140503684823

CUI Global, Inc. Q1 2017 Earnings Conference Call
May 10, 2017

C: Sanjay Hurry; LHA; IR
C: William Clough; CUI Global, Inc.; President and CEO
C: Daniel Ford; CUI Global, Inc.; CFO

P: Eric Stine; Craig-Hallum; Analyst
P: Joe Maxa; Dougherty; Analyst
P: Rob Brown; Lake Street Capital; Analyst
P: Amit Dayal; Rodman & Renshaw; Analyst
P: Jeff Bernstein; Cowen Prime Advisors; Analyst
P: Jim Kennedy; Marathon Capital; Analyst
P: Mike Breard; Hodges Capital; Analyst
P: Gregg Hillman; First Wilshire Securities Management; Analyst

+++ presentation
Operator^ Good day, ladies and gentlemen, and welcome to the CUI Global's First Quarter 2017 Results Conference Call. (Operator Instructions) I would now like to turn the call over to Mr. Sanjay Hurry, Investor Relations. Sir, you may begin.

Sanjay Hurry^ Thank you, Chelsea. Good morning, and welcome to CUI Global's first quarter 2017 results conference call. A copy of the company's earnings press release and accompanying PowerPoint presentation to this call are available for download at the Events & Presentations page on the Investor Relations section of the CUI Global Web site. With us on the call this morning 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 financial results for the first quarter and to provide you with management's current perspective on 2017. Following management's remarks, the call will be opened to questions and answers. A telephonic replay of this call will be available until May 24. You may also access the archived webcast and accompanying PowerPoint at any time on the Investor Relations section of the CUI Global Web site.

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, our 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 our products. These factors and others could cause operating results to vary significantly from those in prior periods and 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 and present at several investor conferences over the next two months. A full listing of these conferences is available for your reference under the Events & Presentations tab of the CUI Global Web site.

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

William Clough^ Thank you, Sanjay. Good morning everyone, and thank you for joining us on our fiscal first quarter 2017 results conference call. I'll start with a brief overview of our performance for the quarter. After which, Dan will review our financial results in greater detail. Once Dan has concluded his remarks, I will provide some additional commentary on several key initiatives we are working on for both our Energy, and Power and Electromechanical segments that I believe still have us firmly on a growth trajectory for 2017. We will then open the call up to Q&A. Let's begin.

Our financial results for the first quarter reflected very strong start to the year for our Power and Electromechanical segment, and continued affected business development activities in the Energy segment. Timing of orders, however, brought revenue for the Energy segment below last year.

Let me address the performance of our Power segment first. The uptick in order trend we noted on our fourth quarter conference call in March continued through the first quarter. Revenue increased by approximately 5% year-over-year as strengthening industry fundamentals drove demand for our products across a distribution base now broadened with the addition of Arrow Electronics in the quarter. Our direct sales efforts also bore fruit with the receipt of a $1.6 million purchase order from a new customer, a U.S.-based infrastructure installation company that serves retail store environments. Power and Electromechanical backlog stood at $19.6 million at March 31.

In our Energy segment, business activity in this segment is increasing as the value proposition of our GasPT product resonates with prospective customers. In perhaps the two most clear-cut signs of the gas industry's growing adoption of our GasPT since the signing of our contract in Italy last year: one, we entered into a collaborative agreement with energy market leader, ENGIE, in the quarter that spans multiple points for revenue across multiple geographies; and two, we finally received confirmation of the regulatory change to relax the fiscal monitoring requirements in the U.K. from the U.K.'s Office of Gas and Electricity Markets or OFGEM. This regulatory change was made by OFGEM to specifically accommodate our GasPT technology and will result in a significant expansion of our technology's footprint in both the U.K. and Western Europe, where in OFGEM is highly respected.

Having key reference customers, such as Snam Rete and National Grid, with ENGIE soon joining their ranks, are critical for the more widespread adoption of our gas solutions. You don't get these three market leaders to buy in to new technology unless that technology is reliable, durable, repeatable and does what you say it can do. With our GasPT, we have built the replacement technology to the gas chromatographs, and the industry knows it.

As we know from experience with Snam Rete, these large gas operators proceed at a very methodical pace when deploying new technologies that directly impact the performance of their networks. Our opportunity set is substantial, but the conversion of opportunity to contract is slower than we would like. Orders totaling approximately $6.8 million from both new and existing customers had Energy segment backlog at $14.3 million at quarter-end.

Now, let me turn the call over to Dan Ford, our CFO, so that he can run through our financial results in more detail. Dan?

Daniel Ford^ Thank you, Bill. I'll start with a review of our financial results for the first quarter of 2017 and then focus on our balance sheet. Total revenues were $17.8 million, a decrease of approximately 14% from $20.7 million in the first quarter of 2016.

Power and Electromechanical segment revenues were $13.7 million, an approximate 5% increase that was driven by increased customer ordering, particularly through our distribution partners, including the addition of Arrow as a distributor in January.

Energy segment revenue was $4.2 million, a decrease of 45%. The decrease in the Energy segment revenue was attributable to the impact of exchange rates on our U.K. operations following Brexit, the timing of customer project delivery schedules, and the temporary halt of deliveries of gas-related metering, monitoring, and control systems, including GasPT units to our customer in Italy due to the regulatory hurdle we have previously discussed.

Bill will update you on this in his remarks to follow. But as a reminder, the Italy contract is fully funded, and it is our expectation that deliveries will return to previous levels once the regulatory issues are resolved. Partially offsetting the decrease in Energy segment was a $0.6 million increase in revenue in our Power and Electromechanical segment due to the timing of customer delivery schedules, and as a result of sell-through activity at distributors. Consolidated backlog is $33.9 million, of which Power and Electromechanical is approximately $19.6 million and Energy is approximately $14.3 million.

The Power and Electromechanical segment has continued to see an increased ordering, as discussed during our yearend 2016 earnings call. To give you a better perspective of this trend, over the past six months ended March 31, 2017, the segment has seen an increase in customer orders of approximately $3.6 million, a trend that has continued through April as well. Using constant currency, the last six months of ordering history for the Energy segment has been generally flat exclusive of the spike in orders during Q1 2016 for the initial GasPT order from Italy for 400 units. We are confident that our backlog schedule, recent orders won, opportunities pipeline, and overall outlook for each segment will result in a growth year for 2017 despite the decrease in revenues during the first quarter.

Consolidated cost of revenues as a percentage of revenue increased to 68% from 61% last year. The percentage varies based upon the mix shift within both of our business segments, as well as contract labor costs within our energy segment and foreign exchange rates.

For the Power and Electromechanical segment, cost of revenues as a percentage of revenue was 68% compared to 64% in the prior year. The majority of this change is associated with product mix sold and production costs due to underutilization within our Canadian production facility. We've implemented cost-saving measures during Q2 that are expected to save $600,000 of production costs through October this year, which will have a direct positive impact on cost of revenues as there will be greater utilization of the remaining costs towards production.

For the Energy segment, cost of revenues as a percentage of revenue was 69% compared to 56% in the prior year. The increase is due to a less favorable product mix in the first quarter of 2017 due to the aforementioned temporary halt of deliveries to Italy. Gross profit was $5.7 million or a 32% margin, versus $8 million or a 39% margin in the prior year impacted by those items discussed surrounding the cost of revenue.

The Power and Electromechanical segment generated gross profit margins of 32% compared to 36% last year, and Energy segment generated gross profit margins of 31% compared to 44% last year. We are focused on improving margins within our Power segment through increasing efficiencies and controlling variable costs at our Canadian manufacturing facility, and through new product and technology introductions in the marketplace.

The Energy segment experiences improved margins when it sells more of its leading technologies, including GasPT and VE sampling systems which offset lower margin integration type project work. During Q1, the Energy segment was more heavily weighted to integration as the significant Italian project for GasPTs remained on hold. We expect margins in both segments to improve during 2017 through improved product mix sales of higher margin technology-based products in both operating segments and efficiencies at our Canadian manufacturing facility.

Selling, general and administrative expenses decreased $0.7 million to $8.6 million from $9.2 million in the prior year. This is due to lower bonus payments and from severance costs in 2016 that did not recur in 2017. Selling, general and administrative expenses increased to 48% of total revenue, compared to 45% of total revenue due to lower revenues.

Similar to the efforts being undertaken to address improving gross margin on sales through improving utilization, we are focused on reducing selling, general, and administrative costs by approximately $1.25 million on an annualized basis during 2017. The necessary steps and improvements have already begun and are expected to be fully enacted during Q3 2017.

Our EBITDA loss was $3.3 million compared to an EBITDA loss of $1.7 million for the reasons mentioned previously. Net loss was $3.9 million or $0.18 per share, compared to a net loss of $2.7 million or $0.13 per share last year. Cash and cash equivalents stood at $3 million at March 31, 2017, a decrease of $1.7 million since December 31, 2016.

Finally, we did not sell any shares under our at-the-market equity program associated with our S-3 filed March 14th and related prospectus filed March 31st. In addition, the company is exploring the sale and leaseback in its Oregon headquarters facility. Any sale is likely to close within six months time given the robust local real estate market and would be expected to return a substantial amount of equity back to the balance sheet in the form of cash while at the same time paying off the mortgage note.

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

William Clough^ Thank you, Dan. As we look ahead to the second quarter and the second half of the year, we are focused on expanding our opportunity set for our gas products to generate growth and convert opportunities already in the pipeline into contracts. For those of you who are new to the CUI Global story, our strategy leverages our Power and Electromechanical business, a profitable strong cash generator, to support the potential for greater and longer term growth offered by our Energy business through disruptive technology that offers lower cost, significantly lower maintenance cost, and rapid measurement time to the gas measurement market.

Energy market trends validate our strategy. At a time when the use of gas globally is increasing due to more strict emission regulations and historically low prices, our gas technology products are uniquely positioned to address operators' demand for technology solutions that enable sustainable energy, climate change mitigation, and the responsible use of resources.

Let me spend a few minutes on our pipeline of opportunities that have the potential to drive growth this year. Let's begin first with the Energy segment and an update on ENGIE. Since we last spoke, we have developed two opportunities with ENGIE, one of which is immediately ahead of us. First, we are in the process of finalizing a business relationship with Endel, ENGIE's integration subsidiary, to deploy as many as a thousand biomethane-to-grid skids over the next several years. Look for an announcement from us about purchase orders in the next couple of months.

The second is with regard to the odorizer technology we licensed from ENGIE as part of our collaborative agreement. Snam Rete has expressed a very strong interest in this technology given that its 3,300 offtakes, incidentally same ones for which we were awarded the contract for our GasPT, are currently delivering non-odorized gas, which is a significant safety issue.

Testing at field trials of our odorizer solution will begin in July. And while we are in the very early stages of this process, we believe the potential for growth from Snam Rete alone could be material to us in 2018. Staying with Snam Rete, the tariff antitrust issue is not yet resolved. As a reminder, ours is a 3,300-unit contract that is fully funded. We have delivered 400 GasPT units under the first purchase order, and expect a second purchase order for 100 units per month upon resolution of the tariff issue. Initial installations indicate the Snam Rete is seeing the ROI they expected. So we have every confidence that deliveries will restart once the issue is resolved.

As I previously noted, OFGEM has formally relaxed the accuracy requirements for fiscal monitoring solutions like our GasPT. You may recall that OFGEM cited specifically our GasPT when it initially proposed the relaxation. With this relaxation, OFGEM is making available the speed advantage with which the GasPT can accurately analyze gas on its network and at offtakes, and at a lower price point. In essence, the relaxation is a deliberate effort by OFGEM to get a less costly, faster and still highly accurate analyzer on to its network to make it easier for their operators to get biomethane into the network. In effect, OFGEM is enabling U.K. gas networks to go green with CUI Global.

In terms of market opportunities, this makes smaller offtakes in the U.K. and Western Europe potential customers of our biomethane-to-grid skids and GasPT solutions. We have been preparing for this eventuality, and later this month and in early June, we will be hosting two industry open house days at our U.K. facility to showcase our GasPT to prospective customers.

As part of this event, we have set up a side by side comparison of our GasPT device in operation on a simulated high pressure pipeline right next to the fastest available competitive gas chromatograph. The demonstration, which uses OFGEM-approved sample gases and an OFGEM-approved sampling configuration, will show that while the GasPT accurately displays minute changes in the gas quality within seconds, the gas chromatograph with its eight minutes cycle time can fail to show changes of as much as 25% for more than 30 minutes.

If you look at slide 6 in the slide deck to this call, we have provided a slide charting that time difference and its effect. You will note on the chart that the actual gas quality changes dramatically at approximately one hour, 26 minutes, 34 seconds, the green line; a change accurately noted almost immediately by our GasPT, represented by the blue line; a change that was not fully recognized by the GC for more than one hour, the red line. Interestingly, according to OFGEM studies, the amount of natural gas, which transits a 10-inch high pressure pipeline in only eight minutes is enough gas to operate 560,000 residential customers for a period of 24 hours; gas which is simply invisible to the gas chromatograph under the best of conditions. We have invited more than 300 industry representatives from throughout the U.K. and Western Europe to these two events.

Further, building on OFGEM's decision, last week we were awarded a follow-on contract to study the distribution of unconventional gases such as biomethane within the U.K. regional distribution network. This 36-month development contract awarded by our partner, DNV GL, under the U.K. National Gas Network Innovation Competition scheme, studies the feasibility of deploying a modified GasPT product that could influence a policy change within the U.K. regarding CV measurement and billing for residential customers. Longer-term, this could pave the way for further deployment of our GasPT much like OFGEM's relaxation does for us today with commercial customers.

By way of example, the potential market size in the U.K. for the DNV GL application would include more than 17 million residential customers amounting to an estimated 50,000 GasPT analyzers. In France, with ENGIE, we are contemplating a similar fiscal schemes, which would apply to more than 21 million residential customers deploying a number greater than that in the U.K.

Turning to North America, we continue to aggressively pursue opportunities with large operators there. Through our Houston office, we are pursuing VE probe opportunities with the region's largest gas operators. Earlier this month, we conducted live in-field testing of our VE probe in front of some of the world's major gas operators. The test conducted at the Southwest Research Institute in San Antonio, Texas consisted of our placing one of our VE probes with its proprietary helical fins into a pipeline directly next to a standard probe. We then ran standard natural gas through the pipeline at 20% pressure, then stepped up to 40%, 80%, and finally 100% pressure.

The VE probe maintained a constant force of 1G across all pressures and velocities, while the standard probe experienced as much 20Gs at 20% and up to 500Gs of force at 100% pressure. The performance of the two probes were both measured and videotaped from various angles. The results, as expected, confirmed the viability, reliability, and durability of our VE technology when compared to a standard pipeline probe.

Southwest Research, a highly respected R&D problem solver providing independent premier services to both government and industry clients, will be preparing and publishing a white paper documenting the results. Both the white paper and the video will be posted to our Web site in the very near future.

With regard to our ethylene opportunity, we are nearing the end of that pilot phase and hope to report on results when we speak again next quarter. Finally, in Canada, at this very moment, we have a team in Calgary and Ottawa working to obtain the necessary certification for our GasPT with Measurement de Canada; certification that we believe will catalyze demand for our product. Concurrently, that same team is pursuing a multi-pronged approach with our distributor, Benchmark, to expand market awareness of our capabilities through our partner ecosystem as well as our own efforts. In that regard, we have upcoming meetings scheduled with Alliance Pipeline and TransCanada, among others.

Turning to the Power and Electromechanical segment, the electronic industry is in the early stages of an up-cycle, giving a boost to demand in the market segments we serve. In particular, lead times across the industry are being extended, and distributors are investing in inventory. This is a positive trend as we service a significant amount of our customers through their channel for both new designs and production business.

To that end, we have been winning more at larger customers. This is something we have been working on for quite a while, and our efforts in new product introduction and in our sales organization are becoming production business and are beginning to generate revenue across multiple industries. We added Arrow as a global franchise distributor in the quarter. Early trends are quite positive with them, and we believe that their presence globally as well as their ability to engage with and close fulfillment business will expand our sales footprint, particularly in geographies in which we have been historically underrepresented, such as Europe.

With regard to ICE Block, which has been developed and is manufactured at our Canadian facility, our beta units are proceeding very well in their field trials. For those of you who follow Intel, you may have caught its general manager of its Data Center Solutions Group keynote speech at the recent OCP U.S. Summit in March. If you haven't, we link to an archived copy in the Media Room section of the CUI Global website. At about 8 minutes and 15 seconds, you'll hear Intel self identify as one of ICE Block's beta customers and articulate the ICE Block technology's value proposition to datacenter markets. We remain on target to post initial ICE Block revenues later this year with a ramp forecasted in 2018.

In conclusion, our opportunity set for our energy products in fiscal 2017 is considerable, and a rebound in the electronics market bodes very well for growth in our Power and Electromechanical segment supplemented by our ICE Block technology. The management team and I are focused on growing our revenue to reach our goal of profitability and enhance shareholder return.

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

+++ q-and-a
Operator^ Thank you, Mr. Clough. (Operator Instructions) And our first question comes from the line of Eric Stine with Craig-Hallum.

Eric Stine^ I just wanted to start with ENGIE. So you talked about the odorization opportunity there in testing in July. Just any thoughts -- I know it's early, but any thoughts on how long that testing may be. And then maybe just refresh my memory on the economics of that system.

William Clough^ Yes, it is early on. I think we've had indications from them that the testing for this will be three to six months. There is no regulatory requirement, so there's no issues regarding certification or anything like that. Odorization is something that is simply managed today by making sure the odorant level is properly dispersed into the pipeline. And, again, it's not something that's regulated. It's done by the individual carriers and transporters.

Snam is quite eager to get something in place because they understand that these, actually, 7,000 offtakes, where they're delivering non-odorized gas is really a catastrophe waiting to happen. I mean obviously you can understand that these consumers who are using that gas, mostly industrial consumers, but who are operating office spaces and others with this gas, run the risk of having a leak that's undetected. And that could be obviously a catastrophic problem for them. So they want to resolve it. And they're talking as if they're very interested in moving forward very quickly. Now, for them, very quickly is a matter of months, not a matter of days or weeks. But, again, I think the indications we've got is that the test will be three to six months.

The economics will be difficult to say. We believe that the units were still in the initial beta phases with those. We're going to deliver a production level market to them -- rather a production level unit to them in July. We think that unit will be between EUR7,000 and EUR10,000, something in that frame. I'm assuming that they'll roll it out much like they're rolling out the GasPT to the first 3,300, the largest customers first. So, again, I mean, you can do the math. They're going to obviously get some kind of a discount because of the size of their order. But I think the units themselves will be between EUR7,000 and EUR10,000 a piece.

Eric Stine^ Okay. And is that, I mean, the regulatory issues, which are impacting GasPT? Is that something that would also apply to this? Or are they two separate things?

William Clough^ Two very separate things. GasPT, remember, has to provide accurate, repeatable measurements that are used for fiscal monitoring. So they have to be certified as accurate, as durable over a lengthy period of time. Odorization is not -- much like VE probes, there's no regulatory body that looks at odorization but it looks at gas sampling. All that has to happen is the operator needs to be satisfied that the gas is being property odorized. And realize you're replacing no odorization at this point. So they're eager to get something in place. And the problem with the current technology involving odorization is it requires a constant gas flow. And the offtakes that they're talking about don't have a constant gas flow. It's intermittent gas. And so you have to have something unique, and that's what this system addresses.

So, again, no regulatory issues; simply the field trials to make sure it does what we say it will do. And then I think we'll be talking about deployment.

Eric Stine^ Then just the biomethane opportunity. You mentioned that you expect some purchase orders here in the somewhat near-term. I mean is that -- now that you're into that a little closer, I mean if you're able to speak on it, do you have any thoughts over what time frame that rollout may be? I mean honestly it's multiple years, but any clarity there would be helpful.

William Clough^ Yes, I think the rollout itself they're [ENDEL] looking at two to three years. That's a thousand units over the next two to three years. But I think we'll see some beginning purchase orders in the next couple of months. They're eager to get started. And I think that was one of the things we talked about in another conference call.

Initially, their integration unit that we were meeting with started to talk about, well, we have to test the unit, we'll have to see if it works. And they were told immediately by ENGIE's R&D division, you don't have to test it, you don't have to see it works. We know it works. We know it's durable. It's already been certified. So that was taken out of the mix. So, really, now, it's just a matter of them getting their build schedule up and running, and then sign the order. So we expect to see that.

The other side of the biomethane is we also expect to have some pretty good news on biomethane to grid skids in the U.K. We have, I think, five out for bid right now. We have already reduced the bid price because we are now able to eliminate the gas chromatograph. You can simply use our GasPT. So we expect to get most, if not all of those bids. And those are all very -- GBP300,000, GBP400,000 projects that should be quite profitable and will fall into this year's revenues.

Eric Stine^ Maybe last one from me. Just on the balance sheet, just to clarify. Did you say that you're considering a mortgage on the Oregon facility? And just -- I mean you previously had thought that you may do that on your U.K. facility, so just clarification on that?

Daniel Ford^ Yes. No, Eric, the comment was that we actually have a mortgage on the Oregon facility. What the comment was is that the real estate market where our Oregon facility is at has seen some pretty good growth in value. And so we are looking at doing a sale and leaseback of that property, where we would essentially cash out our equity and pay off our mortgage, bringing cash back to the balance sheet, a pretty good amount of cash it looks like based on what we're hearing, and pay off that long-term note as well. So, in general, just strengthening up the balance sheet and capitalizing on that asset's increasing value, whilst at the same time locking in a reasonable market lease, so.

William Clough^ (Multiple speakers) at the U.K. facility, as you did note, we still have the option to get a mortgage on that if we choose to. Currently, it's completely unencumbered, owned outright.

Operator^ And our next question comes from the line of Joe Maxa with Dougherty.

Joe Maxa^ That biomethane-to-skid opportunity, a thousand units over two to three years and expecting appeal in the next couple of months, are we expecting a sizable PO to start? I mean how should we think about that progressing?

William Clough^ Yes. That’s -- I really don't know. What they've talked about is -- that's why I said they'll have to look at their build schedule. These big companies don't order product to sit on the shelf. In other words, they'll set up a build schedule. Depending on what that build schedule is, that's how they'll order the product. And sometimes they order two months in advance, maybe three months in advance. It'll depend on how fast they're building the units and how they ramp up. And then we'll see that as we start to see the purchase orders.

Much the same as with Snam Rete. It's 3,300 units that they want, but their initial order was for 400. They've then said that they're going to increase that deployment schedule to a hundred a month, and so we see that as the next logical step. But we have not gotten a build schedule at all from ENGIE, we just know that there's a thousand units that they propose.

Joe Maxa^ And are you anticipating you would get that entire thousand-unit order?

William Clough^ Absolutely, yes. Especially now, after what's happened in the U.K., they're quite excited about the fact that they can deploy now, in essence, a cheaper unit that does the same exact thing as the gas chromatograph. So, there’s nobody else that will get them at this point.

Joe Maxa^ And is this similar in scope to the skid, I mean kind of an apples to apples comparison with the five you have out for bid today?

William Clough^ Yes, except the only difference is, understand, we wont be building the skids, we'll be providing components, like the GasPT and probably some other components. But their -- Endel, which is their integration on -- they'll actually be building the skid. So it'll be unlike in the U.K. where we build the entire skid. Here we'll be providing components.

Joe Maxa^ I see, okay. And then the components, obviously some you make and some is it pass-through?

William Clough^ Exactly.

Joe Maxa^ Okay, that's helpful. So obviously you started to see a little bit of order pickup this quarter, I think, on both segments. Can you give us a sense on how you think about revenue as we progress through the year, kind of the trends you may see Q2 in the back half?

William Clough^ Yes, I think -- again, a lot of it depends on when Snam Rete starts reordering. I mean one of the things we've talked about internally, extensively is that that one customer going back to their build schedule of 100 a month makes this company incredibly healthy overnight. So it depends on when that happens. And frankly, I don't think they know when it's going to happen, and certainly I can't tell you if they don't know. But I think as we get to the second-half of the year, hopefully that will begin at some point during that second half of the year. So that will change, I think, quite dramatically the revenue scheme.

But with or without that, I think we're going to start seeing increased growth with ENGIE obviously. We've got some nice opportunities in North America with the VE technology. As I mentioned during the conversation we had, there are several really big Fortune 100 pipeline operators and gas operators generally -- actually come to Southwest Research and witness what happened with the probe. They're all very excited about that probe. And the fact that they will not have to do the calculations they do with the standard probe, nor will they have to replace the probe on a regular basis because of the lack of that VE, that vortex effect. We also have a team up right now, as I mentioned, in Canada, meeting with TransCanada and Alliance. So think we'll see an increased revenue in both segments during the second half of the year.

The other thing that we'll start seeing during the second half of the year in the Power and Electromechanical section, we should start to see some initial revenue from ICE Block. The initial results of that have been quite good. As we mentioned, since Intel identified themselves, we could tell you that they're one of the beta test participants, and they've been quite impressed as were the other participants. So, again, we think that the second half of the year is where we'll see the revenue growth.

But you're absolutely right. Both segments saw increased ordering this first quarter, $6.8 million in the energy division and a nice uptick as well in the electronics division. So, we'll see I think steady growth from here on.

Joe Maxa^ On the increase and productivity cutting the -- for the $600,000, I'm sorry. Yes, $600,000 savings you’re expecting, was that more on across the board or was that more to the Power and Electromechanical segment?

Daniel Ford^ That's primarily in the Power and Electromechanical segment.

Joe Maxa^ Okay. So we should start to see gross margins pickup in that and was it Q3?

Daniel Ford^ Well, I think we’ll start to see them taking up in Q2. But, yes, they’ll be -- that full cost savings will be realized by Q3.

Joe Maxa^ Okay. And then as far as reducing the sales and marketing by $1.5 million per year, what are some of the key savings you’re seeing? And what are you doing to achieve that?

Daniel Ford^ It's primarily taking a look at personnel, seeing where we've got some surplus workforce essentially, where we’re a little overstaffed for the project both that we have in place right now. So we are taking a look at certain positions in support roles kind of throughout the organization right now to see where we can remove costs that are not being fully utilized right now and push some others.

William Clough^ So, that's across both segments, too, Joe, just so you know.

Joe Maxa^ I see, okay. And then, lastly for me, on this 36-month contract, what's kind of the revenue opportunity with that? Is that meaningful? I know it's a longer-term opportunity, but I just wanted if there is something as you are doing this?

William Clough^ If you followed the link that I put in the press release to the DNV GL press release, you'll see that the total project was GBP4.8 million, I believe it is. And I can tell you that about half of that is coming to us directly. And that is really to design and fabricate and manufacture the prototypes, and then monitor the testing along with DNV GL. So I think you will look at somewhere around GBP3 million something like that.

Joe Maxa^ Okay. And is that in the backlog or is that just as it goes?

William Clough^ No, that's in the backlog.

Operator^ Thank you. And the next question comes from the line of Rob Brown from Lake Street Capital. Your line is now open.

Rob Brown^ Good morning, I just wanted to move back to up Bill, what sort of the unit opportunities that commercial market that you are now able to address with the change in regulation?

William Clough^ Well, the largest part of it is going to be the biomethane skids, that's the big issue that they had and we see that as probably somewhere between 8 and 15 of those units on annual basis and that will continue for three or four years as long as -- certainly as long as supplemental tariff continues and there is every indication that once there an election, if it is a Tory government that comes in which is likely will be that they will continue that.

Then from that of course the big issue we get into that residential market. The residential market is a much bigger market and you are talking about 17 million customers and we are doing with OFGEM and DNV GL at this point is just so you're clear on it is there purpose in putting us into is to be able to give the residential customer the ability to monitor their gas usage on pound basis or on a monetary basis, second-by-second.

So they are taking our units, four of them, and they are connecting them each by Bluetooth technology to 50 homes, in essence smart meters, that currently measure the amount of gas and report that to a smart phone or iPad or whatever else consumer might have. But it does not have the calorific value necessary to compute the dollar usage or the pound usage for them.

Our device will be used to give them that CV application, so you will end up with customers who can see second-by-second how much money they are spending on their energy and they believe that that will tend to make people conserve, which in essence studies have revealed that it does make people conserve. If that test is positive and if they see conservation on the basis of those 200 customers, then I think that deployment could occur. But again understand something, that's a three-year process, so we are very early on -- this is not something you're going to see in the next few months. It's definitely multi-years.

But the payoff is as many as 50,000 analyzers to be deployed throughout U.K. and many, many more than that in France and across Western Europe. It will be a much smaller if you will, much lower MSRP unit, it's something we could put together. They are not quite as aggressive about the accuracy they are seeing and not quite as aggressive about the speed. But again it's going to be a different unit, but it will have to be a unit like ours, that has no service gas that's very, very low maintenance and could be deployed broadly without a lot of service.

So again, we're at the beginning stages of what could be a very huge deployment. So that's the opportunity, gentleman.

Rob Brown^ Okay, good, thank you. And then, on Italy, you said you delivered 400 units, how many are actually installed and running now? And I guess, related to that, what's sort of the remaining hurdles there in the regulatory issue?

William Clough^ Sure. I think my understanding is there is around 30 to 35 that have been deployed and broadly across those 30 to 35, they're seeing an increase of around 15%, 1-5 percent, in their billable revenues, which is dramatic, if you think about it because it's the same customers getting the same gas who are now in essence seeing 15% more revenues coming to Snam Rete. So again, I think, they're definitely eager to get them out there because they see a big return on investment.

The tariff issue is a -- as I've explained in the past, it's an antitrust issue that was raised by the industry. It was something that Snam to their discredit, actually had not thought of in the original proposal. And what it is simply this, it's a voluntary program where they're paying to buy the offtakes, assuming that everybody does that then there'd be no issue. The problem is if there are people or entities who choose not to buy the offtakes or not to sell the offtakes to Snam Rete, they were forced to pay the same tariff as those who did, which the regulator found to be an antitrust issue. There had to be a resolution where if a person or an entity did not participate, they would have an opportunity not to pay the same tariff.

So that's what they're in the process of doing is trying to set-up a tariff scheme that would address that potential antitrust issues And again, that's -- it's nothing more or less than that, but it is a difficult -- apparently a difficult regulatory issue that they're trying to get over.

Rob Brown^ Okay. I think that's a good overview.

Operator^ Thank you. And our next question comes from the line of Amit Dayal with Rodman & Renshaw. Your line is now open.

Amit Dayal^ Just as a follow-up to the previous question, why is only around 10% of those units deployed? I mean what's holding them back from putting together the units in the field?

William Clough^ Because they can't buy the offtakes; that's the whole regulatory scheme. What's been deployed are offtakes that they already own. Their scheme is to buy the offtakes and then retrofit the offtakes, not just with our GasPT, they're retrofitting with new flow meters or flow computers. They're putting on some pressure gauges. They're updating them to some regulatory changes that the EU is insisting on. So they're actually going to buy those offtakes, and they cannot do that until they take care of this regulatory issue.

So what's happening is, not just us, but the Tier 1 contractor who is installing these is in essence waiting and they're very upset about it. Frankly, they're putting more pressure on than anybody is, our distributor is obviously, SOCRATES, who are in Italy, they're putting pressure on because they want to get the commissioning done, and obviously we're putting what pressure we can as well, but the problem is they can't move forward with the purchase of these offtakes until they take care of this traffic issue. So what they've deployed are those offtakes that they own themselves.

Amit Dayal^ Understood. And just moving on to the gross margin softness this quarter; do you expect this could potentially bounce back in the second quarter or will it take a little longer to sort of come back to normalized levels?

Daniel Ford^ We think it's going to begin improving this quarter, yes.

Amit Dayal^ Okay, understood. And then, just on the sort of the higher level revenue outlook for the year, it looks like there are a several interesting opportunities in the pipeline, but in relation to the year-over-year softness, do you think we still have a chance to sort of grow revenues at somewhat higher levels than last year?

William Clough^ Yes. We don't -- obviously, Amit, we don't do forecasting but I think it's going to be a growth year, and I think it's going to be -- obviously it's going to be a growth year compared to last year. And I think that you'll see that towards the second half of the year. Yes, if you're asking me if the revenues we think will be higher than last year, we do think that.

Amit Dayal^ Understood. And in relation to sort of ramping your business development efforts on the Power segment, agreement with Arrow, I guess, plays into that, are we doing anything else to capitalize on the improving cycle in that space?

Daniel Ford^ We're doing -- I mean, and that's a pretty broad question. Yes, we're doing lots of different things. We've got various programs with our four distribution channel partners, which they're all in the top 10, if not the top 5 or 6 globally for distribution. Our marketing team and our reps are all out and our direct sales guys are out working with direct customers as well.

We're participating in certain conferences, we were at APEC this year, we're going to the Distribution Conference in May, we’re advertising, we’re putting out new products, we're continually putting out new product introductions and then of course we're working on getting the ICE Block through its regulatory certifications with UL and TUV and getting that to become a saleable product to reach out to customers like Intel as mentioned earlier.

So those are the -- I guess those are the main initiatives going on through the Power segment to reach new customers and to further penetrate existing customer channels.

Operator^ Thank you. And our next question comes from the line of Jeff Bernstein with Cowen Prime Advisors. Your line is now open.

Jeff Bernstein^ Just a couple of questions, can you give us an update on what’s going on with the GE?

William Clough^ Not much, I think the same thing that we talked about last time, it's still working at their commercial division in Italy in Florence, we did receive a couple of brief comments from them that it's performing as expected, we don't have a timeline on what that means, they are the ones who do make the decision about packaging though, so they would be the ones that could say, we're going to put it on the bill of materials, which is what we're really waiting for.

Again, I don't really have an update other than what we talked about in the past. And there is no timeline on that, they work at their own pace. Again, I guess the good news is no news, there’s been no indication that it’s not doing exactly what we thought it would do and what it's supposed to do.

Jeff Bernstein^ Okay. And then you talked about the ethylene plant trial and again at some point in the not too distant future, if there’s a second wave here of ethylene plants being planned in the U.S. what is your sort of outlook about at what point in the process you might be able to get into dialog with people?

William Clough^ Well, I think we're waiting for the results from the one that we're obviously out testing, once we have those results and what they’ve told us, the customer and it's a very large Fortune 100 customer. They’ve told us that they will share the results with us and that we will be able to use those in our marketing efforts. So obviously, we're waiting for that so we have some strong evidence that it does what we say it will do. And once we have that, our sales people will be out immediately pushing and obviously we’ll be negotiating with that customer as well because they have various other plants of their own.

The key to that though is all timing and here is what it's dependent on, those plants are shutdown routinely for maintenance that's when this type of an installation would have to occur is when each individual plant is being shutdown for other maintenance. So, again, it would be timed around those shutdowns and it would be a plant-by-plant shutdown decision. So but again, as soon as we get that information, believe me, we'll be out there pushing this, there is no reason for us to keep it a secret.

Jeff Bernstein^ Got it. And do you know if that customer recently announced a new very large ethylene plant?

William Clough^ If I said that, I'd be identifying the customer, which I committed not to do, right.

Jeff Bernstein^ All right. And then, the -- I guess there's some biogas initiatives going on both in Quebec and in California where they're paying some crazy amount for biogas versus natural gas. Any clarity on what kind of opportunities might be developing there?

William Clough^ Yes, we have seven bids out right now in the US, North America for biogas units. We have two in Toronto and five in California -- there is -- actually four in California, I think one in Oregon. And we -- again, there's no time frame as to when we get those back. The bids went out, I want to say late last year, these were -- again it's kind of new for everybody in North America, but you're absolutely right, they are, they are moving forward and we expect to get some, if not all of those, simply because we have such a leadership role in Europe as to producing these skids. But we have the bids out and we certainly are pushing. Our sales people call them at least weekly trying to find out what the status of the bids are and none of those, none of those bids have yet been granted. So, again, we're definitely looking in that direction, and they are California, Oregon and I think it's the city of Toronto for two.

Jeff Bernstein^ Okay, and any kind of update on progress with Daily Thermetrics?

William Clough^ Yes, they're doing very well. In fact, they partnered with us on this demonstration we talked about at Southwest Research, they actually brought some really, really prominent operators to the demonstration who actually watched it and have asked for films to give to their procurement department. And then, we are seeing sales from them. We don't have an individual breakout of what the sales are, Dan?

Daniel Ford^ It's not material to disclose yet, but we are -- really the key was that relationship is getting in front of the customers that for example the ones that were brought into that demonstration test at Southwest Research because it's not the thermowells that we're looking to get the business. We're actually looking to penetrate their customers for the larger sampling systems like the ethylene plant type of sampling systems, the discrete analyzer, so --

William Clough^ But it's a positive relationship.

Jeff Bernstein^ Understood. And then what is the outstanding mortgage on the Franklin Business Park building?

Daniel Ford^ Well, you even knew the business park name; it's $3.4 million.

Jeff Bernstein^ $3.4 million, okay, great. Thanks so much.

Operator^ Thank you. And our next question comes from the line of Jim Kennedy with Marathon Capital. Your line is now open.

Jim Kennedy^ Could you clarify an issue in Italy in terms of Snam Rete having to purchase the offtake locations? What does that mean? Who owns them now? And is there an incentive to sell them to Snam Rete?

William Clough^ Yes, the owners of those facilities now are the individual big operators. The power supply -- I'm sorry the power generation station, the steel mill, the ceramics factory. Those offtakes are owned by the individual consumer; the big industrial consumer. And here's the incentive, the EU issued a regulatory change for these types of offtake. They took effect in January and has to be completed within 12 months. That regulatory change by the EU is going to require a substantial investment by the owners of those offtakes to update those offtakes. There's a number of different things they have to do and I couldn't give you the details. But it's a relatively extensive update that they have to do.

Snam Rete saw that as an opportunity to go to those big consumers and say, look, here's what we'll do. We'll take that cost that you have to invest in that offtake off your hands and in addition, we'll pay you. We want to buy the offtake back, so we'll own it. And we want to buy an easement in perpetuity to be able to come in and service our equipment. And for that purchase, we will provide to you the update that the EU requires. We'll provide you a new flow computer and an actual analyzer that will tell you the specific amount of gas you are getting. So what --

Jim Kennedy^ So should I read into that as Snam Rete has to go out and negotiate with 2,900 offtakes?

William Clough^ No, it's not -- they are all standard -- so, no, it's not a negotiation. In other words, it will be a set price and a set purchase. And so it's not a negotiation because they're all the same. They're all standardized. There is not 2,900 different offtakes. They're all very, very standard.

Daniel Ford^ Jim, it's more like an easement to gain access to your national gas meter in your house. It's just an easement type of access. It's not actually buying the land and everything. It's (multiple speakers) --

Jim Kennedy^ I guess where I am going with it is in terms of the timing is Snam anticipating being able to accomplish 2,900, shall we say, contracts or agreements in a very short period of time?

Jim Kennedy^ Or is this a multi-year effort?

William Clough^ No, this is a three- to five-year program. But that's what it's always been a three- to five-year program. But the program was never delayed by negotiating the terms. The terms are set. They [Snam Rete] can set the terms. The problem is as I mentioned before is it's got to be voluntary. They can't simply take the offtakes. It's got to be voluntary. But it's a set fee that they would pay and a set, in essence, tariff that each operator would pay as a result of that.

The problem is they didn't take into account those operators who would simply say, no, we don't want to sell our offtake. We'll take care of it ourselves. We're going to invest the money and move on. Those people need a second tier tariff and that's the issue. So no, it's not a complicated -- it's not a complicated negotiation nor is it a complicated situation once they have the tariff scheme setup properly.

Jim Kennedy^ Okay. And then a question for you, you said upon resolution of the tariff issue, you're anticipating orders of 100 a month to be installed. With 365 of them still on the shelf, is that going to be an issue? Are they -- you're assuming 100 a month, do we need to get those 365 installed first? And if so, how long would that take?

William Clough^ Yes, I think they will definitely install it. Well, they want to install all 365, but they'll certainly install to a base where they have maybe a 100 or 150 left. So we will have somewhat of delay. But again, they were fully prepared even at the outset is install 50 a month. I can tell you right now that the Tier 1 contractor, who got this deal, has got team standing by. They're ready to install 200 or 300 a month if they can get them.

Now, it won't go to that, but I think they could very easily gear backup to a 100 a month or 75 a month and go through those in a month or two and they're not going to wait if my understanding is if they get this resolved and when they get this resolved, they are going to want start ordering because again they understand we won't be able to deliver a 100 a month right off the gate, although we do have right now some on the shelf that could deliver.

The bottom-line is we've told them, we are going to have to ramp up. So we want them to understand that they got to give us some advance notice. So I think there will be a or maybe a two-month period where they are installing the units they already have, but I think once that tariff deal is taken care of, certainly, within 60 to 90 days, we'll be delivering to them.

Jim Kennedy^ Okay. And then, last issue. I guess on the last call you said that you all were looking to be an aggressive acquirer and I believe it was complementary to the gas side of the business, can you comment on any progress there where we are?

William Clough^ Yes, we've identified some opportunities, but nothing that I can really point to at this very moment. We are not -- we’re really concentrating right now on doing two things, one is developing new customers and getting product out to the market and two is in essence streamline the operation and cutting overhead and cutting some cost. But again, we’re going to be opportunistic, we’re out there looking. There are a couple of opportunities that we may take advantage of and we think that some of those might come to fruition before the end of the year.

Jim Kennedy^ Okay. And this will be complementary to the gas side of the business?

William Clough^ Exactly.

Operator^ Thank you. And our next question comes from the line of Mike Breard with Hodges Capital. Your line is now open.

Mike Breard^ Just a further question of the ethylene, do you think that the large customer might just order all them at once and setup a delivery schedule or would they maybe order one or two or three at a time as needed?

William Clough^ We would push them to order all at once, Mike, but I got to be honest with you, these big companies don't do that, that's not how they operate, that's not how Snam operates. Most of them what they do is -- they don't want to have merchandize sitting on their counter or on their shelf that they are not using. So I suspect it would be a project-by-project as they shut-down a factory or shut-down a plant, they’ll purchase the necessary sampling systems and move in at that point. That's what I suspect. Obviously, we would push them to order and to deliver when they need them, but I think to be, I think to be cautious and to be conservative, we would expect them to order as they needed them.

Mike Breard^ Okay. But they’ll tell you -- give you an indication that the total -- they will give you an indication of the total need?

William Clough^ Yes, I believe that’s absolutely true. And again, if you look at it, the projects are $2.0 to $2.5 million a piece, so every order is important for us.

Operator^ Thank you. (Operator Instructions) And our next question comes from the line of Gregg Hillman with First Wilshire Securities Management. Your line is now open.

Gregg Hillman^ First of all, can you talk about ENGIE, what's the value that you’re going to provide per skid for them for the components you’re going to sell them?

William Clough^ Sure, two things. First of all, the first benefit is the fact that the GasPT is solo maintenance. If you put a $40,000 Emerson GC into one of these skids, you got to have a guy out there at least twice a week calibrating it, you've got to make sure that every three to six months you're replacing carrier gas, calibration gas, you've got all the issues about reliability, the fact that about 16% of the time, it's not working for whatever reason, its out of calibration or there's something wrong with it, they just are not that dependable. So all those things are increasing cost.

And remember, biomethane operators are not gas operators, you're not talking about Chevron, Shell, BP. What you're talking about is a farming consortium, a landfill operator, anywhere we have in essence organic materials that is decaying and methane gas is being produced, you have these opportunities. But these people are not operators, who can afford to spend the kind of money that often times it takes to put in and operate gas chromatographs. What we allow these skids to do is be, first of all, very economically install and then there's little or no maintenance. Our device requires no maintenance whatsoever and it's fast enough so that they can use if they need to for propane injection, which is what the U.K. is doing now or for nitrogen injection although that would be rare, generally, it's propane injection --

Gregg Hillman^ Bill?

William Clough^ Yes.

Gregg Hillman^ When I said value, I meant the dollar value.

William Clough^ Dollar value, I'm sorry, I apologize. I thought you meant the technical value. So the value of the GasPT, the one that they would be purchasing would be the same type that Snam Rete purchased, it's the analyzer only, they don't need the high pressure probe or the high pressure implementation. And as we've talked about historically those devices cost on a one-off basis is around EUR18,000 to EUR20,000 and obviously the size of the order would determine the discount they would get, so they would get some volume discounts.

Gregg Hillman^ Okay. And in terms of doing a 1,000, I mean are these going to be custom projects, each of these 1,000 skids, they're going to -- and this is in Europe, right? That's the opportunity in Europe, not just France, but all over Europe?

William Clough^ It's just France, it's just France, it's just France.

Gregg Hillman^ Okay. But isn't each project a custom project or they going to be standardized?

William Clough^ No, it's a standardized skid. The skids are -- the large skid themselves and we do the same thing, they're sold as a product. In other words, we put them together, there is a menu, there is certain things you can get or not, get -- depending on the size of your operations. But again, they're pretty much a productized piece of equipment.

Gregg Hillman^ Okay. But are there a 1,000 biomethane -- are there a 1,000 projects in France possible today? I mean are there?

William Clough^ Absolutely. They already have the identified locations, they want -- they get -- France is very pro green, energy green gas. They have a mandate that they need to get a 7 percentage of their gas from renewables by 2020 and it's quite -- it's a quite large percentage of their gas and they've already identified the 1,000 locations where they want to install this. They already have them set.

Gregg Hillman^ Okay, so that's not a problem. So that's a reasonable estimate that it could be more?

William Clough^ Could be more.

Gregg Hillman^ And could it, but not less?

William Clough^ But not less. My understanding is they've identified 1,000.

Gregg Hillman^ Okay. And then the timetable, I think you suggested earlier, it would happen -- the first they're going to do it like a demo with a few of these skids and that will happen over like six to nine months, and then after that, it would start to pick up.

William Clough^ No, I think it could pick up sooner than that. The demo was the odorizer I was talking about, the skids, the biomethane skid, they're contemplating 1,000 units over two to three years, and I have not seen a build schedule so I don't know how that's rolled out, but they're talking 1,000 units over two to three years.

Operator^ Thank you. At this time, I'm showing no further questions, I'd like to hand the call back over to Mr. Clough for any closing remarks.

William Clough^ Thank you, Chelsea, and thank you all for attending the conference this morning. As always, Dan and I are available for follow-up. If you contact Sanjay to schedule a time to speak, we'd be happy to talk to you. And thank you again. We look forward to speaking to you in upcoming conference presentations that we have scheduled, and obviously next quarter. Again, thanks for your support and we appreciate your time. Thank you, Chelsea.

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