PIONEER POWER SOLUTIONS INC.

First Quarter 2015 Conference Call
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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Matt Koranda, *ROTH Capital Partners, LLC*

Michael Potter, *Monarch Capital Group, LLC*

William Bremer, *Maxim Group, LLC*

PRESENTATION

Operator:

Good day and welcome to the Pioneer Power Solutions, Inc. First Quarter 2015 Conference Call. Today's conference is being recorded. At this time I'd like to turn the conference over to Jeff Stanlis from Hayden IR. Please go ahead.

Jeff Stanlis:

Thank you, Danny, and good day everyone and welcome to Pioneer Power Solution's 2015 first quarter financial results 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 first quarter financial results.

Before we get started, let me remind you that the 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 risks 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 the call.

I would now like to turn the call over to Nathan Mazurek, Chairman and CEO. Nathan, go ahead.

Nathan Mazurek:

Thank you, Jeff. Good morning and thank you all for joining us today for our conference call. The first quarter of 2015 was a quarter of solid double-digit growth and operational progress. We are on the right path, we delivered 38% revenue growth due in part to our acquisition of Titan Energy in the fourth quarter, at the very end of the fourth quarter of 2014, but just as importantly, on an organic basis, we grew revenue at a notable 14% year-over-year rate. Normalized for foreign currency fluctuation, our organic growth rate translates to 21% year-over-year. Our growth was derived both from both segments of our business with the impact from foreign currency on our Canadian business being more than offset by growth from our US businesses.

Our two largest business units both in our T&D Solutions segment performed very well and each exceeded our top- and bottom-line expectations for the first quarter. Our T&D Switchgear business which we acquired in the second half of 2013, is getting closer to achieving our operational performance expectations, revenue more than doubled versus last year, and its losses narrowed as the business continues to scale. More work is needed with our Canadian Dry-Type Transformer business which still faces challenging conditions in the commercial construction market and we are taking specific steps to increase utilization, reduce costs, increase profitability, and bring this business in-line with our expectations and standards.

In our Critical Power Solution segment, we are very encouraged by the growth of our Titan Energy Systems acquisition, which has being delivering a growing stream of recurring service revenues. We are also pleased with progress in integrating its operations and have taken decisive actions to simplify its business for greater profitability and alignment with our strategic priorities.

As most of you know we have been building a diversified organization through acquisitions. Our model so far has been based on buying smaller technically competent and frequently undercapitalized businesses at attractive valuations. We then professionalize these organizations from a sales and marketing standpoint, bring their production operations up to our standards, and increase their market opportunities by integration with other businesses we own through cross-selling and by introduction of new product lines.

Our goal has been to take businesses acquired at valuations favorable to shareholders and make them worth significantly more in a relatively short period of time. Our Jefferson Electric business is a case in point. This doesn't always happen according to our original schedule in each case, sometimes faster and sometimes slower. But our track record so far has been quite good. We only have one real laggard at the moment out of our six reporting units.

Our Canadian Dry-Type Transformer business continues to face challenging conditions in its market. It has not grown as expected and in the quarter it lost money, which is not acceptable to me or any member of our Management Team. A lot of this was due to external factors that we did not adequately anticipate, but we are taking specific steps to reposition this business, in order to meet our expectations and standards, which we believe will show acceptable results in 2016.

Our backlog at the end of the first quarter was $31.7 million up nearly 25% from a year ago, but down sequentially as we converted a portion of it to the current period revenue. Our order backlog continues to be diverse both in terms of size and source of orders, and provides us with the clarity to reaffirm our 2015 full-year guidance. Our focus this year will be to leverage the earnings power and the acquisitions we've already made through a focus on integration and optimization, setting the stage for which I will believe—which I expect will be a compelling earnings trajectory from 2015 forward.

I will now turn the call over to Andrew Minkow, our Chief Financial Officer, to provide the details of our first quarter financial results, as well as a review of our 2015 guidance, which as I mentioned, we are reaffirming today.

Andrew Minkow:

Thank you, Nathan. First quarter revenues were $28.9 million, up 38.3% from $20.9 million in the first quarter of 2014. The $8 million year-over-year increase was driven by a $4.1 million increase in our Critical Power Solution segment. That includes Titan revenues of $5.1 million. The increase due to Titan revenues was partially offset by a $1 million year-over-year decrease resulting from a lack of major projects shipped by our original Critical Power Switchgear Manufacturing business whose revenues we expect to be back-end loaded in 2015, specifically with datacenter-related projects from a repeat customer.

The remaining $3.9 million increase in our consolidated revenue was derived from our T&D Solution segment and includes higher sales of our transformer product lines, which was also heavily skewed towards datacenter applications, as well as a three-fold increase of sales of Switchgear equipment.

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 where approximately 36% of our consolidated sales were to Canadian customers at a blended 11% lower currency conversion rate as compared to the same quarter of 2014.

Our gross profit for the first quarter was up to $5.4 million or an 18.7% gross margin compared to a $4.9 million gross profit or a 23.5% gross margin in the first quarter of 2014. The decrease in gross margin percentage was driven mostly by the results of our larger T&D Solution segment, which included a smaller proportion of custom engineered higher margin liquid-filled transformers and unfavorable material purchase price variances due to the strengthening of the US dollar, together with an unfavorable mix shift in our Critical Power Solution segment.

For the quarter, SG&A expenses increased 33.7% on an absolute dollar basis, to $5.1 million as compared to $3.8 million in the first quarter of 2014. Most of this increase is as a result of the acquisition we completed in December of 2014, that being Titan, who's SG&A expenses not included in our first quarter results of 2014 due to purchase accounting. As a percentage of revenue, SG&A expenses decreased from 18.4% of revenue in the first quarter of 2014 to 17.8% of revenue in the first quarter of 2015.

We had an operating loss for the quarter of $0.1 million compared to operating income of $1 million in the first quarter of 2015. The decrease was primarily the result of challenges at our Canadian Dry-Type Transformer business and the timing of orders at our Paralleling Switchgear Manufacturing business, as well as an additional $0.4 million of non-cash amortization expense related to intangible assets arising from the Titan acquisition, and an increase, a small one be it, in general corporate expenses.

Our net loss for the quarter was approximately $225,000 compared to net income of $590,000 in the prior year's quarter. Adjusted EBITDA was $834,000 during the quarter or 2.9% of revenue compared to $1.4 million or 6.9% of revenue in the first quarter of 2014. Non-GAAP diluted EPS was $0.03, down from $0.10 in the prior year.

Turning to the balance sheet, our total debt at the end of the quarter was down to $14.6 million as compared to $18.9 million at the end of 2014. As of March 31, 2015, we had networking capital of $5.4 million compared to networking capital of $9.7 million at December 31, 2014.

Our ratio of current assets to liability stands at 1.2 to 1 and we had $5.4 million of available and unused borrowing capacity from our revolving credit facilities. The availability of this capacity under our revolving credit facilities is subject to some restrictions on the use of proceeds and is dependent upon our continuing ability to satisfy certain financial and operating in covenants, including financial ratio.

Lastly, as Nathan mentioned, today we are reiterating full-year revenue and earnings guidance for 2015, which includes revenue of between a $110 and a $120 million, of which $85 to $95 million is expected to be derived from our T&D Solution segment and another $20 to $25 million from our Critical Power Solutions reporting segment. On a consolidated basis we're expecting Adjusted EBITDA of between $6.5 million and $7.5 million and non-GAAP diluted EPS between $0.45 and $0.55.

Our guidance is also based on the following key assumptions: the exclusion of the impact of any future acquisitions and an updated foreign currency exchange rate budget of USD$0.82 to CAD$1, which equates to an 11% unfavorable variance due to foreign currency translation as compared to last year, which is expected to affect almost 40% of our sales.

In addition, our below the line assumptions continue to include an effective tax rate at or above 28% and a share count of approximately 7.4 million. Based on the composition of our backlog, we expect that our second quarter results will be above the same quarter of 2014 in terms of revenue, and at or slightly below our second quarter results last year in terms of profit.

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

Nathan Mazurek:

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

Operator:

Thank you, sir. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you are joining us today using a speakerphone, to make sure that your mute function is off to allow that signal to reach our equipment. Once again, that is star, one if you would like to ask a question, and we'll pause for a moment to allow everyone an opportunity to signal.

We will take our first question from Matt Koranda with ROTH Capital.

Matt Koranda:

Good morning, guys. Thanks for taking my questions.

Nathan Mazurek:

A pleasure, Matt. Good morning to you.

Matt Koranda:

So, just wanted to start off on the SG&A line. Is this the right quarterly run rate to now use for the rest of the year now that Titan has been pulling in for a full quarter? It looked like there may have been a couple of one-time items and would you expect any reductions to SG&A as we go through the year?

Andrew Minkow:

It's a pretty good, clean number to annualize for your purposes. I'd point out, you know, there is a significant non-cash component now in there now resulting from Titan. There is almost $400,000 in intangible amortization as a result of the (inaudible) accounting. But, otherwise all the other cash-based type SG&A expenses are good to go off for your purposes and for cap ex.

Matt Koranda:

Okay. All right, that's helpful. Then just looking at backlog composition, wondering if you guys could kind of just flesh that out a little bit for us and talk about what's in there in terms of Titan versus the base Transformer businesses? What kind of visibility does that give you into gross margins for the remainder of the year? Are we kind of flat from Q1 in terms of gross margins or do you see any improvement happening?

Andrew Minkow:

Sure. I mean the backlog—now we're in a new place for us in the last five years, where a significant portion of our backlog is not liquid-filled transformer, and of the $31 million of backlog that we have as of March 31, approximately $9.5 of that is Titan, and a large portion—I don't know have it exactly in front of me—is Service business, which increases, to the latter point of your question, the margin profile we can expect out of the backlog. So, that accounts for—that leaves about $21 million of backlog. Our Liquid-Filled Transformer business, it ended the quarter a little lower. We had a negative exchange rate, which affects how we report that backlog. It's in the range of around $15 million of the $31 million total and we've seen as of April a nice pick-up in that, so we'd expect it to grow going into the second quarter.

Nathan Mazurek:

The balances is Switchgear, I mean the biggest portion of that is going to be the LA business, the Specialized Switchgear business of which he's probably at about—for the backlog purposes, he was about two; he's at three right now, so that should tick-up.

Andrew Minkow:

We also have a large—you know, we had a lot of growth this quarter on our revenue and the profits of our original Jefferson business, which has on-boarded a major new OEM customer in the datacenter space. So, their backlog for that business is—you know, it used to be no more than $2 million, $1 million on any given month, which for the most part, in effect represented a portion of the next month's sales. That business of ours, Jefferson, has now become a real backlog business with long run orders to the point where they're at about a $4 million level in backlog as a portion of our total.

Matt Koranda:

Okay, that's very helpful, guys. Thanks for the color on the backlog. Looking at Liquid-Filled growth, I mean, it looked pretty strong and stronger than I had expected in the quarter. Can you just talk about some of the end markets that are helping drive some of the Liquid-Filled growth?

Nathan Mazurek:

The Liquid-Filled is actually facing challenges. Any growth it's experiencing is a testimony to its diversity of markets that it services. You know, the single biggest industrial market, oil and gas, there are almost no revenue associated with that in the first quarter. I say almost no just to be careful; I really think there's none, and we don't look for very much to be associated with it for the balance of this year. So, oil and gas is very weak, mining is very, very weak.

That being said, its network business, its utility business, is stronger; general industrial activity has been helpful. So it's really a—again, it's a reflection of how over time as we build a very diverse high-end custom engineered business, how it's weathering really headwinds, frankly, in its path to more growth and profitability.

Andrew Minkow:

Yes. I mean, in the first quarter on a local currency, no FX translation basis, it was up, but—versus the same quarter last year. But that business is so project driven with 12 to 16 week lead times. I wouldn't read too much into it in terms of a trend. You can expect—you should assume that the increase this quarter versus last end quarter last year was really due to project timing.

Matt Koranda:

Okay, got it. Then the last one for me just on the Critical Power segment, the organic part of the business. You mentioned the back-half loaded year potentially with some datacenter customers. Could you just talk about kind of some puts and takes there? What kind of gives you the confidence that you'll be able to recognize that in the second half of the year and where's the customer spend in terms of taking delivery on stuff there (ph)?

Nathan Mazurek:

Right. Right. You know, we're projecting it because it's our belief that, you know, that because (ph) these projects have to be done this year, that's the customers' schedules. We're in advanced talks with them. It's not part of the backlog yet, but it should be part of the backlog relatively soon and we expect those jobs to ship the second half of this year. That business, when we look at it by itself because it's still so small and so project-driven, it's subject to these kinds of erratic kinds of swings. You know, let's say in ballpark numbers, that business did about a $5 million last year. It did about $1 million the year before. It should do about $5 million this year. When you have a business that small, it's subject to this kind of severe lumpiness.

Matt Koranda:

Okay, that's helpful, guys. Thank you and I'll jump back in queue.

Operator:

Ladies and gentlemen, if you would like to ask a question or have any comments for today's session, please signal us by pressing star, one on your telephone keypad. Once again, that is star, one on your telephone keypad.

We will take our next question from Michael Potter with Monarch Capital Group. Please go ahead, sir.

Michael Potter:

Hey, guys.

Nathan Mazurek:

Hey.

Andrew Minkow:

Good morning, Mike.

Michael Potter:

Good morning. Thanks for the detailed information you're giving this morning. The Titan acquisition has been fully integrated at this point?

Nathan Mazurek:

I mean, what do you mean by fully integrating; from reporting; from you know…?

Michael Potter:

No. No, operationally.

Nathan Mazurek:

Yes. I'd say it's—let's say for the most part, yes. I mean, there's still a lot of consolidation that we need to do facility wise in Minneapolis that's not going to be done until the end of this year because there's no reason for us to have two facilities. We're also holding probably too much space between the two facilities that we have in Minneapolis. I'd say, other than that, the integration went quickly. Yes. Sorry it's a long-winded answer to your question.

Michael Potter:

It's okay. So, we should see some additional cost savings from future consolidation whether it's the end of this year or going into 2016?

Nathan Mazurek:

Right. There'll be some additional cost savings on the facility integration, yes. We've rejiggered, you know, some—a lot of the senior positions there. We've probably seen most of the savings from that. If anything, we should see—frankly, we think the surprise will be to the positive in service and more equipment sales than we're really projecting because we've put, in addition to realigning their sales forces, both the service and the equipment sales forces, we've added three equipment sales people in territories that we have to increase our business there, and added two service sales people. So, we're really looking forward to a very strong year from Titan.

Andrew Minkow:

Yes. I mean, Titan is, with a little bit of investment—and it hasn't taken much—is proving up probably to exceed our expectations for the year. This quarter, their revenue is about 8% over what they did in the prior year and they beat our internal budget for the quarter by about 18%. So we're pretty pleased with where things are going directionally there.

Michael Potter:

All right, terrific. What about the—do we have opportunities to expand our territory with Generac?

Nathan Mazurek:

Yes. I mean, we definitely do, as do others I'm sure, in our little club with them. Our first order of business has been to prove to them that we're better stewards of this business in the territories that we've been given and to do a bang up job of which we measure—we and they measure very, very carefully not just in sales, but in profitability and then, you know, how we handle the give and take every single day. That's going very, very well.

As the year progresses, we're definitely going to try to push. The equipment business has been a very positive surprise to us, both in profits and both in just the nature of that business. It's an exceptionally strong business and was under—I don't want to say undermanaged as the euphuism for all kinds of things. It was just not aligned. The sales people's interest were not aligned with the Company under Titan, and they had a wide territory that they did not exploit.

You know, some of these states are very large and they only dealt with one, for example, even our own home state there of Minnesota. We put a sales person in the Duluth. That whole section of this state was really not being tapped into. We only had a sales person in Des Moines and the rest of Iowa was not being dealt with. We only had one sales person in Omaha. The rest of Nebraska was fallow for the business. So, that's why we're pretty optimistic, and on the Equipment side, you make an investment, it doesn't take very long for you to see results from that investment.

Michael Potter:

Okay. All right, terrific, guys. Thank you.

Nathan Mazurek:

You're welcome, Michael.

Operator:

Ladies and gentlemen, another reminder that is star, one if you would like to ask a question. Move on to our next question from William Bremer with Maxim Group.

Andrew Minkow:

Hey, Bill.

William Bremer:

Andrew, how are you?

Andrew Minkow:

Morning. Good, thank you.

William Bremer:

Looking at the transmission in markets in particular, we're seeing more and more of the large scale transmission projects really being cut up into smaller pieces and given out to more players. I was just wondering if that trend helps you guys in any way. That's my first question. Secondly, in particular on the onsite power-gen, is there any particular markets—and you voiced some that have fallen off by the wayside a little bit and others have picked up—any others that have come out that you're seeing a little more growth in that's a little surprising to you at this point? We're all cognizant of the oil and gas activity and mining, but more in essence the datacenter market and areas of that nature, any other potential end markets there that we should pay attention to?

Nathan Mazurek:

Yes, two great—you know, one question, two great parts to it. For the first part, you know, I mean you know, we top out with the transformers. We top out at 72 KV. You know, most of the transmission projects that you're talking about are so way above that that we don't participate whether they're in one piece or in several pieces. Even at that, that's at the outer edge of our participation. So, to your first question, it's not really having any impact on us, you know, at that level. We're really focused on the substation. The substation is a substation. Most of that activity is at 5, 15, 25 KV, of which that part is not—that part of the grid is not changing that much.

Onsite generation or distributed generation or whatever you want to call it, micro-grids, semi-micro grids, those are big words and they encompass a lot, and our perspective is not the be-all and end-all. We're just seeing what we see. Taking that into account, when we talk about on-site generation, the area that we've seen, grow at least for us and that we're trying to do more in both with gear and in transformer-type products, are CHP-type projects; are small gas turbine combined heat and power, what they used to call co-generation. Different states have different incentives. Different industries have different dynamics that make them better, more profitable participants in that. I think also the development of smaller gas turbines has made that more economical and more appealing to a lot of big users. That definitely has been driving, if it hasn't been driving enough demand from us, it's been driving a lot of quotation, and I guess, the mind share from us.

I don't want to call it (ph), the reintroduction or the new love with reciprocating engines in similar dynamic has also led to that, you know, to micro-grids where we feel that we can't participate. So, that's where we see it from us. I don't want to ramble on and on. I'm happy to answer more questions about it, but that's kind of where we've been able to. The truth, I guess in my view, you know what's a real micro-grid-type project, if you would be taking you know a big college campus—take the University of Texas, at Austin or Ohio State or any of these monster-type state university campuses or military bases or very large sprawling medical complexes where they're trying to balance and use a diversity of sources of power. They want to be connected to the grid; they want use a little gas turbine; they want to do some combined heat and power; they'll throw wind and solar and you have issues of controlling and balancing all those different loads.

Those would be appealing projects for us, as well. There are many that are talked about, very few get done, and very few get done in a timeframe that I can keep focused. They just drag on for so long. For a company our size, there's only so much attention we can pay to those kinds of things.

Andrew Minkow:

To throw a little more color on it, when Nathan talks about CHP and more affordability in smaller gas turbines, how does that eventuate itself in market opportunities for us as opposed to the datacenter business we've been doing? What we're seeing is some traction with large retailers, specifically super markets. That's really a whole new market to us, facilitated by this development and our capabilities. The other would be independent power producers who are using the gas turbines to supply the grid. It's been a fertile market for our business development activities since last quarter in particular.

William Bremer:

No. That's interesting, Andrew. In terms of the supermarket, have you just done one-offs or have you being able to sort of do some pilots and now hoping to branch out for the full chain?

Nathan Mazurek:

Right. So, what Andrew's referring to is actually our customer is the engineering and constructing firm that's under contract to ShopRite, is the one.

Andrew Minkow:

As an example.

Nathan Mazurek:

As an example, and they're putting in CHP-type arrangements. They're going to save money. They're going have built-in backup and so forth and so on. We started with one that mushroomed into three jobs. There should be about 11 of those particular jobs as opposed to those from a ticket price, as opposed to a big paralleling job for a datacenter. Instead of being a $1 million ticket job for us, probably each one for the equipment that we're providing, is somewhere, you know, let's say, call it $150,000 on average. Nicely profitable for us, but that's how it works. But, yet, they're doing—you know, they're multiplying. They're taking that customer and they're doing one after the other after the other. So, that's becoming an arena that we're paying a lot of attention to.

Andrew was referring to another customer in Texas that's building—they've got their own system. They've built a modular pod with reciprocating engines to do really primarily for the oil and gas and chemical industry and have them as big users of power. Again, it becomes a very—you know, each sale is not that much, but they're multiplying them because they're doing in pod-like form of which our equipment is a part of each installation.

William Bremer:

Mm-hmm. Okay. Good color. Good balance between the datacenters, large scale and then also on the smaller block (inaudible) type work. I want to go to the balance sheet, okay. You sort of referenced integration of Titan and there's possibly some additional synergies there. The other project, or I should say, the other facility that you're referencing with over capacity, is that owned by you or is that leased?

Nathan Mazurek:

Both facilities in Minnesota are leased. Both their leases are up in less than 12 months or so. So it behooves us to make some changes. Titan is not really in the correct physical kind of facility that is appropriate for that business. That business is also growing, especially on the equipment side, especially on the parts and service side. So, we need to have a different profile and they need a little bit more space. At the same time, our Switchgear Paralleling business that we bought in 2013 and took on sort of their lease that they were in the middle of, they are having an excess. They definitely have too much space for their needs, and at the same time we don't need two separate facilities that are 10 miles apart.

William Bremer:

Got you. Andrew, one last one for me; your projection of cash flow from operations and cap ex for '15, please?

Andrew Minkow:

For cap ex, that's going to be a modest number, that's the easy one in this case, be in the range of—we have a few big projects, but it'd be in the range of $500,000 to $750,000 for the year. Operating cash flow is a little more challenging, I don't have that in front of me just at this moment; happy to talk to you about it after the call.

William Bremer:

Absolutely, that's fine. Thank you.

Andrew Minkow:

All right, William.

Operator:

Ladies and gentlemen, this does conclude today's question-and-answer session and I'd like to turn the call back over to Management for any additional or closing remarks.

Nathan Mazurek:

All right. Thank you very much, all of you for your time and attention. We look forward to updating you again on our next call.

Operator:

Ladies and gentlemen, this does conclude today's presentation and we appreciate everyone's participation.