Cactus, Inc. (NYSE: WHD)

Q3 2022 Earnings Call Transcript

November 07, 2022 @ 09:00 AM Central Time

Call Participants

EXECUTIVES

Scott Bender
President, CEO and Director
Stephen Tadlock
Vice President, CFO and Treasurer
Joel Bender
Senior Vice President, COO and Director
Steven Bender
Vice President, Operations
William Marsh
Vice President of Administration and General Counsel
John Fitzgerald
Director of Corporate Development and Investor Relations

ANALYSTS

Stephen Gengaro
Stifel Financial Corp
Conner Lynagh
Morgan Stanley & Co.
Dave Smith
Pickering Energy Partners LP

Presentation

Operator
Good day and thank you for standing by, and welcome to Cactus Third Quarter 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [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, John Fitzgerald, Director of Corp Dev and IR. Please go ahead.

John Fitzgerald
Director of Corporate Development and Investor Relations
Thank you, and good morning. We appreciate you joining us on today's call. Our speakers will be Scott Bender, our Chief Executive Officer and Steve Tadlock, our Chief Financial Officer. Also joining us today are Joel Bender, Senior Vice President and Chief Operating Officer, Steven Bender, Vice President of Operations, and Will Marsh, our General Counsel and Vice President of Administration.

Please note that any comments we make on today's call regarding projections or expectations for future events are forward-looking statements covered by the Private Securities Litigation Reform Act.

Forward-looking statements are subject to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to review our earnings release and the risk factors discussed in our filings with the SEC. Any forward-looking statements we make today are only as of today's date, and we undertake no obligation to publicly update or review any forward-looking statements.

In addition, during today's call, we will reference certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are included in our earnings release. With that, I will turn the call over to Scott.

Scott Bender
President, CEO & Director
Thanks, John and good morning to everyone. During the third quarter, the company set records for both quarterly revenue and Adjusted EBITDA. This was also our 7th consecutive quarter with Adjusted EBITDA growth of over 10 percent. Results were strong across the board and highlighted the Company’s best-in-class margin and return profile.

Some third quarter highlights include:

- Revenue increased 8% sequentially to a company record of $184 million;
- Adjusted EBITDA improved by 13% sequentially;
- Adjusted EBITDA margins were 34%, up 140 basis points versus the second quarter;
- We paid a quarterly dividend of $0.11 per share; and increased our cash balance to $321 million.

I'll now turn the call over to Steve Tadlock, our CFO, who will review our financial results. Following his remarks, I'll provide some thoughts on our outlook for the near-term before opening the lines for Q&A. Steve?

Stephen Tadlock
Vice President, CFO and Treasurer
Thank you. As Scott mentioned, Q3 revenues of $184 million were 8% higher than the prior quarter. Product revenues of $122 million were up 9% sequentially, driven primarily by an increase in rigs followed and higher revenue generated per rig. Product gross margins at 39% rose 100 basis points sequentially.

Rental revenues were $27 million for the quarter, up 14% versus the second quarter, driving a 450 basis point increase in gross margins resulting from lower depreciation expense as a percentage of revenue.

Field service and other revenues in Q3 were approximately $36 million, up 4% sequentially. This represented 24% of combined Product and Rental-related revenues during the quarter, in-line with expectations. Gross margins were 24%, up 170 basis points sequentially driven by lower fuel and ancillary service costs, despite continued labor challenges.

SG&A expenses were $16 million during the quarter, up $1.2 million sequentially. The increase was attributable in part to higher PSU-related stock-based compensation expense related to our return on capital employed performance and to higher bonus accruals tied to stronger than expected financial results. SG&A was flat at 8.7 percent of revenue during the period. The third quarter included nearly $1 million dollars of professional and legal expenses related to the evaluation of growth opportunities. We expect SG&A to be relatively flat in Q4 2022 with stock-based compensation expense of approximately $2.6 million dollars.

Third quarter Adjusted EBITDA was approximately $63 million, up 13% from $56 million during the second quarter. Adjusted EBITDA for the quarter represented 34% of revenues, compared to 33% in the second quarter.

Adjustments to EBITDA during the third quarter of 2022 included approximately $3 million in stock-based compensation and the removal of $1 million in other income related to the revaluation of the Company's tax receivable agreement. SG&A expenses related to the evaluation of growth opportunities were not added back to calculate Adjusted EBITDA.

Depreciation expense for the third quarter was $8.4 million. A similar amount is expected in the fourth quarter. We reported income tax expense of $12 million during the third quarter.

During the quarter, the public, or Class A ownership of the Company averaged 80% and ended the quarter at 80%. Barring further changes in our public ownership percentage, we expect an effective tax rate of approximately 21% for Q4 2022.

GAAP Net income was $42 million in Q3 2022 versus $36 million during the second quarter. The increase was driven by higher operating income during the period.

We prefer to look at adjusted Net Income and earnings per share, which were $39 million and 52 cents per share, respectively, during the third quarter versus $33 million and 44 cents per share in Q2. Adjusted net income for the third quarter applied a 25% tax rate to our adjusted pre-tax income generated during the quarter. We estimate that the tax rate for adjusted EPS will be 25% during the fourth quarter.

During the third quarter, we paid a quarterly dividend of $0.11 per share, resulting in a cash outflow of approximately $8.5 million, including related distributions to members. The board has approved a dividend of $0.11 per share to be paid in December.

We ended the quarter with a cash balance of $321 million, up $9 million sequentially. Operating cash flow was approximately $30 million during the quarter, which was inclusive of a $12 million outflow tied to our once-a-year TRA payment. Net capex was $7 million during the quarter. Reduced transit times and improvements in the global supply chain bode well for increases in operating cash flow going forward.

Capital requirements for our business remain modest, and we will continue to exercise discipline with regards to capital expenditures. For the full year we expect net capital expenditures to be approximately $25 million.

That covers the financial review, and I will now turn the call over to Scott.

Scott Bender
President, CEO and Director
Thanks, Steve.

As stated earlier, the Company generated record revenue and EBITDA during the quarter.

U.S. Product market share remained strong at 38.5% during the period as rigs followed increased by 4%. Product revenue per U.S. land rig followed increased by 5% and Product EBITDA margins improved by 110 basis points during the quarter to over 40%, approaching 2018 levels.

Latest projections from our customers point toward up to 25 rig additions from mid-September to year-end, most of which are expected in the back half of the quarter. If correct, such an increase should be favorable to our market share. Recent conversations also indicate expectations of additional rigs in early 2023. We expect that public operators will make up most of these rig additions by year-end, and an even larger portion during the early part of next year.

For the fourth quarter of 2022, we expect Cactus' average rigs followed to be up in the mid-single digits percentagewise. The quarter is off to a strong start, as market share rose to 39% in October. Product revenue is expected to be up in the low single digits on a sequential basis, even assuming delayed production tree shipments associated with year-end holidays. Product EBITDA margins are forecasted to continue to strengthen during the fourth quarter.

Activities related to the establishment of a Middle East facility continued during the period, and there are no changes regarding our plans for commercialization by 2024. Over the last few months, we've booked orders for equipment into the Middle East and Africa. We will continue to selectively target international markets, as we progress plans for more meaningful growth abroad.

On the supply chain front, transit times and overseas freight costs are improving while a strengthening dollar further supports improving margins. As noted on our last call, this should bode well for Working Capital reductions and Product margins in 2023 as we work through existing inventory. We expect inventory balances to stabilize at current levels in the near-term before beginning to decline in early 2023.

On the Rental side of the business, revenues increased by over 14% during the quarter and are up nearly 80% year-over-year. For the fourth quarter, Rental activity should be up slightly. We've picked up additional work in the near-term, although our legacy customers are indicating some year-end-related slowdowns. Any such activity slowdown around the holidays should reverse in the new year.

In Field Service, EBITDA margins improved by 130 basis points during the third quarter. Field Service revenue for 4Q is expected to be between 23 and 24 percent of Product & Rental revenue. Typical margin seasonality is expected during the fourth quarter, which could represent a five-to-six hundred basis point reduction versus the third quarter. Margins should again return to more normalized levels during the first quarter of next year.

Regarding the potential for M&A, management has continued to carefully evaluate a number of opportunities in the market. As mentioned on previous calls, we are focusing on high quality businesses with characteristics similar to our own. Our large cash balance provides the company with optionality to act opportunistically.

In summary, we are optimistic regarding the macro environment for our industry. Cactus remains well positioned to deliver for shareholders amid this constructive market backdrop. With that, I will turn it back over to the Operator so that we may begin Q&A. Operator?

Question and Answer

Operator
Thank you. [Operator Instructions] And we please ask that you limit yourself to one question and one follow-up. And one moment for our first question. And our first question comes from Stephen Gengaro from Stifel. Your line is now open.

Stephen Gengaro
Stifel Financial Corp.
Thanks. Good morning, everybody.

Scott Bender
President, CEO and Director
Good morning, Stephen. How are you?

Stephen Gengaro
Stifel Financial Corp.
Good, thank you. I mean, two things for me. The first is just to clarify something you said. You talked about 25 rig additions. That was a Cactus specific comment, correct?

Scott Bender
President, CEO and Director
Yes, sir.

Stephen Gengaro
Stifel Financial Corp.
Okay. Great. So, when you talk to customers – and we've heard obviously a lot about cost recovery efforts and what you've been able to achieve there over the last year. When we think about margin progression in 2023, I mean, the supply chain is obviously – it seems to be helping you get a full year of those cost recovery efforts, probably better overhead absorption. Any guidance on how we should be thinking about the potential for product margins to ramp, maybe using history as some type of guide.

Scott Bender
President, CEO and Director
Yeah. I would say you're going to see typical incrementals in the high 40s.

Stephen Gengaro
Stifel Financial Corp.
Okay. Okay. Thanks. That's helpful. And then, just the other quick one, when you – you talked about the international order flow you've seen, and it sounds like you're starting to gain traction. If you were sitting in our seat, you were trying to put together model for 2023 and 2024, when would you start to think about any impact that kind of moves the needle?

Scott Bender
President, CEO and Director
Yeah, I would – it hasn't changed since the last call. I would say it's going to be 2024.

Stephen Gengaro
Stifel Financial Corp.
Okay. Great. Thank you for the color.

Scott Bender
President, CEO and Director
Thank you.

Operator

And thank you. [Operator Instructions] And one moment for our next question. And our next question comes from Connor Lynagh from Morgan Stanley. Your line is now open.

Conner Lynagh
Morgan Stanley & Co.
Yeah. Thank you. I wanted to square the circle on what E&Ps are saying versus what service companies are saying. And you guys seem to be pretty well aligned with, for example, land drillers who are talking about increased activity. It's hard to find a lot of E&Ps who were talking about growing next year, including on the public side. So, I'm curious, is the concentration of these rig adds very high? In other words, is it just a few customers that are looking to grow? Or is it pretty broad based?

Scott Bender
President, CEO and Director
Conner that's a very good question. First, I know that our – that this – the 25 rig increase that I discussed from mid-September through the end of the year does seem high vis-à-vis what you've heard industrywide. But we have very good visibility over the next, I'd say, 90 days. And so, these numbers reflect our particular customers and may not reflect the industry as a whole.

In terms of concentration, I'm going to guess that two-thirds – maybe a half to two-thirds have to do with additions from our existing customers, which would be the public's and the other would be new logos. So, I guess the short answer is it probably is concentrated with a large – by the end of the year, certainly concentrated with the large publicly traded E&Ps, at least ours.

Conner Lynagh
Morgan Stanley & Co.
Okay. Makes sense. Kind of pivoting here, but I'm curious what your visibility is. I know it's always historically been shorter, but on the rental side of the business, sort of two questions in one here. But just first off, how is your communication with customers around activity levels for next year? But more importantly, do you feel like you're now at a point where you're sort of regaining share with presumably pricing moving higher? What's sort of the competitive dynamic out there right now?

Scott Bender
President, CEO and Director
Yes, so, first, let me address your second question. I think that in general, this holds true for both our drilling products and our frac products, as spread rates increase, drilling and frac – our products become more attractive, which will inevitably lead to enhanced market share.

In terms of visibility into next year, our visibility is really good in terms of frac activity through year-end. I would say into the first quarter, we feel like we're going to see an uptick. We always see an uptick in Q1. But in terms of customers actually saying prepare equipment for Q1, we never see that this far in advance. So, it's just that the customers with whom we do business have indicated that their activity is going to continue well into the first quarter, and I would expect beyond that.

There was a lot of conversation – I'm giving you more information than you asked for. There was a lot of conversation about customers building DUCs, and we really haven't seen that in a great degree from our existing customers. We have seen some whitespace, but that's probably attributable to the fact that these frac crews are getting more and more efficient. And I feel like our customers are under pressure now to increase their drilling activity to stay ahead of their frac crews. That being said, I think that as many frac crews as our customers can put to work, they're going to continue to put to work.

Conner Lynagh
Morgan Stanley & Co.
All helpful context. Thank you.

Operator

Thank you. And one moment for our next question. And we have a follow-up question from Stephen Gengaro from Stifel. Your line is now open.

Stephen Gengaro
Stifel Financial Corp.
Thanks. Thanks for taking another question, gentlemen. You mentioned M&A in the prepared remarks, this theme throughout oil services of excess cash coming back to investors, it seems to be kind of happening in more aggressive numbers over the last quarter or two. Can you just kind of refresh us on how you're thinking about what's out there on the M&A landscape? And at what point would you just say, you know what, we got over $4 in cash and no debt - we're going to accelerate capital returns?

Scott Bender
President, CEO and Director
Okay, Steve, I'm not there yet. So, I would say that, I hate to sound like a broken record, but the opportunities, M&A opportunities have increased considerably over the last quarter or two. Some very interesting opportunities and mostly product oriented. We're not interested in any rental-based revenue generation. There's just a lot of very interesting stuff out there. Unfortunately, we have a pretty high threshold in terms of free cash flow, margins, differentiation, when will we reach a point? I can't tell you when we'll reach a point. I thought we would have reached a point by the end of this year, but the opportunities seem to be increasing, so – and I've also said many times, we are the largest shareholders. We like cash distributions. We like dividends. But we think that a good M&A opportunity was going to provide much better long-term value for ourselves and our shareholders. So, be a little patient.

Stephen Gengaro
Stifel Financial Corp.
No, that's helpful. And I think one of the things we get asked about is the – your franchise is so strong on the product side, particularly in the U.S. land market. And it seems like you guys sort of stick to a really strict discipline about not diluting the differentiation you guys bring to the table if you were to make a deal.

Scott Bender
President, CEO and Director
That's exactly right.

Stephen Gengaro
Stifel Financial Corp.
Okay. Great. Thanks for the color.

Operator
Thank you. And one moment for our next question, please. And our next question comes from David Smith from Pickering Energy. Your line is now open.

Dave Smith
Pickering Energy Partners LP
Hey, good morning. Thank you for taking my question.

Scott Bender
President, CEO and Director
Hey, David. How are you?

Dave Smith
Pickering Energy Partners LP
Doing all right. Thank you. Apologies if you talked about this already, just looking at rental in the third quarter, nice sequential revenue increase. Maybe the margins look just a little bit, I'm guessing, related maybe to some growth cost. I wanted to ask how we should think about the rental margin progressing into Q4 with the revenue guidance that you gave.

Stephen Tadlock
Vice President, CFO and Treasurer
Yeah. I think we expect them to be pretty much flattish with where we were in Q3, and that was pretty much in line with Q2 and really looking back to Q1 as well. As we – when we ramp up rental revenues, we tend to see margins depressed a little bit as we have to increase activity to get things ready. But now that we're in more of a steady state at a higher level, we should expect to continue at these levels.

Dave Smith
Pickering Energy Partners LP
Appreciate the color. My other questions have been asked. So, that's all I have.

Scott Bender
President, CEO and Director
Thank you.

Operator
Thank you. And I'm showing no further questions. I would now like to turn the call back over to John Fitzgerald for closing remarks.

John Fitzgerald
Director of Corporate Development and Investor Relations
We appreciate everyone joining us for today's call. We'll speak with you soon.

Scott Bender
President, CEO and Director
Have a good week.

John Fitzgerald
Director of Corporate Development and Investor Relations
Thank you.

Scott Bender
President, CEO and Director
Thanks.

Operator
This concludes today's conference call. Thank you for participating. You may now disconnect.