



Cactus, Inc. (NYSE: WHD)

Q4 2022 Earnings Call Transcript

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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

J. David Anderson

Barclays Capital

Stephen Gengaro

Stifel, Nicolaus & Co.

Dave Smith

Pickering Energy Partners LP

Presentation

Operator

Good day and thank you for standing by. Welcome to the Cactus Q4 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 Corporate Development 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 fourth quarter, the company set records for both quarterly revenue and Adjusted EBITDA. This was also our 8th consecutive quarter with Adjusted EBITDA growth. I was particularly pleased with the margin performance in each of our revenue categories. The fourth quarter is usually our weakest due to seasonal factors, but results were strong across the board and highlighted the Company's best-in-class margin and return profile.

Some fourth quarter highlights include:

- Revenue increased 2% sequentially to a company record of \$188 million;
- Adjusted EBITDA improved by 4% sequentially to a company record \$66 million;
- Adjusted EBITDA margins were 35%, up 90 basis points versus the third quarter;
- We paid a quarterly dividend of \$0.11 per share; and
- We increased our cash balance to \$345 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, Scott. Note that all the historical and forward-looking data referenced today will be for Cactus on a standalone basis only, and not inclusive of any potential impact from the pending FlexSteel transaction, which is expected to close in the coming weeks. As Scott mentioned, Q4 revenues of \$188 million were 2% higher than the prior quarter. Product revenues of \$125 million were up 2% sequentially, driven primarily by an increase in rigs followed. Product gross margins of 41% rose 120 basis points sequentially due largely to operating leverage and lower branch costs.

Rental revenues were \$27 million for the quarter, up 1% versus the third quarter. Gross margins were up 420 basis points due to better asset management and lower repair costs, as well as declining depreciation expense.

Field service and other revenues in Q4 were approximately \$36 million, up 1% sequentially. This represented approximately 24% of combined Product and Rental-related revenues during the quarter, in-line with expectations. Gross margins were 24%, up 20 basis points sequentially driven by lower supplies costs and branch-related expenses.

SG&A expenses were \$23 million during the quarter, up \$6.9 million sequentially. The increase was attributable to higher professional fees and expenses, \$7.4 million of which were related to the pending acquisition of FlexSteel. Excluding these transaction-related expenses, SG&A was \$15.5 million, and 8 percent of revenue. We expect SG&A exclusive of transaction-related fees to be relatively flat in Q1 2023 with stock-based compensation expense of approximately \$3 million dollars.

Fourth quarter Adjusted EBITDA was approximately \$66 million, up 4% from \$64 million during the third quarter. Adjusted EBITDA for the quarter represented 35.4% of revenues, compared to 34.5% in the third quarter.

Adjustments to EBITDA during the fourth quarter of 2022 included approximately \$3 million in stock-based compensation, \$7 million in FlexSteel acquisition-related fees and expenses, and an add-back of \$2 million in other expense related to the revaluation of the Company's tax receivable agreement. Consistent with the fourth quarter's presentation, we've now revised the Adjusted EBITDA for the third quarter of 2022 to exclude \$1 million in FlexSteel acquisition-related expenses that were not previously added back to our adjusted results.

Depreciation expense for the fourth quarter was \$8.1 million. Approximately \$8 million is expected in the first quarter of 2023. Income tax expense during the fourth quarter was \$7.9 million.

During the fourth quarter, the public, or Class A ownership of the Company averaged 80% and ended the quarter at 80%. Following the equity offering we completed in January of this year, our Class A ownership is expected to average 81% of the total shared outstanding during the first quarter. Barring further changes in our public ownership percentage, we expect an effective tax rate of approximately 21% for Q1 2023.

GAAP Net income was \$41 million in Q4 2022 versus \$42 million during the third quarter. The decrease was driven by higher transaction-related expenses, which more than offset increased gross profit across our various revenue categories.

We prefer to look at adjusted Net Income and earnings per share, which were \$44 million and 57 cents per share, respectively, during the fourth quarter versus \$40 million and 52 cents per share in Q3 2022. Adjusted net income for the fourth 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 first quarter of 2023. As previously stated, we've revised the adjustments for the third quarter of 2022 to include the \$1 million in acquisition-related expenses that were not previously added-back.

During the fourth quarter, we paid a quarterly dividend of \$0.11 per share, resulting in a cash outflow of approximately \$8.4 million, including related distributions to members. In January, the board approved a dividend of \$0.11 per share to be paid in March.

We ended the quarter with a cash balance of \$345 million, up \$24 million sequentially. Operating cash flow was approximately \$39 million during the quarter, with net working capital representing a cash outflow of approximately \$21 million. This was driven in part by a decrease in accounts payable due to the timing of seasonal payments. In addition, payables declined in advance of anticipated first quarter inventory declines. Excluding non-routine items associated with the FlexSteel transaction, we expect net working capital to be relatively flat during the first quarter of 2023 and down as a percentage of revenue following a strong January.

Net capex was approximately \$6 million during the fourth quarter of 2022. Capital requirements for our business remain modest, and we will continue to exercise discipline with regards to capital expenditures. For 2023 we expect net capital expenditures to be in the range of \$35 to \$45 million dollars. This is inclusive of the potential purchase of a currently leased domestic property for approximately \$7 million, the buildout of a new R&D facility in Houston and assumes \$5 to \$10 million in growth capital dedicated to international expansion toward the end of the year.

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 increased to 40.2% during the period as rigs followed rose by approximately 7%. From 3Q 2022 through December of 2022 we added 26 rigs, in-line with projections provided during our last earnings call. Product EBITDA margins improved by 110 basis points during the quarter to 41%.

During the fourth quarter, the majority of our rig additions came from public companies, but we also increased our rig count with private operators. Thus far during 2023 we have witnessed a mid-single digit percentage increase in public rigs followed, which has been partially offset by a slight decrease in private rigs followed, particularly in gas basins.

For the first quarter of 2023, we still expect Cactus' average rigs followed to be up 3 to 5 percent sequentially, despite the overall decline in the U.S. land rig count. As you know, our core customers tend to be the larger, well-capitalized oil producers, who are less reactive to short-term swings in commodity prices. Nonetheless, we are prepared to deal with the impact that lower natural gas prices will likely have on the industry, particularly in the Haynesville, an area weighted towards privates. We are also excited to be introducing several technical wellhead enhancements which are in the final stages of testing.

First quarter 2023 Product revenue is expected to be up approximately five percent versus 4Q. Product EBITDA margins are forecasted to be in the 41 to 42 percent range for the first quarter. We feel good about the prospects of market share gains as evidenced by our ability to achieve market share of over 42% in February.

From an international perspective, there are really no changes regarding our plans for Product commercialization in the Middle East by 2024. In addition, we continue to benefit from opportunities outside of Saudi.

On the Rental side of the business, revenues increased by 1% during the fourth quarter and were up over 40% year-over-year. International increases drove the sequential top line improvement. For the first quarter of 2023, we expect rental revenue to remain relatively flat. EBITDA margins should be in the low 60 percent range with potential for expansion late this year as we introduce cost-saving enhancements.

In Field Service, EBITDA margins improved by 20 basis points during the fourth quarter, overcoming what is typically the weakest seasonal quarter of the year. Revenue was 23.6 percent of combined Product and Rental revenue during the period. Field Service revenue for 1Q 2023 is expected to remain between 23 and 24 percent of Product and Rental revenue. Field Service EBITDA margins are expected to be approximately 28 percent.

Regarding the FlexSteel acquisition, management is excited and optimistic about this unique combination. As noted earlier this month, we received no comments from the FTC or DOJ during the HSR waiting period. From a financing perspective, we successfully raised \$166 million of net proceeds from an equity offering in January and have made substantial progress regarding our permanent debt financing. At this time, we expect to close on a new \$125 million Term Loan A facility and a new \$225 million upsized revolving credit facility upon transaction closing, which should occur during the first quarter of this year. FlexSteel's fourth quarter financial performance was in-line with our expectations. Following the closing of the transaction, Cactus will provide additional details on the expected financial impact of the first quarter. We look forward to sharing the same once we close.

Despite recent weakness in natural gas prices, we are optimistic regarding our customer base, which is larger and primarily oil-focused. Cactus remains well positioned to deliver for shareholders amid an overall healthy market backdrop. With that, I will turn it back over to the Operator and we can begin Q&A. Operator?

Question and Answer

Operator

Thank you. At this time, we'll conduct a question-and-answer session. [Operator Instructions] Our first question comes from the line of David Anderson of Barclays. Your line is open.

J. David Anderson

Barclays Capital

Thanks. Good morning, Scott. How are you?

Scott Bender

President, CEO and Director

Hey, David. How are you?

J. David Anderson

Barclays Capital

I'm doing great. I was hoping if you can step back a little bit and talk about the US, the overall US onshore market, and really how you see duration of this cycle compared to, say, other cycles, let's say 2008, 2012 or 2013 timeframe. You touched on the end there. Everyone's sort of waiting for this natural gas story to have this ripple effect. Some people even think it's going to collapse the US services market. But would you make the case it's a more resilient market? I mean, there's fewer players – everyone seems more disciplined in terms of capacity and pricing. I think you're seeing in your business as well. Shouldn't this all result in a cycle with more duration? Can you maybe expand on that a little bit?

Scott Bender

President, CEO and Director

Wow, David. All right. So I think that what we've seen – let me first talk about natural gas. What we've seen is weakness in the Haynesville. I'm sure you know that. We've not seen the same weakness in the Northeast. And the Haynesville is a very high-cost area to operate and it's dominated by private players. So one would expect that with lower gas prices, the Haynesville would suffer. For those of our customers that have multi-basin exposure, we're seeing a redeployment of rigs out of the Haynesville and into those

oil basins. So let me maybe now turn my attention to the areas that we expect to see continued activity strength.

I can only tell you what our customers tell us. And you know that we visit personally with all of our large customers on a regular basis. They indicated no reduction in activity and you know that none of them planned on \$100 oil. So if I think about our major customers, I'm actually seeing evidence of increases in their oil basin activity, and those increases will likely offset losses in the Haynesville.

David, that said, I don't know how low it could go in the Haynesville. I just feel like there's enough indication of demand in the Permian – well, actually in the Bakken as well. I think that in terms of fundamentals, I'm probably more bullish on oil fundamentals than maybe a lot of the people. I think US production rates are disappointing right now. Well efficiencies are disappointing. I think that we're going to see China open up, which is – also has implications in terms of costs. But China opening up, I think that Russian sanctions are going to start biting, I feel pretty good about the duration of this current oil-based cycle. Gas, I don't even want to offer an opinion on gas except that I think \$2 gas makes no sense for really anyone.

J. David Anderson

Barclays Capital

So you're not really concerned that natural gas can sort of tip the applecart here – it doesn't seem like that could be big enough to really be more than an air pocket? Is that a fair way to look at it?

Scott Bender

President, CEO and Director

Well, David, I'm always concerned about our customers' cash flow. And so to the extent that natural gas prices are low, their cash flow is going to be reduced. But I don't think that it's going to – I don't have this this overreaching concern about the impact of natural gas on the rest of our customers. And I've visited with many of them over the last two weeks. So it's been very, very recent.

J. David Anderson

Barclays Capital

That's good to hear. I know everybody always loves to ask about M&A and you're just dying to tell us about all the deals you're working on right now. But outside of FlexSteel, is really a smaller deal, it's around the well side, different things that you're already doing. But I guess, when I look at this market, the reality is most of the bad actors are gone. There's really no private equity money on the side that we can tell. Is it fair to say that the M&A route is going to be pretty hard over the next two or three years and then maybe the organic opportunities you've talked about in the Middle East, I know Latin America is another area you sort of expanded. Does that make that more – a more likely growth route organically than M&A because of just – it seems like there's fewer opportunities in a more consolidated market?

Scott Bender

President, CEO and Director

No, I would say, there are certainly no fewer opportunities, David. There are fewer buyers, but there are no fewer opportunities. There are an awful lot of people who are interested in monetizing during this period of time. I'm going to reiterate what I've said before. My preference has always been and will continue to be to consolidate this market. And so when I think about M&A opportunities, I need to think about – I think about consolidation.

FlexSteel was an incredibly unique opportunity for this company and you know all the reasons. I can't think of another company that we've looked at that checked all the boxes. Is there another FlexSteel out there? I mean, we haven't seen another FlexSteel. That's not to say there's not another FlexSteel, but I would probably tell you, look for organic growth or an opportunity internationally.

J. David Anderson

Barclays Capital

Thanks a lot, Scott. Have a good day.

Scott Bender

President, CEO and Director

Thank you, David.

Operator

Thank you. One moment for our next question. This question comes from the line of Stephen Gengaro of Stifel. Go ahead. Your line is open.

Stephen Gengaro

Stifel, Nicolaus & Co.

Thanks. Good morning, everybody.

Scott Bender

President, CEO and Director

Good morning, Stephen. How are you?

Stephen Gengaro

Stifel, Nicolaus & Co.

Two things for me. If you could start – and I know you gave some good color on the first quarter outlook. When you – you had very strong margins in the fourth quarter across the board. Can you just talk a little bit about your conversations with customer on the product side and what you're seeing from a pricing perspective relative to inflation and how we should be sort of thinking about margin trajectory for the rest of the year? And maybe as part of that, you did talk about some technical enhancements, which I would assume would be a net positive the back half of the year.

Scott Bender

President, CEO and Director

Yeah. I think that this team feels pretty good about sustaining margins in terms of cost impact. I think we've done – Joel has done a remarkable job of managing our costs. And a lot of our input costs are just now beginning to flow through. We still have to get rid of some of this higher cost inventory, but we're seeing the replacement costs decline. So I think that from a cost perspective and the impact that that has on margins, I'm feeling pretty positive.

Stephen Gengaro

Stifel, Nicolaus & Co.

And just along those lines, I know you talked a little bit about maybe using more capacity out of Louisiana because of some of the supply chain issues. Where do the supply chain issues stand now.

Scott Bender

President, CEO and Director

Transit times are much improved. I'll defer to Joel on this.

Joel Bender

Vice President, COO and Director

I mean, supply chain has actually sort of returned to some normalcy. There are pockets of it that are still problematic; elastomers, some resin material, things like that. It's available. You just have to plan ahead for it, which we've done. In terms of vessels and things, you can ship out of China now and pick up a weekly shipment, drop it off at the port and pick it up in about a week. So that's returned to normal. I think the only challenge there is maybe blank sailing. But if you prepare yourself and you have contracts like we do, there should be no disruption in terms of getting product.

Stephen Gengaro

Stifel, Nicolaus & Co.

Okay, great. Thank you, gentlemen.

Scott Bender

President, CEO and Director

Thank you, Stephen.

Operator

Thank you. One moment, please. Our next question comes from the line of David Smith of Pickering Energy Partners. Your line is open.

Dave Smith

Pickering Energy Partners LP

Hey, good morning.

Scott Bender

President, CEO and Director

Hey, David.

Dave Smith

Pickering Energy Partners LP

Thank you for taking my question and congratulations on a quarter and really looking forward to the post-close Q&A. But for now, my bigger questions were asked, so I'll ask a couple of minor ones. Circling back to the natural gas theme, sorry if I missed this. But wanted to ask if you're having any conversations with clients who indicate that they might accelerate oil programs if additional frac spreads became available to them.

Scott Bender

President, CEO and Director

The short answer is no. So the – because we're – our customer base is so dominated by larger players, they're not nearly as reactive. And so most of our major customers have indicated slight increases in activity, and they have not mentioned any change in their plan as a result of the availability of additional frac pressure pumpers.

Dave Smith

Pickering Energy Partners LP

Makes perfect sense, but I had to ask. And just circling back to the enhancements or innovations that you're planning to introduce in the product segment, just wanted to ask if – really looking forward to hearing to – I'm all ears if you want to share any color on those. But should we be thinking about those as potentially beneficial to market share or maybe just more accretive to margins? And I hate asking because your market share and margins are already so strong.

Scott Bender

President, CEO and Director

Yeah. David, we've always believed that if we don't continue to innovate – innovation is one of our greatest defenses in terms of our market share. And so, yes, I think that these enhancements will be attractive to people who perhaps were not Cactus customers, but the real reason for this is to continue and expand the gap between what we offer and what our competitors offer. It provides us not only with the ability to retain market share, but it provides us importantly with the ability to protect our margins.

Dave Smith

Pickering Energy Partners LP

Great answer. Appreciate the color. And if I can slip in one minor one, the field service margins held up remarkably well in the fourth quarter. I wanted to ask if that was just exceptional execution, if you're able

to get maybe better margin protection? I'm basically trying to think through this year and going forward whether you've figured out how to mitigate the historical seasonality hit to those margins.

Scott Bender

President, CEO and Director

Yeah, I'm going to let Steven answer that. That's his department. We were all very, very pleasantly surprised with our fourth quarter field service results.

Steven Bender

Vice President Operations

Yeah. I think, just to reiterate, we were very proud of what we achieved in the fourth quarter. I think we're optimistic that things will continue in that trajectory. There's still quite a bit of pressure on wage inflation, at the field service levels, so we're keeping an eye on that, but concentrating more on utilization at this point.

Scott Bender

President, CEO and Director

And, David, we probably do. I haven't worked for a lot of competitors, obviously, but we do an extraordinarily good job of monitoring utilization. So we're particularly sensitive to that during the fourth quarter when it usually drops because of the holidays. So I think we planned better this year. We executed better this year. And I think that we'll continue to take those lessons forward.

Dave Smith

Pickering Energy Partners LP

Thank you for all that color. Between the acquisition and the international expansion, there's a lot of good stuff we're looking forward to. Thank you all for your time.

Scott Bender

President, CEO and Director

Thank you, David.

Operator

Thank you. We have another question from Stephen Gengaro of Stifel. Stephen, your line is now open.

Stephen Gengaro

Stifel, Nicolaus & Co.

Thanks. Thanks for taking the questions, gentlemen. Two quick ones, one was, on the market share improvement we saw sequentially and what you highlighted in February, is this more rigs from existing customers, or is it new customers, or is it a combination.

Scott Bender

President, CEO and Director

It's a combination.

Stephen Gengaro

Stifel, Nicolaus & Co.

Okay. Great. Thanks. And the other one – and I know I asked you this on the call – on the FlexSteel call, but maybe just to refresh and we're getting this question from investors. The differentiation that FlexSteel brings, can you just give us a minute on the key differentiating factors? And, obviously, that's a big part of the Cactus story. So I think it would be useful for me just to kind of get another summary on the big differentiation of FlexSteel versus their competition.

Scott Bender

President, CEO and Director

Steve, you want to take that?

Stephen Tadlock

Vice President, CFO and Treasurer

Sure. Yeah. I think it comes down to a lot of what makes Cactus in the wellhead side so special, which is really in our mind, they just have a superior product and they do a better job of executing on the service and customer interactions than everybody else. When you look at the formulation of their product, they're the only spoolable composite that utilizes steel. So it has a robustness that the others lack. And in my experience, customers really value that just because less problems, less things to worry about, they've got enough to worry about out there in the field.

Stephen Gengaro

Stifel, Nicolaus & Co.

Okay. Is the ultimate benefit to the customer one of sort of cost savings, efficiency, less maintenance? How should we think about sort of the value prop to the customer?

Stephen Tadlock

Vice President, CFO and Treasurer

Yeah. It's really multifold. You get a cost benefit in terms of more rapid installation, getting wells online faster. What are some of the other aspects?

Scott Bender

President, CEO and Director

I mean, this product handles higher pressure, so it has a much larger addressable market.

Stephen Tadlock

Vice President, CFO and Treasurer

Larger diameters offered...

Scott Bender

President, CEO and Director

Larger diameter which means that it can be used further downstream of the choke or the wellhead. So it has greater exposure to the market.

Stephen Tadlock

Vice President, CFO and Treasurer

We do have less maintenance as well versus steel, corrosion ...

Scott Bender

President, CEO and Director

The company has had zero field failures since they introduced the product. And I think that's a function of the fact that it's not fiberglass or aramid fiber, it's steel. And so you still have to join it. You have to put couplings ultimately on this product. And it's – you can imagine it's a lot better to couple steel to steel, so the couplings are steel and steel to plastic.

Stephen Gengaro

Stifel, Nicolaus & Co.

Great. Thank you. And if I can ask one more around FlexSteel. The equity raise, I mean, when you did the deal – or you announced a deal, our math suggested you could deleverage this thing very quickly. You didn't necessarily need to do equity. And I was just curious on the thought behind that. And does that maybe tell us that there's potentially more that you're looking at and you wanted the financial flexibility?

John Fitzgerald

Director of Corporate Development and Investor Relations

I think that's right, Stephen. We've certainly been rewarded by having the strength in our balance sheet to date and we let the cash balance grow over time with no debt. And that gave us an opportunity like the one we saw with FlexSteel. And so it doesn't necessarily mean that it's because there's some other M&A

trade that would be imminent or that's out there right now. But having the flexibility to provide those options is something that we certainly had in mind when we did the equity raise.

Scott Bender

President, CEO and Director

I can just summarize it, it's definitely on our minds.

Stephen Gengaro

Stifel, Nicolaus & Co.

Great. Okay. No, thank you all for the color. I appreciate it.

Scott Bender

President, CEO and Director

Thank you.

Operator

Thank you. 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's interest in Cactus and look forward to speaking with you on the next quarter's earnings call.

Scott Bender

President, CEO and Director

Thanks, everybody. Have a great day.

Operator

Thank you for your participation in today's conference. This does conclude the program and you may now disconnect.