Pioneer Power Solutions Inc.
Second Quarter Fiscal 2014 Conference Call
August 7, 2014

Operator: Good day and welcome to the Pioneer Power Solutions Second Quarter Fiscal 2014 Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Brett Maas of Hayden IR. Please go ahead, sir.

Brett Maas: Thank you. Good day and welcome to Pioneer Power Solutions' 2014 Second Quarter Earnings Conference Call. The call today will be hosted by Nathan Mazurek, Chairman and Chief Executive Officer; and Andrew Minkow, Chief Financial Officer. Following this discussion, there will be a formal Q&A session open to participants on the call. We appreciate having the opportunity to review the 2014 Second Quarter Results.

Before we get started, let me remind you this call is being broadcast over the Internet and that a recording of the call and the text of Management's prepared remarks will be available on the Company's website. During this call, Management will be making forward-looking statements. These statements are based on current expectations and assumptions that are subject to risk and uncertainties that could cause actual results to differ materially. Please refer to the cautionary text regarding forward-looking statements contained in the Earnings Release issued today, and in the posted version of these prepared remarks, both of which apply to the content of this call.

I'd now like to turn the call over to Nathan Mazurek, Chairman and CEO for opening remarks. Nathan?

Nathan Mazurek: Thank you, Brett. Good morning and thank you all for joining us today for our conference call. I'll first discuss the business highlights for the first quarter and then I'll turn the call over to Andrew Minkow, our Chief Financial Officer, who will cover the financial results for the second quarter and year-to-date, as well as our guidance for 2014. We will then open up the call for questions and answers.

While the second quarter operating results were somewhat lower than our expectations, the underlying metrics have reinforced our confidence in the intermediate and longer-term trends for our business. Our new orders and backlog increased dramatically, but our profitability for the quarter was impacted in large part by follow-on investments we are making and continue to make in our latest acquisitions and in our corporate selling group, principally, the hiring of additional sales and engineering personnel; 25 people in all, since the end of last year. We have been consistent in communicating that this was what we would be doing and that it would be—and that it would negatively impact results for 2014, as these new professionals take time to get up to speed and have an impact on our—positive impact on our profitability.

At this early stage, however, I am happy to be able to report that this effort is bearing fruit, as evidenced by the 100% plus revenue growth delivered so far this year by our latest acquisitions, in their platforms and our corporate selling group, as compared to the year-ago, three and six month periods. While this revenue growth is reassuring, not enough time has yet passed for it to fully offset the incremental overhead expense associated with the investments we made and will continue to make in these divisions.

As expected, new and existing customers are responding well to our expanded portfolio of capabilities and I'm increasingly confident that our investments will drive accelerated and sustainable revenue growth and incremental profits. But, we expect this growth to come later this year in 2014 than our initial guidance anticipated and it will be felt in an even more robust way through 2015 and, hopefully, beyond that. As a result, we are adjusting our 2014 guidance, Andrew will cover it in more detail in a few moments, but we have revised our full-year revenue guidance down by approximately 4% and non-GAAP EPS down by approximately 19%.

It is important to note that this is partially a timing issue. In our minds, it's not a question of if, but really when. We have not lost any significant projects nor are we seeing any systemic weakness in our target markets. The largest and most profitable parts of our business have always been project-oriented and a small number of significant orders can materially shift our near-term outlook. These projects are often subject to delays beyond our control. This situation does not impact our confidence or our optimism, in fact, while 2014 will not quite meet our earnings expectations, these strategic investments and the delays related to certain projected opportunities, position us for an exceptional 2015 with a record current backlog, growing bookings, a more comprehensive suite of offerings, and increasing demand.

I am more confident today that we are absolutely on the right path towards greater and more predictable profitable growth than at any time before. One reason for my optimism and one reason where (inaudible) the area that it manifests itself is in our record backlog. Our backlog as of June 30 was up 33% or $8 million, to $32.4 million, as compared to the $24.4 million we reported both as of the end of 2013 and at the end of the second quarter of 2013. Again, most of our business has long sales and production cycles, so the bookings we have seen in the first half of the year are not expected to significantly appear in our reported results until our third and fourth quarters of this year, and on into 2015.

We are also encouraged by our improving book-to-bill ratio which demonstrates strong demand for our products across our entire

Company. Bookings during the second quarter exceeded $28.2 million with $21 million shipped and billed. At 1.34, our book-to-bill ratio is the highest it's been in the last 11 quarters and this sets the stage for stronger results in the near future, bolstering our confidence for a strong 2015. The top and bottom line results for the second quarter were down year-over-year, as a result of the timing of certain customer orders which is inherent to our project-based business model, as well as external factors like foreign currency exchange.

As we look out into the second half of the year, barring any unforeseen delays, we see there being a clean beat of last year's strong top line and bottom line second half performance. Make no mistake, we are disappointed that our progress is taking longer than we expected and also that we are lowering our earnings outlook today. Nevertheless, our key sales and operational indicators point to solid underlying fundamentals and a return to growth, and increasing earnings in the second half of 2014, as well as into 2015.

I will now turn the call over to Andrew Minkow, our CFO, to provide details of our 2014 second quarter and year-to-date financial results, as well as our 2014 guidance.

Andrew Minkow: Thank you, Nathan. Let's first take a look at the results for the June quarter and year-to-date in a little more detail and then I will address our 2014 guidance. Second quarter revenues were $21.1 million, down 4.2% from $22 million in the second quarter of 2013.

To break this down further, the $0.9 million year-over-year decrease includes a $1.8 million decline in sales of electrical transformers, which was partially offset by a $0.9 million increase in switchgear-related equipment by our newest businesses, Critical Power and Pioneer CEP.

Gross profit for the second quarter was down to $4.2 million or a 19.9% gross margin, compared to a $5.6 million gross profit or a 25.4% gross margin in the second quarter of 2013. The gross margin percentage on sales of transformers decreased by 4.5% during the quarter, driven mostly by lower sales and a less favorable mix as compared to the prior year, particularly in our liquid filled product categories.

The gross margin percentage on sales of circuit protection and control, or CPC, equipment also declined during the quarter as a result of mix due to the timing of acquisitions, and due to the timing of a large customer order—several orders, pardon me, which affected our ability to absorb manufacturing overhead.

Critical Power, generally our highest gross profit margin business represented just 15% of CPC equipment sales during this quarter, as compared to 100% of CPC equipment sales during the June 2013 quarter of last year. As a result, Critical Power's gross margin percentage decreased due to its lower sales volume. During the June 2014 quarter, the balance of our CPC equipment sales were by Pioneer CEP, a business whose products earn an inherently lower gross margin percentage than Critical Power Solutions. In addition, as evidenced by its sales growth, Pioneer CEP is undergoing a major expansion and is not yet operating at targeted long-term gross profit margin levels.

For the quarter, selling, general, and administrative expenses were flat essentially at $3.5 million or 16.7% of revenues in the second quarter of 2014, compared to 16.1% of revenues in the year-ago quarter. Operating income for the quarter decreased 72% to $571,000, from $2.1 million in the second quarter of 2013. The decrease was driven by lower sales and a decrease in our gross profit margin.

Net earnings declined in the quarter to $302,000, from $1.3 million in the prior year's quarter. Adjusted EBITDA for the quarter was $1.1 million compared to $2.5 million in the second quarter of 2013. Our non-GAAP diluted EPS was $0.06, down from $0.24 in the prior year and as a reminder, during 2013 we completed a follow-on offering in our common stock and diluted our EPS by approximately 22% in the current period, just based on our increased share count alone.

Moving on to our six month financial results for the period ended June 30, 2014, our revenues were $42 million, down 5.8% or $2.5 million, from $44.5 million in the comparable period of 2013. Breaking this down further, the $2.5 million decrease includes approximately a $5.2 million decrease in transformer sales, which were partially offset by a more than six-fold increase in our circuit protection and control equipment businesses, which increased to sales of $3.1 million.

The decrease in liquid filled transformer sales was driven by foreign currency translation which resulted in a 7.5% decline for that part of our business, as well as the comparative effects of lower Canadian utility customer spend, and there being fewer large long-lead time projects scheduled for shipment during the first six months. The decrease in dry-type transformer sales resulted mostly from our standard product sales channels and to a lesser extent, by lower shipments of custom engineered medium-voltage units. Offsetting these decreases, dry-type transformer sales benefited from increased shipments of custom magnetics for OEM customers, particularly in the US.

Turning to our newest businesses; Critical Power accounted for almost half our sales of circuit protection and control equipment during the first six months of 2014, which consisted mostly of three large projects. One for a waste water treatment facility and the other two at US Government sites. Pioneer CEP doubled its sales on a sequential quarter basis and accounted for the remainder of sales of circuit protection and control equipment during the first six months of 2014.

For the first six months ended June 30, 2014, our gross profit was down 14.6% to $9.1 million at a 21.7% gross margin, compared to $10.7 million of gross profit dollars at a 23.9% gross margin for the year-ago period. The decrease in gross margin was driven by a sales mix that was more heavily weighted towards our less profitable product categories and by lower overall sales volumes.

For the six months ended June 30, 2014 as compared to the same six months in 2013, our liquid filled transformers represented 45.3% of our consolidated revenue, which is down from 51% of our consolidated revenue. Dry-type transformers represented 47.2%, down slightly from 47.8% in the year-ago period, and circuit protection and control equipment represented 7.5% of our sales for the six months ended 2014, up from 1.1% in 2013. The mix of these different product categories affects our gross margin and as the numbers determine or show, we're becoming a more diversified business in our revenue streams.

For the six months ended—for the six months, our SG&A expenses were $7.5 million or 17.8% of revenues, compared to $7.1 million or 15.8% of revenues in the year-ago period. The 2% increase in our SG&A dollars was driven primarily by a $1 million—by $1 million of incremental expense, due to the inclusion of the two businesses we acquired during the six months ended June 2013, as well as a $0.2 million increase in our corporate expenses, including for the expansion of our corporate selling group. Offsetting these increases, SG&A expense in our transformer businesses was down $0.8 million or 14.8%, primarily as a result of lower variable selling expense.

Our six month operating income decreased to $1.6 million, from $3.6 million in the year-ago period. Net earnings came in at $892,000, down from $2.2 million in the year-ago period. Our Adjusted EBITDA for the six months was $2.5 million or 5.9% of sales, as compared to $4.4 million or 9.9% of sales—9.9% of sales in the first two quarters of 2013. Lastly, our non-GAAP diluted EPS was $0.16, down from $0.42 in the comparable 2013 period.

Turning to our balance sheet: Our total debt is down to $9.6 million, as compared to $10.1 million at the end of last year. As of the end of the second quarter, we had net working capital of 14.1 million, compared to net working capital of 13.8 million including 0.4 million of cash and equivalents at December 31, 2013. Our ratio of current assets to liabilities stands at 1.9 to 1, and we had$ 10.2 million of available and unused borrowing capacity from our revolving credit facility, without taking into account cash and equivalents on-hand.

The availability of this capacity under our revolving credit facilities is subject to restrictions on the use of proceeds and is dependent on our continuing ability to satisfy certain financial and operating covenants, including financial ratios, all of which we satisfy at this point in time.

Lastly, I'd like to provide you with an update on our full-year revenue and earnings guidance for 2014. We are modifying our guidance for each of the metrics, which will now be revenues in the range of $88 to $92 million, our EBITDA is now expected in the range of $7.5 million to $8.5 million, and non-GAAP EPS diluted of between $0.60 and $0.66.

At a high-level, the combination of more rapid spending on growth initiatives, together with longer than expected sales conversion cycles has shifted our revenue and profit assumptions out by one to two quarters, which in turn, is driving the downward revision to our full-year revenue, EBITDA, and EPS guidance. Several of the underlying assumptions and inputs to our projections do, however, remain the same. Our revenue guidance assumes no acquisitions, is based on the current composition of our backlog, and revenue growth of up to 5% overall, led by our Critical Power and Pioneer CEP divisions, and achieved despite an approximate 3% headwind due to currency translation.

We assume a foreign exchange rate of $0.91 to CAD$1.00, up slightly as of the start of the year when it was closer to $0.90, which is still expected to affect approximately 55% of our revenue, as compared to 60% in 2013. We also continue to expect Critical Power to make a meaningful contribution towards our bottom line, especially during this third quarter while Pioneer CEP is now not budgeted to begin contributing profit until 2015.

Our "below-the-line" item assumptions continue to include an effective tax rate at or above 30% and a share count of approximately 7.2 million, due to the full-year impact of our 2013 public offering.

This concludes my remarks and I will now turn the call back over to Nathan.

Nathan Mazurek: Thank you, Andrew. Operator, I'd now like to open the call for questions.

Operator: Thank you. If you would like to ask a question today, you can join the queue by pressing star, one on your telephone pad. If you are joining us over a speakerphone, please make sure that your mute function is off before posing your question. Once in the queue, if you find your question has been answered, you can remove yourself by pressing star, two. Again, it's star, one to queue up for questions.

We'll first go to Matt Koranda with Roth Capital.

Matt Koranda: Good morning, Nathan and Andrew, thanks for taking my questions.

Nathan Mazurek: Our pleasure Matt.

Matt Koranda: I just wanted to start out with sales cycles. You guys mentioned that you were seeing some cycles kind of elongate. In what segments are you seeing gestation periods elongate the most?

Nathan Mazurek: It's mostly in the Critical Power business, that said, you know, they are typically very large jobs and they tend to be — they tend, not exclusively, as Andrew indicated, you know, the largest was a waste water treatment plant. But, they tend to be large datacenter-type jobs and the difference to us of one job shipping or not shipping in June and spilling into July or August, you know, shifts an entire quarter. You know, typically these jobs are let's say 250, 500, up to about a million dollars at a time. To a Company our size, you know, a million dollars is more than 1% of the revenue in any given year.

Andrew Minkow: Yeah, so it's both, you know, we get requests for proposals, we submit the proposals, and we can't control, you know, how fast that becomes a purchase order. The other side of it, if they're orders we have on-hand, you know to use an example, our Critical Power business had budgeted about 1.2 million of sales for the second quarter, which—oops, shipped out in the first 15 days of July. So, the second quarter didn't benefit from that and the third quarter will look especially strong because of that.

Nathan Mazurek: Not because we wanted to ship late, but because the ultimate customer decided for whatever other reasons, they weren't ready to take delivery until a later date.

Matt Koranda: Okay, that's very helpful guys. Then, just touching on backlog. You know, looks like some really nice backlog growth. Can you talk about the mix of products in the backlog? Is it similar to the sales mix in the first half and then, what kind of visibility does that give you into the second half of 2014?

Nathan Mazurek: Sure. It's a little bit more diverse than it's been or than it's ever been, I would say. So at 32.5 million, I'll try to break it down for you from the top of my head. You know, a little over 3 million of that is Critical Power now, which is great. Our dry-type business represents about 4.5 million of that; I don't think it's ever been that high. Our newest business in California is about 1.3 million, so that's up from zero last year.

Andrew Minkow: Right, the balance is liquid filled transformers.

Nathan Mazurek: Yeah.

Andrew Minkow: It's still whatever it is, 24 or 25 million is liquid.

Nathan Mazurek: Yeah, if you pick it apart, you know, Critical Power is one of the big changes that's happened in the last quarter and the other big change is about 6 million of new liquid filled transformer orders.

Matt Koranda: Okay, great and then, you know (cross talking).

Nathan Mazurek: You know, as an indicator, I think that was part of your question. As an indicator, the vast majority—let's say, more than 80% of our typical backlog, even with Critical Power will be shipped in six months, about. That's a fair indicator.

Andrew Minkow: Yes, and the other thing to add, is that the big uptick in the liquid filled, that's not all just for 2014. We have a bunch that's spreading nicely over the first part of 2015 as well, which positions us to be aggressive in what orders we take and how we schedule and hopefully, drive the profit margin.

Matt Koranda: Okay, great. That's helpful, as well, and then, if you could just comment briefly on order trends that you've been seeing since Q2? Can you give us a sense for July and how August has been tracking?

Andrew Minkow: July, I mean, I've looked at some flash numbers so far. I think in the businesses that are in—I'm thinking Jefferson and Critical Power. You know, I'd say the backlog into July has been stable versus June, in that (inaudible).

Nathan Mazurek: I'd say the same thing. I would've answered the same way; it's about the same in July. You know, August is still young. It started off, you know, really, really hot this week, I don't mean the temperature, but the order rates in both—in really, all the businesses, but some of that is maybe due just to some people's July lulls. So, (inaudible) we'll see.

We're not seeing any, you know, I think we said in the comments, it's not like we're seeing any systemic weakness in any of our target markets. It's not, for example, oh, distribution is down, construction is down, utility spend is down; it's all pretty much, you know, at the levels it was during the first half and last year.

Matt Koranda: Okay, great and then, in terms of gross margins. You know, what is a reasonable gross margin figure for the second half and just talk about how it sort of trends into 2015? I know it's kind of trothed (ph) out here. Do you think it's reached a troth or where do we go in the second half?

Andrew Minkow: Yeah, I think you're going to see a big improvement in the second half and that's driven completely by the mix of how much liquid filled transformers, how much Critical Power. So, you know, Critical Power will be a big component of the third quarter, and you'll see the gross margin growth there. I think this quarter we came in at 19.9%, its almost—I hate to make such a bold statement, it's inconceivable to me that in the third quarter we're not in, at least, the mid-20s, maybe a little less, maybe a little bit more than 25%. The fourth quarter, while still very strong relative to the third and strong compared to the fourth quarter of last year, I'm also looking at mid-20s gross margins. Although, slightly less than the third quarter.

Matt Koranda: Okay, great and then, one more here on the sales force. You know, you guys have invested heavily on the sales side of the business and it looks like it's really paying off, in terms of backlog growth. You know, how do you measure productivity of your sales force and can you give us a sense for how an average number of the sales force is tracking?

Nathan Mazurek: Yeah, I mean productivity at the end of the day is, you know, orders and shipments. For some of them it's still too early to—so that could be a full measure, they just started, some of them started recently, and we hired more in the last few months. We are actually hiring three more people this month, in August. One from more an engineering/marketing level and two pure sales people.

It's—you know, what doors have they opened, what is the access, what is the reception? We've been—it's not our first rodeo. We know when we're getting a real bite, when we're getting real opportunities or where it's just smoke. I didn't say it in the script, but you know, I'll say it here clearly, you know, the people that we've hired, these are consummate professionals, and these are people very, very well respected in the industry. These are hard-working people, people that have a lot of credibility whether they be more on the sales-end or on the engineering side.

The reason we hired them, the reason we're making these investments is that we're trying to build these businesses into being more sustainable, more profitable, more predictable over the coming years, and accelerate their growth. You know, these individuals give it that access and give it that gravitas much earlier than if we would've waited.

I mentioned, yesterday, we had our quarterly Board Meeting, you know, we could've had a much better quarter. We could not have had a strategic sales group, we could've avoided having, you know, nine more of these people. You know, nine individuals, you know, total up the salaries, that's a drag of $0.20 on an annual basis to us, given our size. But then Critical Power, you know, it would look good this year, but it's not a sustainable, it's not then predictable, it's not going to be a consistent grower without these people additions. You know, we're at this point we've made a lot of investments in equipment and in businesses and we don't really need any more physical assets in that way or inanimate objects. We're investing in animated, you know, capital right now.

Andrew Minkow: I think the only way I'd amplify what Nathan said is, you know, we've invested, we've made these acquisitions to broaden our product capabilities, right? Those entities that we bought had a certain ability to generate their own sales and profits. We're now trying to put that on turbo-boost and I look at some of these key people that we've hired and, frankly, at the expense of our bigger competitors in those product areas, and they should really be able to push the accelerator on what we've built for them.

Matt Koranda: Okay, great, guys. That's really helpful and then, you know, just one last one here. In terms of acquisitions, just any updated thinking there? I know you guys have mentioned the potential of some, you know, some potential acquisitive (ph) growth on the past calls here. Just give us, you know, a window into your latest thinking?

Nathan Mazurek: Yeah, we're seriously engaged in several discussions. So there are willing sellers, some of those transactions are larger and would be more transformative. Some of them are smaller, would be more bolt-on or, you know, additions to what we're doing. Again, we try not to comment more than that. It's a robust pipeline, it's more than a pipeline. These are serious discussions and these are actual sellers. Whether we'll successfully complete them or be the successful bidders is still a little bit too early. Hopefully, this same time in the third quarter we'll be able to be more definitive, hopefully, in a positive way.

Matt Koranda: Okay, thank you and I'll get back in queue.

Nathan Mazurek: Any other questions?

Operator: As a reminder to the audience, if you do have a question today, you can signal by pressing star, one. That's star, one on your telephone keypad.

Our next question comes from Michael Potter with Monarch Capital Group.

Michael Potter: Hey, guys.

Nathan Mazurek: Hey, Michael.

Michael Potter: Just a follow-up question on the hiring and sales side. Nathan, are you targeting any particular industries or sectors? Are we hiring any specific people with particular background, let's say, in energy or chemical industry or backup power? Anything along those lines?

Nathan Mazurek: Right. So, the hiring is primarily for the Critical Power business. I think I should say it's really two; it's for Critical Power, it's for the custom power equipment and, two of the hires for August are on the power dry-side business which again, is a growing nascent business for us. One is a very well-regarded engineer who's going to be spending most of his time marketing to the consulting engineers and one is a pure sales person. Someone that I've known for many, many years that has a lot of respect; had a lot of success for a competitor of ours.

So, the theme is that they're all for the growing parts of our business. We don't need any sales and marketing help on the liquid filled side, we don't need any help on the Jefferson, more standard-type side. It's really for the three platforms that are the most—that are growing fastest for us which is Critical Power, the part of Bemag which is power dry transformers and our Los Angeles-based, the custom power equipment business.

Andrew Minkow: Yes, in terms of what backgrounds they are, I mean, our approach isn't so much to find someone from an end-market, say chemicals was an example you used, and then try and teach them how to sell our products into it. Our approach, you know, at our size, is that we don't necessarily have the resources or the patience for such a person to get up to speed, so we tend to go after and hire people who have had success at our competitors, selling, and engineering our gear and we want them to do it now for us, as opposed to where they were before.

Nathan Mazurek: Yeah, Mike, just to give you a little more—on the Critical Power side, it's more a geographic coverage. Meaning, that business is driven by consulting engineers/large contractors who are doing mission-critical work. We're covered in Washington, D.C. We just hired a sales person who started this Monday to cover the Northeast which is essentially New York/New Jersey. We have someone in the Rocky Mountain area, although he is able to generate less because that region is less exciting.

We are still looking for somebody in Northern California and in Houston; those are two big markets where a rep is really not going to serve Critical Power correctly. We hired a, basically, specialist for Power dry transformers. He's going to, as he was in his prior position, he's going to basically deal with the large OEMs on his own. So, no reps, no geographical boundaries, you know, he doesn't need any help geographically. He's targeting, you know, maybe 40 large customers that buy enough of this equipment to make it worth all our whiles. I'm not sure if this answers your question or not.

Michael Potter: No, it does and then, on the acquisition side, I know you touched on it a little bit. You say you're looking at some small bolt-ons to some large transformative opportunities. That's a big part of the story of Pioneer. Do you anticipate that we will see something before the end of the year on the acquisition front?

Nathan Mazurek: I'd say that's fair—that would be a good bet to make.

Michael Potter: Okay. All right, guys, I'll get back into the queue.

Operator: As another reminder to the audience, it's star, one if you have any questions. That's star, one to join the queue.

Gentlemen, it appears that we have no further questions. I'll turn it back to you for any additional remarks.

Nathan Mazurek: Okay, thank you very much everyone for your time and attention. I look forward to updating you again in our next call. Take care.

Operator: Once again, that does conclude today's conference. We thank you for your participation.