CUI Global, Inc. – Q3 2019 Earnings Conference Call - Transcript

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CORPORATE PARTICIPANTS:

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

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PRESENTATION:

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the CUI Global's Third Quarter 2019 Results Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to your speaker today, Mr. Sanjay Hurry, Investor Relations Counsel. Thank you. Please go ahead, sir.

Sanjay M. Hurry - *LHA Investor Relations - VP*

Thank you, operator. Good afternoon, and welcome to CUI Global's third quarter 2019 results conference call. A copy of the company's earnings press release and accompanying PowerPoint presentation are available for download on the Events and Presentations page of the Investor Relations section of the CUI Global website.

With us on the call today are William Clough, Executive Chairman; Jim O'Neil, Vice Chairman 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 third quarter and to provide you with Jim O'Neil's vision for CUI Global as it becomes an energy-centric services company. Following management's remarks, the call will be opened to questions and answers. A telephonic replay of this call will be made available until the 28th of November. You may also access the archived webcast and accompanying PowerPoint at any time on the Investor Relations section of the CUI Global website.

As a reminder, this call will contain certain forward-looking statements made within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended. Such statements are subject to risks and uncertainties that could cause actual results to vary materially from those projected in 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 the 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 as a result of the divestiture of the company's electromechanical components business on September 30, 2019, the November 11, 2019, agreement with Bel Fuse to sell the majority of the remaining power business and with the remaining assets and liabilities of that comprise the Power and Electromechanical segment held for sale, the company has reclassified its Power and Electromechanical segment as discontinued operations for the 3- and 9-month periods ended September 30, 2019 and September 30, 2018. As a result, the review of the third quarter results on this afternoon's call will focus on the company's continuing operations, which consists of the company's Energy segment.

With that, I'd like to hand over the call to the first of our 3 speakers, William Clough, Executive Chairman of CUI Global. Good afternoon, Bill.

William J. Clough - ***CUI Global, Inc. - Executive Chairman***

Thank you, Sanjay. Good afternoon, everyone, and thank you for joining us on our earnings conference call that follows yesterday's release announcing our agreement to sell the majority of our power business to Bel Fuse. Given the significance of this divestiture, I'll start today's call with some comments about the transaction before recapping our performance for the third quarter. Dan will then provide a detailed view of our financial results for the quarter; Jim O'Neil, our new CEO, will then offer his go-forward vision for CUI Global as it becomes an energy-centric services company.

We have agreed to sell the majority of our power business to Bel Fuse for $32 million plus the assumption of certain liabilities and subject to closing working capital adjustments. This transaction is another bold action that unlocks the value of our Power and Electromechanical business and demonstrates our resolve to creating an energy services company. Together with the recent sale of the electromechanical components segment of the Power and Electromechanical business, we have effectively recast CUI Global's balance sheet. We are debt-free and still hold approximately 21% equity stake in Virtual Power Systems. Proceeds from the 2 transactions sets CUI Global with a strong cash position, a $5 million long-term note receivable, a debt-free balance sheet, and the flexibility to implement our strategy to build an infrastructure services company through strategic M&A and organic growth. Most importantly, the company will now focus its resources and management's time on executing on its energy-centric growth strategy with Jim at the helm.

While we move forward closing the sale of the power business, the Board is evaluating the company's capital allocation plans, including potentially returning a portion of the proceeds from the sale to Bel Fuse to our shareholders in the form of a share repurchase program.

Turning to our results for the third quarter. Revenue increased year-on-year for the quarter and year-to-date, reflecting strength at our Orbital facility in Houston while we prepared the 2 business units within our Power and Electromechanical segment for sale. We have continued strength in integration revenue at our Houston facility that offset lower integration revenues from our U.K. facility. In Houston, we have been added to the preferred vendor list of several major gas networks and infrastructure companies based in the region, benefiting results. In the U.K., gas network operators have essentially frozen their CapEx spend given the ongoing uncertainty around Brexit. In response, and on Jim's advice, we've taken steps to realign resources there given this business reality, while continuing to fulfill the U.K.'s demand for bio methane skid and support GasPT customers. Jim will speak more about this in his prepared remarks.

We continued to pursue initiatives to try broader adoption of our gas technology products during the quarter and continued to make progress along our threats in the U.K., Europe and North America. With a new regulatory scheme expected to come online in Italy on January 1, 2020 that requires a rollout plan to be in place by the spring for the remaining project, our distributor, Socrate, has a meeting scheduled this month with the end customer to better understand the plan to be presented to the government. We are also seeing incremental order flow from SAMSON AG's global sales footprint for industrial applications in geographies we have never previously approached.

Finally, before I turn the call over to Dan for his review of our financial results, let me just say that it has been a tremendous privilege to serve as the CEO of CUI Global. The reins of the business are now in Jim's hands, and I could not be more confident in his ability to ensure our success. Jim is a proven leader with an incredible track record of growth and shareholder returns. With the sale of the power business to Bel Fuse, I believe the company is well positioned to execute on his vision. As Executive Chairman, I look forward to supporting Jim's leadership. And as a shareholder myself, I look forward to him realizing the company's long-term potential to the benefit of all shareholders.

Thank you for your time and attention today. I'll pass the call to Dan who will review our financial results for the quarter. Dan?

Daniel N. Ford - ***CUI Global, Inc. – Chief Financial Officer***

Thank you, Bill. Good afternoon, everyone.

As a reminder, I will focus my remarks today on the company's continuing operations, which consists of our Energy segment. The Power and Electromechanical segment is classified in discontinued operations as the electromechanical was disposed of during Q3, with the gain on disposal recognized of $3.6 million and the remaining operations are presented in discontinued operations as held for sale at September 30. Total revenues increased approximately 18% to $6.1 million from $5.2 million for the third quarter of 2018. The increase in total revenues was driven principally by higher integration revenues in our North American operations that offset lower integration revenues from our U.K. operations. The year-on-year variance also reflects the timing of customer project schedules.

As Bill noted, we are benefiting from business development initiatives associated with our Houston facility and a substantial buildout of energy infrastructure taking place in the U.S. that is centered in Houston. Gross profit for the third quarter was essentially flat at $1.4 million resulting in a gross profit margin decline to 23.4% from 25.6% last year. The decrease in gross profit margin reflects a higher contribution of lower margin projects within Energy segment.

Margin improves when the mix favors our leading technology solutions, including GasPT and VE sampling systems, and when we realized operational efficiencies from greater throughput of integration projects in our facilities.

SG&A expenses increased approximately 14% to $4.8 million from $4.2 million in the year-ago period. Due primarily to increased corporate costs related to strategic initiatives, higher professional fees and due diligence activities related to perspective acquisitions, SG&A expenses as a percentage of revenue was approximately 79% compared to approximately 81% for the same period last year.

Adjusted EBITDA loss for the third quarter was $3.2 million compared to a loss of $800,000 in the year-ago period. Backlog was $10.8 million at quarter end compared to $15.7 million at December 31, 2018, reflecting the timing of orders and delivery schedules for integration customers. In terms of our balance sheet, we ended the quarter with cash and cash equivalents of $1.7 million. We received

$4.7 million in cash upon the sale of the electromechanical components business on September 30, 2019. We used this cash to pay down our line of credit. And with the sale of those electromechanical operations, the buyer also assumed a $5.3 million related party note payable that was due next year.

Following the sale of the electromechanical operations, our Bank of America line of credit was reduced to $6 million from $10 million to reflect the reduction in go forward revenues and related operating needs at this time. Total debt at quarter-end stood at approximately

$1 million.

Upon completion of the sale of the majority of our power business to Bel Fuse, we will add $32 million to our cash balance, subject to working capital adjustments and transaction expenses. We expect the sale to close within 30 days.

That concludes my prepared remarks. I will now turn the call over to Jim.

James Francis O'Neil III - CUI Global, Inc. - Vice Chairman & CEO

Thank you, Dan, and hello, everyone. It's good to be speaking with you today.

Let me begin by saying how pleased I am to now be leading CUI Global. I joined CUI Global's Board in July and have been working closely with Bill to architect my vision for the company to become a diversified energy-centric infrastructure service provider, serving the electric power, oil and natural gas and telecommunication industries with strong and experienced management, a differentiated value proposition, and in end markets that are growing and expected to continue to grow. This strategy is predicated on a disciplined acquisition strategy, funded in part by the proceeds from the sale of the Power and Electromechanical business units.

The timing is right to execute on CUI's global diversified energy-centric strategy. For those of you I have not yet met, I have a track record of creating value and growth through acquisitions. At my last organization, I helped to shape and then led a market leader at which I was responsible for approximately 185 acquisitions, delivering double-digit revenue and earnings growth.

The market opportunity ahead of CUI Global is generational. We're in a very prolific time in energy infrastructure. There is a significant amount of capital being invested due to an aging infrastructure across all of the industries we're targeting, the rollout of the 5G network, and the shift in power generation towards renewables.

For instance, there are 2.6 million miles of oil and gas pipeline in the United States, almost half of which are more than 50 years old. In the telecom sector, the deployment of 5G spectrum will require operators to pursue network densification strategies and build new macro-sized and small cells. In the electric power market, the transmission grid is shifting from coal and nuclear power to renewable sources such as wind, solar and natural gas.

Our electric grid is ill-equipped to accommodate these new sources of generation, which in turn is catalyzing a reconfiguration of the grid all the way down to the end consumer. From new sources of generation to the proliferation of smart grid technologies and the sea change in the adoption of electric vehicles, power grid needs an upgrade.

In addition, 50% of the workforce across these industries is set to retire in the next 5 years. We expect in the future that our customers will outsource more work currently being done in-house, which should make for more favorable demand and pricing environment for our services. Our strategy is to diversify our energy business into the infrastructure services market and build a recurring revenue and earnings stream through acquisitions and organic growth. This strategy should yield an EBITDA-profitable business with a good growth profile that also preserves the upside potential of our gas products as they mature and gain revenue traction in the marketplace.

I often say that it's not the acquisitions that you do, but rather the acquisitions that you don't do, that are more important. And after completing 185 acquisitions, I can tell you that this principle has served me well. In fact, since embarking on this path, we have evaluated many target companies to acquire. In fact, we decided to move on from the 4 acquisition candidates we announced we were pursuing last May. We are now well down the road with a viable target, and I expect this opportunity, which is an oil and gas infrastructure services company, to close by the end of the year and add substantially lower dilution costs to our shareholders relative to what we announced in May. And we continue to develop additional targets for our acquisition funnel.

Our acquisition criteria reflect the disciplined strategy to pursue well-established, well-run companies with clearly discernible moats that have positive EBITDA and margins that are better than the industry average. These companies typically demonstrate some differentiator from their competition, such as a proprietary work method, or maintain a strong customer relationship in which their customer sees value; revenue visibility in the form of solid backlog; a good outlook for growth; and leaders who demonstrate excellent operations management, who are strategic thinkers and have a proven track record of execution.

Most of our acquisition targets are growth-constraint by their balance sheet. The infrastructure services industry today is highly fragmented with opportunities for those companies with the right resources and balance sheet. In many cases, successful smaller companies cannot grow with their customers because there often becomes a time when they cannot bond or provide working capital to support their growth. With CUI Global's access to capital, we can partner with smaller, successful service providers and remove the single biggest barrier to their growth curve. As their capital partner, we can help them take advantage of scale economics.

In my experience, successful acquisitions rely on deep relationships with market participants and the ability to empower or acquire companies to succeed. Having honed my management philosophy over the years, I believe we provide a unique model that will incent owner operators who will want to partner with CUI Global. I strongly believe in empowering employees to succeed through a decentralized model that sets policies and procedures and clearly defines a broad range of operating boundaries and then letting employees work within these boundaries. It's about giving them the framework to go out and develop that customer relationship, to go out and sell services, or to go sell the company's total capabilities. It's about making sure that everybody understands that we're all in this together and that we're out for a common goal.

We'll support their growth with the right amount of governance such as financial reporting, safety and HR, so that we can let the operators work to continue to do what they've been doing to make the company successful and reap their rewards through earn-outs. In my experience, this philosophy resonates with owner operators, and we're already seeing an increase of inbound inquiries from owner operators who understand our model and want to partner with us.

With my deep knowledge of the energy services industry, relationships built up over decades and domain expertise in the energy, power and telecommunication infrastructure industry, I believe we have the right methodology in place to build a pipeline of targets that will yield 2 to 3 acquisitions a year. However, there is also much value to extract from the existing energy business. Our Houston facility is renowned for its integration expertise to the oil and gas sector. This expertise can directly apply to other sectors such as through the construction of electric subsystem control centers for the power sector or radio base stations for cell towers for the telecommunications sector. I recently visited Orbital-UK, and as the opportunity for us there faces headwinds, as Bill described, I've taken steps to reduce Orbital's cost structure and concurrently expand our business development efforts to address new industries in addition to our master gas and renewable green gas focus, such as emission monitoring and controls in the automotive industry.

At the same time, we're not abandoning the opportunities afforded to us by our gas technology products. Some of the more notable opportunities are: Future Billing Methodology in the U.K. and its potential for export into Western Europe; biomethane applications in the U.K., and now also in North America; our Italian re-metering contract; our efforts to have GasPT certified as a process control device on a global gas turbine manufacturers equipment; and efforts to have GasPT certified for the North American market and sold into major transporters of natural gas. I firmly believe that our gas integration capabilities and products give us a unique portfolio in the market that serves as a competitive differentiator.

In summary, I believe we are on track to develop a diversified platform for growth and with the right strategy to establish CUI as a leader in the energy infrastructure services industry that will support a sustainable growth trajectory. The CUI Global employees I have met over the last several months are dedicated, incredibly skilled and motivated to turn a fresh page in the CUI Global story and empowered to make CUI Global a success. I am honored to be leading this team and this company.

Now let's open the call to your questions.

QUESTIONS AND ANSWERS

Operator

I show our first question comes from Eric Stine from Craig-Hallam.

Aaron Spychalla - Craig-Hallum Capital Group, LLC - Research Analyst

It's Aaron Spychalla on for Eric. [It's] good to hear on the acquisition front [that you're] targeting a less dilutive deal first. Anything else you can share there on size or multiple, or just maybe a little bit on the financing things, how that's coming together from interest rates or -- I understand the sensitivities, but just any other color you could share there would be helpful.

Daniel N. Ford - *CUI Global, Inc. – Chief Financial Officer*

Jim, do you want to take that first? Or would you like me to address some of that?

James Francis O'Neil III - *CUI Global, Inc. - Vice Chairman & Chief Executive Officer*

[muffled commentary]

William J. Clough - *CUI Global, Inc. - Executive Chairman*

Yes, Aaron, just broadly -- this is Bill. I'll let Jim do more specifics. But broadly, we're trying to look at companies that are trading at multiples that we feel are in a position [where] we can get a good value for what we pay and see a return on the multiple in the marketplace. We do that by picking businesses that are well-motivated, that are well-run, that are efficient, and that make margins [higher] than what the normal entity in that [industry] does. But as far as specific details about size or exact multiples, we are prepared to, we believe, announce something before the end of the year, and all those things will be announced at that time. Other than that, there's not a lot we can say. I think, Jim, if you want to [add to this]?

James Francis O'Neil III - *CUI Global, Inc. - Vice Chairman & Chief Executive Officer*

Yes. I mean, Aaron, in this industry [in which] we're buying this company, I mean, it's no secret that, that runs -- the considerations run between about 4x to 6x earnings or EBITDA. If the backlog is pretty nailed down. It could be all future 12 months, but it's usually all trailing 12 months, and we're right down the middle of that as far as evaluation for this company. So, I've been asked before about whether we're overpaying for companies, and we're certainly not. That's one of the reasons why we've looked at so many companies. I don't think we're trying to find the right company that's been successful and has proven in the industry, but [also] one that we can buy at the right multiple as well.

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

All right. Good. We'll stay tuned there. And then maybe second, you mentioned kind of realigning some of the resources in Orbital [UK]. Can you just -- I'm not -- I know you don't guide specifically for next year. But just as we think about that business with some resources being realigned, is it possible that we could be looking at businesses closer to breakeven? Or just how are you thinking about that business as we move into next year?

James Francis O'Neil III - *CUI Global, Inc. - Vice Chairman & Chief Executive Officer*

Well, I think that's exactly what I was thinking. I was trying to bring it to breakeven at the current level of revenue that are coming in, and we do believe that next year will be better than this year. There are so many opportunities that we think are getting ready to break loose. So -- but we did need to do some cost restructuring. It's for the current level of business. And we've done that over the last 90 days.

Operator

I show our next question comes from Rob Brown from Lake Street Capital Markets.

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

Maybe just one more in your acquisition strategy. It sounds like you're getting a platform business here in the first step. What's sort of…as you look at a strategy, do you build off these platforms? Or do you try to get more platforms in different places and kind of get a geographic expansion?

James Francis O'Neil III - *CUI Global, Inc. - Vice Chairman & Chief Executive Officer*

That's a great question, Rob. What you would normally do if you had a density of companies would be try to leverage off of a platform to try to bring in an adjacent geography or a complementary service line. Right now, I'm trying to build across some of these different industries, so you may not see synergies immediately. And the main reason for that is I think diversification is important to have a across these industries. So, while we're buying an oil and gas infrastructure company first, we may be moving to the electric power sector next. But ideally, once you bring in some of these platforms, trying to leverage off those platforms to make 1 plus 1 equals 3 and bring some synergies in, that will be a focus of ours.

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

Okay. Good. That's great color. And then on these -- I know it's a little hard to say without knowing exactly what you're buying, but is there a typical growth rate these businesses are running at? And what's the growth rate of the industry, or maybe the growth that you'd like to see in the businesses you're acquiring?

James Francis O'Neil III - *CUI Global, Inc. - Vice Chairman & Chief Executive Officer*

I want to see double-digit growth rate on the bottom line and organic growth rate in these companies that we look at. And the one that we're looking at to acquire definitely has a strong double-digit bottom line growth and top line growth over the last 3 to 5 years.

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

Okay. Excellent. Then last question just on the balance sheet. When -- after the sale of the power business, I guess, what's the -- what's kind of the net cash you think you'll have? Is it right around that $31 million, $32 million of net cash after the dust settles?

Daniel N. Ford - *CUI Global, Inc. – Chief Financial Officer*

[inaudible]

William J. Clough - *CUI Global, Inc. - Executive Chairman*

Dan, why don't you take that?

Daniel N. Ford - *CUI Global, Inc. – Chief Financial Officer*

Sure. Yes, that's what it looks like. It's going to be subject to working capital, which is an ever-moving figure with AR and inventory numbers and payables. But yes, it's looking along those lines for the balance sheet at this point in time. We'll pay off the line of credit, which had a small balance at [September] 30, and we'd be running on all cylinders, so. The other thing is there will be no debt, I just want to mention that. We did get rid of the $5.3 million note. Line of credit will be paid off, and so we'll have a very healthy balance sheet. And on top of the cash, we also have the [$5 million] note receivable from Back Porch [the acquirer of the Electromechanical Components business] for the sale of CUI devices that is coming due over the next [5] years.

Operator

I show no further questions in the queue. At this time, I'd like to turn the call over to Mr. Jim O'Neil, Vice Chairman and CEO, for closing remarks.

William J. Clough - *CUI Global, Inc. - Executive Chairman*

[inaudible]…go ahead [Jim].

James Francis O'Neil *CUI Global, Inc. - Vice Chairman & CEO*

Yes, this is Jim O'Neil. Thank you all for joining us today, and we look forward to follow-up conversations with many of you over the next few days. Thank you and have a great evening.

William J. Clough - *CUI Global, Inc. - Executive Chairman*

Thank you, operator.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Good day.