Pioneer Power Solutions Inc.
Third Quarter Fiscal 2014 Conference Call
November 12, 2014

Operator: Good day and welcome to the Pioneer Power Solutions Third 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. 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 Third Quarter Financial Results.

Before we get started let me remind you that 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 make 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 would now like to turn the call over to Nathan Mazurek, Chairman and CEO for opening comments. Nathan?

Nathan J. Mazurek: Thank you, Brett. Good afternoon everyone and thank you for joining us today for the conference call. This was a strong quarter for Pioneer Power, validating our expectations that the second half of the year would be stronger than the first half. More importantly, the strength of our performance was broad-based with essentially all of our business operating on track and this essentially reinforces our confidence in 2015. In the third quarter we delivered solid results by most any financial metric, including double-digit percentage increases in revenue, EBITDA and EPS.

At just over $27 million our order backlog is not only more diverse than it has ever been before, but it is very robust in absolute terms, giving us a higher level of visibility into our expected revenue over the next several months. As of September 30, 2014, our backlog is up 13% as compared to $24.4 million at the start of the year. As compared to the same quarter of last year in September 2013, our backlog is up a full 29%. The same trend is evident in our order rate. During the quarter we received approximately $22.8 million in customer purchase orders as compared to $18.9 million in the third quarter of 2013, an increase of 20%. We expect that 2015 will be a very strong year for us on several levels, particularly as it relates to our year-over-year growth anticipated on our top and bottom lines. This expectation was made possible by our investments in the last 18 months to elevate our core earnings power through the integration of two acquisitions, the broadening of our addressable markets and the expansion of our sales and engineering teams in order to capitalize on previously unavailable sales opportunities. I believe that the combination of these activities have significantly enhanced Pioneer's profile for sustainable growth.

In the short term, however, these activities came at a cost and have had an overall impact on our reported earnings beginning in the fourth quarter of last year, and during this most recent quarter we began to see positive signs that we are close to turning the corner and realizing the return we expect from the talent we have hired in the last several months and the increased SG&A expense we have put in place.

From a qualitative standpoint, the diversity, the size, the rate of our quotation activity is at all-time highs; customers are responding positively to our new capabilities and the expertise we bring to bear.

From a quantitative standpoint our SG&A expense as a percent of revenue is down 0.5% compared to the same quarter last year. As always, the timing of certain customer orders and shipments, which is inherent to our project-based business model, as well as external factors like foreign currency exchange and translation, frequently impacts our quarter-to-quarter results, but over the long term we are headed in the right direction for sustainable revenue and earnings growth.

One of the catalysts driving our business more recently has been the datacenter market. Demand for programmable equipment to manage the distribution of electricity in back-up power scenarios, coupled with demand for magnetic solutions which are integral to managing the quality of the power inside the datacenter, creates a significant and growing opportunity for Pioneer. During the third quarter, we saw these two factors manifest themselves in a significant way. Sales to the datacenter market exceeded $3 million during the quarter or more than 10% of our overall revenues, and we believe this momentum will continue in the fourth quarter and accelerate in 2015.

I think this development is also emblematic of our efforts to make Pioneer more diverse in terms of its exposure to different end markets. For example, in 2013 we benefitted from strong demand in the oil and gas sector. This demand began to ebb somewhat during the first half of 2014 and as the price of oil has fallen dramatically in the last few months we are feeling less demand for major capital projects in the oil and gas related industries for next year. However, given the greater diversity we now enjoy overall in our end markets, we expect that our datacenter and other market segment-driven solutions will be able to more than pick up the slack and indeed be part of the accelerated growth we expect for 2015.

With the third quarter behind us, today we are reiterating our 2014 financial guidance. Andrew will review this in more detail shortly.

The strategic investments we have made position us for incremental growth and earnings improvement in 2015. I remain confident that we are on the right path towards accelerated top and bottom line growth.

I will now turn the call over to Andrew Minkow, our Chief Financial Officer to provide details of our 2014 third quarter and year-to-date financial results, as well as a review of our 2014 guidance.

Andrew Minkow: Thank you, Nathan. I will first review the results for the September quarter and year-to-date in a little more detail and then I will review our 2014 guidance.

Third quarter revenues were $26.1 million up 16.3% from $22.4 million in the third quarter of 2013. More specifically, the $3.7 million year-over-year increase was driven by approximately $1 million in higher sales of electrical transformers, up 4.4% over the last year, and the $2.7 million sales increase of circuit protection and control equipment sold by our Pioneer Critical Power and Pioneer CEP business units. The increase in circuit protection and control equipment, or CPC, represents a $2.7 million or 318% increase compared to the September quarter of last year.

From time to time our sales figures are negatively impacted by the effect of foreign currency translation when comparing our results to prior year periods, as was the case this quarter. But on that subject we achieved an important milestone this quarter which was that for the first time our sales to US customers exceeded sales to Canadian customers. We expect this reversal to become the new norm starting in 2015 and that foreign currency translation will become a more muted factor in evaluating our results.

Turning to our gross profit for the third quarter it was up to $6.7 million or 25.7% gross margin compared to a $5.9 million gross profit or 26.3% gross margin in the third quarter of 2013. The gross margin percentage on sales of transformers decreased by 1.5% during the quarter, driven mostly by a less favorable sales mix in our liquid filled product categories, which was partially offset by slightly higher gross margin on increased sales of dry-type transformers compared to the prior year quarter.

Critical Power, our highest gross profit margin business was the driving force behind the 34.1% gross margin earned on our

CPC equipment sales during the quarter. This is down 1.9% for the product class as compared to the same quarter of last year due to the increased CPC sales of our new Pioneer CEP business unit, a business whose revenues have been growing rapidly and whose products attract an inherently lower gross margin percentage than Critical Power Solutions.

For the quarter, our selling, general and administrative expenses increased 12.8% on an absolute dollar basis to $4.1 million as compared to $3.6 million in the third quarter of 2013. As a percentage of revenue, SG&A expenses decreased from 16.1% of revenue in the third quarter of 2013 to 15.6% of revenue in the third quarter of 2014.

Operating income from the quarter increased 22.6% to $2.8 million, up from $2.3 million in the third quarter of 2013. The increase was the result of higher overall sales, which was partially offset by a lower gross margin and an increase in SG&A.

Net earnings increased 76.7% in the quarter to $1.8 million from $1 million in the prior year's quarter. Our Adjusted EBITDA was $3.2 million during the quarter or 12.4% of revenue as compared to $2.7 million or 12% of revenue in the third quarter of 2013. Our non-GAAP diluted EPS was $0.28, up 33.3% from $0.21 in the prior year.

Turning to our nine month financial results for the period ended September 30, 2014; our revenues in the nine months were $68.1, million, up 1.6% or $1.1 million from the $67 million in the comparable period of 2013. Breaking this down further, the increase is due to a nearly five-fold increase in sales of CPC equipment which increased to $6.7 million compared to $1.4 million in the prior year period, partially offset by a $4.2 million or 6.5% decrease in transformer sales during the nine months ended September 30, 2013.

Approximately two-thirds of the decrease in liquid filled transformer sales was driven by foreign currency translation. The remainder of the decline was due to a number of large unrepeatable project-based orders during the first nine months of 2013, particularly in the oil and gas sector, that were not fully replaced during the 2014 period. Utility sales of liquid filled transformers were stable on a year-over-year basis measured in constant currency, reflecting lower capital spending by some of our largest Canadian utility customers, offset by a significant increase in US utility sales, which still remain a small component of our overall liquid filled transformer revenues.

The net decrease in our dry-type transformer sales during the nine months ended September 30, 2014, occurred mostly during the first two quarters and resulted from lower demand in our Canadian electrical distributor channel, compounded by the effect of currency translation. Our US sales of dry-type transformers were up approximately 1% during the nine months ended September 30, 2014.

Turning to Critical Power, Critical Power accounted for almost half of our sales of CPC equipment during the first nine months of 2014, which consisted mostly of paralleling switchgear and genset controls for large datacenter projects. Pioneer CEP, which was established in August 2013 to serve electrical distributors mostly in the US Southwest, represented the other half of our sales of CPC equipment during the nine months ended September 30, 2014.

For the nine months, our gross profit was down 4.5% to $15.8 million at a 23.2% gross margin compared to $16.6 million of gross profit dollars at a 24.7% gross margin for the year-ago period. The decrease in gross margin was driven primarily by lower project-based industrial orders for our liquid-filled transformers as compared to the prior year period.

As for our sales mix, which is instrumental to understanding shifts in our consolidated gross margin, for the nine months ended September 30, 2014, as compared to the same nine months of 2013, liquid filled transformers represented 45% of our consolidated revenue, which is down from 51% of consolidated revenue in the prior year; dry-type transformers represented 45.1%, down from 46.9%, and CPC equipment grew to represent 9.8% of our sales for the nine months ended 2014, up from 2% in 2013.

Turning to SG&A, for the nine months our expenses were $11.5 million or 17% of revenues compared to $10.7 million or 15.9% of revenues in the year ago period. The 8.3% increase in our SG&A dollars was driven primarily by having additional months of operations in the 2014 period for the two businesses we acquired during the 2013 period, representing $1.4 million of incremental expense. In addition, our corporate expenses increased by $0.5 million primarily due to the expansion of our corporate selling group. Offsetting these increases, SG&A expenses in our transformer businesses were down by approximately $1 million or 12.7%, primarily as a result of lower variable selling expense, including commissions and freight.

Our nine month operating income decreased by 25.2% to $4.4 million from $5.9 million in the year-ago period. Net earnings decreased to $2.7 million, down from $3.2 million in the prior year. Our Adjusted EBITDA for the nine months was $5.7 million or 8.4% of sales as compared to $7.1 million or 10.6% of sales in the first three quarters of 2013. Lastly, our non-GAAP diluted EPS was $0.43 for the nine months, down from $0.63 in the comparable 2013 period.

Turning to the balance sheet, our total debt is down to $9.7 million as compared to $10.1 million at the end of 2013. As of the end of the third quarter we had net working capital of $14.9 million compared to networking capital of $13.8 million which includes $4.4 million of cash and equivalents as at December 31, 2013. Our ratio of current assets to liabilities stands at 1.8 to 1 and we had $10.6 million of available and unused borrowing capacity from our revolving credit facilities, without taking into account cash and equivalents currently on-hand of $0.7 million as of September 30, 2014. The availability of this capacity under our revolving credit facility is subject to some restrictions on the use of proceeds and is dependent upon our continuing ability to satisfy certain financial and operating covenants, including financial ratios.

Lastly, as Nathan mentioned, today we are reiterating the full year revenue and earnings guidance for 2014 that we provided in the last quarterly earnings call. This guidance suggests that revenues will fall in the range of $88 to $92 million for the year, Adjusted EBITDA in the range of $7.5 to $8.5 million, and non-GAAP diluted EPS of between $0.60 and $0.66. Today we are reaffirming this guidance based on year-to-date trends in the business as well as the current composition of our order backlog. As a reminder, key assumptions embedded in our guidance are the exclusion of any impact from potential acquisitions, a foreign exchange rate of $0.87 to $1.00 CAD, which reflects an unfavorable update down from $0.91 when we last gave our guidance in August. And lastly, our Critical Power business is expected to make a meaningful contribution towards our bottom line this year, whereas Pioneer CEP is now not budgeted to begin contributing profit until 2015.

In addition our below the line 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 the 2013 public offering we completed.

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

Nathan J. Mazurek: Thank you, Andrew. Operator, it would be my pleasure to open the call for questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing star, one, on your telephone keypad. If you are using a speaker phone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again press star, one, to ask a question and we will pause for just a moment to assemble the queue.

We will take our first question from William Bremer with Maxim Group.

William Bremer: Good evening, Nathan, Andrew. Nice quarter.

Nathan J. Mazurek: Hey, William.

Andrew Minkow: Hello.

William Bremer: So first off, first question I had is you spoke a little bit about your capex or what you're seeing in capex from your clients. Can you get a little more granular? Some industries, your end markets seem to be holding quite well, others maybe just slightly coming back. Can you get a little more granular there for us?

Nathan J. Mazurek: Yes, I mean we don't break our business down into a lot of different segments. Oil and gas has definitely been weaker this year; that's traditionally a very, very strong market for us. Mining has been weak starting at the beginning of last year. The datacenter market, or those involving any data-driven kind of projects, have been super strong, and general industrial demand for us has been stable, if not maybe something, whatever it is, slightly better than stable. More granular than that I can't tell you. We don't serve some markets in a big enough and consistent way to talk about them, like steel or petrochem and the like.

William Bremer: Right, right. Your backlog figure, quite impressive. Is it safe to assume that the pricing or the mix of that backlog is better than it was say a year ago at this time?

Andrew Minkow: It's probably a little bit better only because it includes much more Critical Power, so that's the highest gross margin business that we have that is in the backlog. Those margins should be up somewhat, but overall the backlog and our margins are still driven primarily by the liquid-filled business.

William Bremer: Right, right. Then my final question and then I will turn it over is, can you give us an idea what was the largest order that was realized during this quarter?

Nathan J. Mazurek: Yes, I mean I don't want to give out customer names but it was, the largest order realized in the quarter was the…

William Bremer: Even the monetary value would be fine. Would it be (inaudible)?

Nathan J. Mazurek: Because I am thinking October is not this quarter. That's a good question. It's probably—yes, it probably would have been a Critical Power order about a $1 million or so.

Andrew Minkow: A little more, it was about a $1.3 million that we shipped in the third quarter, one data center order.

William Bremer: Okay, quite impressive. Nice quarter, gentlemen.

Nathan J. Mazurek: Thank you.

Andrew Minkow: Thank you, William.

Operator: Again, if you would like to ask a question, that is star, one, on your telephone keypad. We will take our next question from Matt Koranda with ROTH Capital.

Matt Koranda: Hey, good afternoon, Nathan and Andrew. Thanks for taking my questions.

Nathan J. Mazurek: Hi, Matt. Pleasure.

Matt Koranda: Yes, so I just wanted to start out with your guidance. The implied guide for Q4, taking the midpoint, that $90 million midpoint, seems to imply that revenues could be down sequentially in Q4. Are you expecting maybe just a little bit of sequential weakness? I mean just talk to us about the factors that kind of swing it around in that $88 to $92 million range that you provided before.

Andrew Minkow: Yes, I would definitely expect to see lower sales when comparing this third quarter to the fourth quarter, because we are not a business that necessarily grows on a constant quarterly slope. It's driven so much by what projects we expect to ship. So while I think you can expect down from the third quarter, you should still expect up from the fourth quarter of the prior year. On that basis, it should become a little bit more clear how we fall within our revenue guidance.

Matt Koranda: Okay, that's helpful. Then could you—just a housekeeping one, could you give us the breakdown between liquid filled and dry-type transformers during the period?

Andrew Minkow: Yes, it's in our Q now available online, and in it you will see we did $11.7 million in liquid filled during the September quarter, as compared to dry type sales of $10.9 million.

Matt Koranda: Okay, great. That's helpful. I didn't get to look at the Q just yet. Okay, and then talk about some of the drivers behind the really strong Critical Power and CEP segment, I mean you guys are—it looks like you are doing a really nice job growing revenue there. How much of it do you attribute to the end market improving? How much is attributed to the new sales force additions? Just talk about some of the dynamics there and what's driving it.

Nathan J. Mazurek: Yes, I mean everything is driving that market but for us but it is really the sales and engineering people who are driving it. We are starting at such a low level and in such a large market, it's being driven by our people going out there, by pushing Pioneer, by referencing the growing list of projects that they've now done, you know, (inaudible) the Critical Power business has done in the history and being successful. I mean you see the numbers. Critical Power did a million bucks for us last year in sales; this year it's going to do five. Their goals for 2015 are well beyond that. Their infrastructure is in place and we push hard because we are rewarded in that segment with the kind of pricing that gets us excited.

Matt Koranda: Great, that's helpful. Then I know you guys haven't given an outlook yet for 2015, but with the Critical Power and CEP segment up pretty substantially this year, could you just talk about kind of the growth rate, the trajectory moving into 2015?

Nathan J. Mazurek: Yes, I mean we normally give that kind of next time, but overall, I would say the liquid filled business is looking for a strong, definitely equal to or better than this year, only because I know what the first quarter is already and how the year is shaping up. It is not the kind of business you can catch up quarters, so if your first quarter is not strong it's hard to make—you can't make it up. So that's going strong. Jefferson, I think is going to be the big surprise. It has been very healthy this year and we are expecting a super stellar year from them next year, and then the continued growth of CEP and Critical Power. So we are very, very upbeat. We haven't come out with—we haven't done our own internal budgeting except kind of on one page. So we should come out with 2015 guidance in a couple of months.

Andrew Minkow: I mean, without giving too much away, and we haven't decided on any budget numbers officially, but if you look at our standard investor presentation, we talk about one of our constant goals which is at least 10% plus organic growth, and sitting where we are here today in November, I would say that's very likely for next year.

Matt Koranda: Great, great, that's very helpful guys. Then maybe you could just talk about—I think this is the stock question that we always ask but I think it's important—so acquisitions, what are you seeing out there? Anything kind of in the near time pipeline? What gets you excited that's out there and the opportunities that are available?

Nathan J. Mazurek: Right, I mean we have two/three that we're actively engaged in and that we expect to complete in the next—hopefully not all at same time but over the next several months. One is significant and it's pretty much based all on Critical Power. The other is based would help broaden our scope within Jefferson into being more of a power quality-driven business, less of just a magnetic solution, and that's a very exciting opportunity; the last would be a real opportunity to enhance the product suite and reach of our CEP business. So the pipeline is full; we have to bring them home.

Matt Koranda: Okay, excellent, that's helpful. I'll jump back in queue here, guys. Thanks.

Operator: At this time there are no further questions over the phone lines. I would now like to turn the conference back to Management for any additional or closing remarks.

Nathan J. Mazurek: Okay, thank you very much for your time and attention. I look forward to updating you all again in our next call, and thank you all for your continued interest, and more importantly, your continued support of Pioneer. Thank you.

Operator: This now concludes the presentation. Thank you for your participation.