenue based on our 2018 results. And as a public company platform, Pro Forma CUI will be poised to embark on an aggressive acquisition strategy to implement Jim's vision and leverage his experience in aggregating and growing energy infrastructure services companies. This is step three.

Jim and I have already identified acquisition targets that will result in a company with about $1 billion in revenue and approximately $180 million in EBITDA on a pro forma basis within 18 months of closing the transaction we're announcing today. The pace of our strategy allows current CUI Global shareholders to realize improved near-term returns and the benefit from long-term valuation expansion.

Our proposed acquisition of the first 4 target companies will give us the scale with which to effectively compete in the energy infrastructure services market and immediate access to some of the largest energy producers in the world. The Gulf Coast sits at the intersection of natural gas production in North America and the insatiable demand for the fuel in East Asia and elsewhere in the form of liquefied natural gas. Currently, there are 9 LNG terminals approved for the Gulf Coast, an additional 11 with pending applications and a further 5 in application pre-filing.

As Pro Forma CUI, we are positioning the company to play a role in the construction of those terminals as well as a much broader scope of infrastructure needed to support the delivery of crude oil and oil products, natural gas and natural gas liquids, including surface and lease equipment, gathering and processing facilities, oil and gas pipelines, oil and gas storage facilities, refineries and oil products pipelines, including export terminals.

By way of example, according to the March 2019 edition of the Oil and Gas Journal, in 2019, spending in the North American gas and oil markets will include Exxon Mobil Corporation's 2019 capital budget of $30 billion, Chevron Corporation's CapEx budget for 2019 of $20 billion, ConocoPhillips' plan on average annual capital budget of $6.1 billion during 2019 and Anadarko Petroleum expecting to make capital investments ranging from $4.3 billion to $4.7 billion in 2019. In effect, as the energy market shifts toward greater production and demand for natural gas increases, we are in the right place at the right time.

I discussed in our fourth quarter conference call that our new and larger Orbital facility in Houston would be a key component of our North American go-to-market strategy in 2019 and beyond. With Orbital added to more vendor-approved lists, our growing reputation for technical and operational excellence with many of the largest oil and gas majors and their EPC and with expanded capacity at our new facility, we are already moving closer to where demand for engineering and integration services is at its highest. We are working on several large projects with Fortune 100 energy companies throughout the U.S. and building a pipeline in both volume and average contract size.

Concurrently, Jim was moving along a similar path to establish a beachhead and scale for his reentry into the energy services sector. We realized, that together, we could achieve complementary goals with CUI Global serving as a public platform and cornerstone to building a sizable and growing diversified energy services company.

As I said earlier in my prepared remarks, this is truly a win-win for our customers, suppliers, employees and shareholders. We can and will continue to service and expand our European and U.K. energy customers, including SNAM Rete Gas, National Grid, Cadent, ENGIE, SGN, Costain, Air Liquide and others. We can and will continue to develop and expand our distribution group, including DigiKey, Future, Arrow, Mouser and Master Electronics in the Power and Electromechanical division and SAMSON AG, Socrate and others in the Energy division. And we can and will dramatically grow our North American energy footprint through the acquisition of these 4 companies at an aggressive M&A strategy modeled after Jim O'Neil's very successful Quanta experience.

Turning to next steps, we expect to sign a definitive agreement on or before June 1, 2019, after which, we will file a proxy and call for a special shareholders meeting to approve the transaction. Our goal is to wrap up everything and complete this transaction toward the end of the third quarter. Upon completion of the transaction, CUI Global shareholders will own approximately 15% of the stock of the combined company.

I'll now ask Dan to review our financial performance and operational highlights for the first quarter. From my perspective, we are off to a good start to the year amid what is clearly a transformational event for the company. Dan?

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

Thank you, Bill. As Bill noted, we are off to a good start to the year.

Starting with our consolidated results for the first quarter, total revenue was $23 million compared to $22 million in the first quarter of 2018, reflecting gains in both the Power and Electromechanical and Energy segments. Power and Electromechanical revenue grew on higher direct sales, while sales for the distribution channel were down slightly. In our Energy segment, higher revenue from our Houston operation was partially offset by lower revenue from our U.K. operation.

Gross profit increased $1.1 million to $7.7 million from $6.6 million in the prior year period. Gross profit margin increased by 370 basis points to 33.6% from 29.9% due to favorable segment mix. Consolidated SG&A expenses increased fractionally to $9.6 million from $9.2 million in the year ago period and was due primarily to increased selling expenses in the Power and Electromechanical segment and higher professional fees in the other category. SG&A expenses as a percentage of revenue was essentially unchanged at approximately 42%. Adjusted EBIT loss for the first quarter narrowed to $2 million compared to a loss of $2.7 million in the year ago period.

Turning to our segment revenue and gross margin. I'll start with our Power and Electromechanical segment. We are pleased to see continued strength in our Power and Electromechanical segment with year-over-year growth in the first quarter in what is historically the first of a 2-quarter revenue trough for this segment. Revenues for the quarter were $17.6 million compared to $17 million in the year ago period, an increase of approximately 3%. We saw a continuation of strong order patterns into the quarter, including the highest distributor sales since 2014, with 0 cannibalism following the recent additions of Arrow Electronics and Master Electronics to our distributor base. We view this as a testament to the effective stewardship of our distribution partner strategy.

To date, segment gross profit was $6.5 million for a 37.3% gross profit percentage compared to $5.2 million or a 30.7% gross profit percentage for the first quarter of 2018, which included a significant royalty expense associated with the ICE Technology revenues.

Turning to our Energy segment, we generated revenue of $5.5 million in the quarter, an increase of 10% over the year ago period when we reported revenue of $5 million and reflects the timing of customer project schedules. As Bill stated, our Orbital operation in Houston is making excellent progress in securing certifications for approved vendor status to both EPC companies and directly with the energy majors. We are seeing opportunities that comprise both integration project work as well as energy product sales and at increasingly greater contract values. The pace of work has steadily increased, and floor capacity is nearing maximum.

Touching briefly on our energy products. We secured CSA certification for the GasPTi solution in the quarter. It is essential for selling this solution into Canada. With this certification in hand, we are progressing trials with the major transmission company we have referenced on prior calls. At the same time, we continue to pursue certification with Measurement de Canada.

VE Probe sales were a standout in the quarter and demonstrated diversification beyond our core customers. Sales in the quarter were 50% of what we recorded in all of 2018. We also launched our sales initiative into the burgeoning biomethane market in California that we discussed on last quarter's conference call, with 3 quotes submitted in the quarter.

In the U.K., we are sustaining our focus on the biomethane market while concurrently pursuing presales initiatives to position us ahead of CapEx spend by gas network operators there. We have a very healthy quote pipeline that speaks to both market interest and biomethane applications following the implementation of RHI scheme last year and understanding the market as a result of the competitive advantage our GasPT solution gives us.

We are seeing a very high level of interest in our recently introduced next-generation remote telemetry unit, or VIRTU, and we will soon be conducting field trials with gas operators, that upon its successful conclusion, will certify the unit for use by any gas operator in the U.K.

Energy segment gross profit declined approximately 560 basis points to 21.7% from 27.3% due to a higher contribution of lower-margin integration project work as is the case at our Orbital operations in Houston. As a reminder, gross margin in our Energy segment improves on the mix of its leading technology solutions, including GasPT and VE sampling systems, offsetting lower-margin integration-type project work.

Consolidated backlog was $33 million at quarter end compared to $37.5 million at December 31, 2018, reflecting declines in both segments due to timing of orders from distribution customers in the Power and Electromechanical segment and integration customers in the Energy segment. Backlog for the Power and Electromechanical segment was $19.6 million as compared to $21.8 million at December 31, 2018. The Energy segment backlog at quarter end was $13.4 million compared to $15.7 million at December 31, 2018.

In terms of our balance sheet, we ended the quarter with cash, cash equivalents and restricted cash of $1.3 million. This compares to $4.5 million as of December 31, 2018. Subsequent to the close of the quarter, we closed on our previously announced revolving line of credit facility of up to $10 million with Bank of America Merrill Lynch that doubles our borrowing capacity and at more favorable terms. We also acquired a 21.4% share in Virtual Power Systems, our partner in the ICE Technology and Software Defined Power. Our ownership stake will be accounted for as an equity method investment.

Looking ahead, with the publication of their March 31 results, many of our Power and Electromechanical segment peers have reported the beginnings of a market correction. We share their outlooks as well as their concern regarding additional tariffs placed on parts manufactured in China. We are working with our OEMs to power through what the industry expects to be a several-quarter correction. And while tariffs to date have been generally accepted into the pricing schemes of most manufacturers and distributors, we are seeking ways to work with our channel partners to mitigate the impact of additional tariffs. Point-of-sale order flow-through at our distributors remains on pace with 2018 levels and tells us that customers remain committed to using our products and solutions.

Design activity, which historically has been a leading indicator of future sales, is at a higher tempo than 2018. With an aggressive new product introduction pipeline slated for this year, we believe we can sustain this activity and potentially improve upon it.

Finally, subsequent to the close of the quarter, our global sales and marketing partnership with SAMSON AG began to bear fruit with the receipt of initial GasPT orders for an industrial application. Industrial use of our GasPT is an untapped market for us and one that complements our efforts alongside SAMSON AG in pursuing large gas network operators. These orders demonstrate SAMSON AG's ability to convert recent joint business development efforts into an exciting pipeline of opportunities. We are pleased with how this relationship has progressed.

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

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

Thanks, Dan. To summarize, we have charted an achievable and attractive path forward at an improved valuation for our shareholders that doesn't rely on uncertain and elongated pace of technology adoption and favorable government regulations that have come to define CUI Global over the past 3 years. This transaction gives us scale and industry-class leadership, with a differentiated value proposition to our market that is growing and is expected to continue to grow. At its core, the Board and I have always managed the company for opportunity, and this opportunity is very much in our shareholder's favor.

Thank you for your time and attention today. 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.

Aaron Michael Spychalla ***Craig-Hallum Capital Group LLC, Research Division - Associate Analyst***

And welcome, Jim. This is Aaron Spychalla on for Eric. Maybe first for me, can you just kind of touch a little more maybe on the acquisition strategy to get to $180 million? Talk about maybe the line of sight towards those other acquisitions. Are those already kind of defined targets that are may be in advanced stages? And then just anything you can share on potential synergies between the companies with your current Energy segment. Or are these just going kind of be run as separate agencies?

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

The philosophy here is to take entrepreneurs who are successful in their own right, allow them to do what they do and really provide them the support and resources that you can get from a public platform. So, I think that answers the last part of your question. As far as the defined strategy, we do have 2, in particular, targets that are quite a ways along in negotiations. But really, the initial acquisitions we make, the 4 companies we're looking at, give you what we're trying to create, and that is a full services company that can provide solutions to energy providers in the midstream and downstream marketplace. And I'll let Jim expand on that just a little bit because, obviously, this is a strategy that he developed and implemented at Quanta. Jim?

Jim O'Neil

Thanks, Bill. Hello, Aaron, how are you? First, real quickly, I'd like to say I'm pleased to join Bill and Dan here on the CUI Global executive team, and I look forward to growing shareholder value as we execute on our infrastructure expansion strategy. Just adding on to what Bill said, look, I think the 4 platform companies that we're bringing in originally, in itself, they will bring double-digit growth because of some of their anchor customers in the multiyear agreements that [they've] signed. Then we do have a vision or a view of companies out there that we believe strongly that would be interested in this model, that would bring us a new customer base or a new geographical region or a new service line that will continue to diversify the company and broaden our capabilities. And then thirdly, yes, the point you brought up about leveraging the capabilities of these companies with one another to provide broader solutions to our customers is absolutely critical and it will happen, and I think that's one of the keys to success.

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

Did that answer your question, Aaron?

Aaron Michael Spychalla ***Craig-Hallum Capital Group LLC, Research Division - Associate Analyst***

Yes. That did. That was very helpful. I guess, maybe second, on kind of the current Energy segment, can you just give us the latest on the RHI biomethane rollout? Are you still kind of thinking hundreds of units there, and just when that might start hitting the P&L?

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

Yes. First and foremost, I think the exciting part is that we now are actually bidding products domestically. We have put bids in for biomethane terminals in California, which is, we believe, is going to be a big market. As far as the U.K. is concerned, we've done a significant amount of work with a couple of large providers. But to be frank with you, due to the Brexit issue and the fact that they've now kicked that can down the road, we're still at the mercy of the U.K. government. We have seen some RHI funds let. And in each case, we've gotten better than 50% of the bids that have gone out of. They're coming out slowly, but we do believe that they're going to loosen up as the year continues. We also just started deliveries now on the Future Billing Methodology units that we're going to be putting out in field trials. We're going to put the first, I believe, 20 of those out over the next 6 weeks, so they're going out to the field. So, we see movement. But again, I think much of the delays in the U.K. are going to continue until they resolve this Brexit issue.

Operator

(Operator Instructions) Our next question comes from the line of Rob Brown of Lake Street Capital.

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

I just wanted to kind of get a sense for the future strategy. Are you really looking at services businesses primarily? Or will there be a mix of product and services businesses? And I guess what's the -- what's sort of the structure of the services business that you caught the margin structure and growth profile of those businesses that you're acquiring, I guess, your strategy, how that all fits in? But kind of what do they look like -- what do those 4 businesses look like?

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

Yes, Rob, I'm going to pass this out to Jim, so he can kind of give you an overview of that. Jim?

Jim O'Neil

So, the services businesses, Rob, I would say the margin expectations would be north of 10% EBITDA and going possibly up to 15% EBITDA, dependent upon what service lines we're talking about. I would say that products, if we continue to acquire products businesses, it would be under the old CUI Global portfolio of products and anything that we can grow there. I do think that there's going to be synergies between what Bill has historically sold from a product standpoint in some of the engineering and integration that they do, and the services that we provide, there's going to be some synergies there that we'll have to explore, that we can deliver to our customers.

And what was the next question, Rob?

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

That was -- yes. That covered it well. And then in terms of the power electronics business, how does that fit into your strategy, or do you -- will look to -- take a look at that at some point?

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

Well, we've talked in the past about a possible divestiture of it. But at least, out the gate, we're going to continue the company as is. I mean that's a big piece of our business, and obviously, it is not only a big part of the revenue, it's a large part of the earnings as well. So, we'll keep that in place for the short term at least. But as we mentioned on prior calls, we are always considering what to do with that piece of business. Once the Energy division is standalone-profitable, and of course, this acquisition will make that occur, so that will be part of the strategic planning that we'll be doing over the next period of time.

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

Okay. Good. And then in terms of the consideration, I just want to clarify, you're issuing stock to the sellers of these entities, is that right?

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

Correct.

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

Okay. And then the earn-out -- the earn-out kind of situation pretty abrupt, but what's that earn-out dependent on?

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

It's dependent on a dramatic increase in EBITDA.

Operator

Our next question comes from the line of Ed Stacey of Capital Network.

Edward John Stacey ***Proactive Investors Limited - Research Analyst***

The first one, any investment required in the 4 businesses that are being acquired? Sort of after you bought them, is there any immediate thought that they will need more capital, and is that sort of provided for somehow in the deal structure already?

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

Yes. Working capital is provided in the deal structure. And as a group, they are quite profitable companies that have plenty of working capital. So again, but it is -- whatever it needs are there already in the deal structure.

Edward John Stacey ***Proactive Investors Limited - Research Analyst***

Okay. Great. And then the other one is just a housekeeping question. Definitive agreement, June 1, is that the earliest that we will get more sort of financial details and more overall details about the acquirees?

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

Yes. I think you'll get more as they develop. Obviously, at some point in the not-too-distant future, we're going to have file a proxy to get the vote on this, and then we'll obviously have complete and full details, including audit and financials. But I think, yes, the next big announcement would be to do with the PSA, the purchase and sale agreement.

Edward John Stacey ***Proactive Investors Limited - Research Analyst***

And, finally, just looking at the numbers here, and obviously, I've only just kind of seen it as everyone has. I'm trying to do a calculation quickly of what kind of EBITDA multiple you are paying on the first year. It seems though for growth companies, it's not a high EBITDA multiple. Is that just sort of normal for service businesses, or were the sellers particularly attracted to going with CUI and you got a good deal because of that?

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

Yes. I believe both are true. I think what you have is a situation where we came together as a management team with Jim and the group of company managers that we're bringing onboard, and the fit was really quite perfect. We saw the opportunity. They saw the opportunity. Obviously, we believe that a public company platform is the way to go. And I think because of that, we were able to make a relatively sharp deal. Now obviously, they're going to want to have that earn-out, but that earn-out is going to be dependent on more companies coming onboard and then growing EBITDA. So, I think that's a good deal for our shareholders, and obviously, for them, if we can grow the way we think we can.

Operator

This concludes our Q&A session. At this time, I'd like to turn the call back over to management for any closing remarks.

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

Thank you, operator, and thank you, everyone, for joining us today. For those of you attending the B.Riley conference next week, we will look forward to seeing you there. And again, thank you for your attendance. Thank you, operator.

Operator

Thank you, sir. Ladies and gentlemen, this concludes today's conference. Thank you for your participation and have a wonderful day. You may disconnect your lines at this time.

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