Cactus, Inc. (NYSE: WHD)
Q1 2023 Earnings Call Transcript
May 09, 2023 @ 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
Thirucherai "TS" Sathyanarayanan
CEO, FlexSteel
Alan Boyd
Director of Corporate Development and Investor Relations

ANALYSTS

J. David Anderson
Barclays Capital
Kurt Hallead
The Benchmark Co.

Presentation

Operator
Good day and thank you for standing by. Welcome to the Cactus Q1 2023 Earnings Conference Call. At this time, all participants are in listen-only mode. After the 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, Alan Boyd, Director of Corporate Development and Investor Relations. Please go ahead, Alan.

Alan Boyd
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, TS, CEO of FlexSteel 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, Alan and good morning to everyone. Before we commence our comments regarding the quarter, I want to take this opportunity to acknowledge some changes to our management team. Alan Boyd, who provided the introductions this morning, has joined us from Halliburton as Director of Corporate Development and Investor Relations. Alan has an extensive background ranging from investment banking to working as a drilling engineer at ExxonMobil. He will be taking over for John, who is moving over to serve as the CFO of FlexSteel. On behalf of our entire team, I'd like to thank John for his efforts leading our Investor Relations function as we matured as a public company and look forward to his continued success in the new role.

The past few months have been incredibly active here at Cactus. We announced and closed the FlexSteel acquisition during the quarter, and our reported results for this quarter include one month of contribution from FlexSteel's business. On a standalone basis, Cactus would have once again set records for both quarterly revenue and Adjusted EBITDA as U.S. wellhead market share hit an all-time-high. Consistent with the past, we will walk through Cactus' results in detail, discussing Product, Rental and Field Service. On a go-forward basis, we will report legacy Cactus as the Pressure Control segment and FlexSteel as the Spoolable Technologies segment, and our guidance will reflect how we intend to report results in the future. Note that we will continue to evaluate the reporting structure, particularly around corporate SG&A.

Some highlights for the first quarter include:

- Revenue of $228 million;

- Adjusted EBITDA of $79 million;
- Adjusted EBITDA margins were nearly 35%;
- Wellhead market share was a record 43%; and
- We paid a quarterly dividend of $0.11 per share.

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, total Q1 revenues were $228 million, which includes one month of FlexSteel results.

Pressure Control Product revenues of $130 million were up 4% sequentially, driven primarily by an increase in rigs followed. Gross margins, inclusive of depreciation expense, were 40%. This was down 40 basis points sequentially due in part to product mix.

In our Pressure Control Product business, U.S. wellhead market share increased to 43.3% during the period. Despite the overall decline in the U.S. land rig count, our rigs followed rose by approximately 6%. This increase was driven by our larger, publicly traded customers. Our rigs followed with private operators remained relatively flat versus the fourth quarter.

Pressure Control Rental revenues were $27 million in Q1, down 2% versus the fourth quarter. The slight decline was driven by lower revenue from our Australian operations, which had a particularly strong fourth quarter. Gross margins were down 200 basis points to 42% due to higher redeployment-related costs.

Pressure Control Field service and other revenues in Q1 were approximately $38 million, up 6% sequentially. This represented approximately 24% of combined Pressure Control Product and Rental-related revenues during the quarter, slightly above expectations. Gross margins inclusive of depreciation expense were 23%, down 80 basis points sequentially due to increased labor costs as retention remains a key focus.

Pressure Control SG&A expenses were $22.7 million during the quarter, relatively flat sequentially despite higher transaction-related fees and expenses, which totaled $8.6 million in Q1. Excluding these transaction-related expenses, Pressure Control SG&A was approximately $14 million, representing approximately 7 percent of Pressure Control revenue. Pressure Control adjusted EBITDA was $69 million, an increase of $2.7 million sequentially.

As a reminder, we closed the FlexSteel acquisition on February 28th, so the first quarter results include approximately one month's ownership of the business. Given FlexSteel's completion orientation, activity is often seasonally lower in Q1 and, to a lesser extent, in Q4. March had a strong finish to Q1 with $34 million of revenue.

Operating Income in our Spoolable Technologies segment during the period was $0.2 million, inclusive of SG&A-related expenses at FlexSteel. Operating income is also burdened by non-cash charges of $4.2 million dollars associated with purchase price adjustments to acquired inventory. Additionally, operating income included $3.7 million of intangible asset amortization costs during the period. Spoolable Technologies Adjusted EBITDA, which backs out these non-cash charges as well as Stock-based Compensation expense was $10.3 million during the month, which equates to an Adjusted Segment EBITDA margin of 30.5%.

On a total company basis, first quarter Adjusted EBITDA was $79 million, up 20% from $66 million during the fourth quarter. Adjusted EBITDA for the quarter at nearly 35% of revenues, was similar to the fourth quarter.

Adjustments to Total Company EBITDA during the first quarter of 2023 included approximately $4 million in stock-based compensation, $9 million in transaction-related fees and expenses, and $4 million related to the aforementioned non-cash purchase accounting related step-up in inventory that increased Spoolable Technologies cost-of-goods sold during the period. We also backed-out a $3.4 million gain from the revaluation of the TRA liability.

Depreciation and Amortization expense for the first quarter was $13 million, which again includes $4 million of amortization expense related to intangible assets booked as part of purchase accounting. Total Depreciation and Amortization expense during the second quarter is expected to be approximately $22 million, $9 million of which is associated with our Pressure Control Segment and $13 million associated with Spoolable Technologies. This figure is inclusive of an expected $9mm of intangible amortization expense within Spoolable Technologies during the quarter. Intangible amortization expense is expected to decline thereafter, with the total amount estimated for the second half of 2023 at approximately $8 million, or $4 million per quarter.

Net interest income during the first quarter was approximately $1 million. We expect interest expense of less than $3 million during the second quarter.

Income tax expense during the first quarter was $2 million. Tax expense was reduced due to a benefit related to a release of our valuation allowance.

During the first quarter, the public, or Class A ownership of the Company averaged 81% and ended the quarter at 81%. Barring further changes in our public ownership percentage, we expect an effective tax rate of approximately 20% for Q2 2023.

GAAP Net income was $52 million in Q1 2023 versus $41 million during the fourth quarter of 2022. The increase was driven by lower income tax expense, and higher Other Income related to the non-cash revaluation of our TRA liability.

We prefer to look at adjusted Net Income and earnings per share, which were $51 million and 64 cents per share, respectively, during the first quarter versus $44 million and 57 cents per share in Q4 2022. Adjusted net income for the first quarter applied a 24.5% tax rate to our adjusted pre-tax income generated during the quarter. We estimate that the tax rate for adjusted EPS will be 24.5% during the second quarter of 2023.

During the first quarter, we paid a quarterly dividend of $0.11 per share, resulting in a cash outflow of approximately $9 million, including related distributions to members. The board has also approved a dividend of $0.11 per share to be paid in June.

We ended the quarter with a cash balance of $75 million and gross bank debt of $155 million. Since the end of the quarter, we have paid off $60 million of the Term Loan balance and the business continues to generate strong free cash flow.

Net capex was approximately $14 million during the first quarter of 2023. This included the purchase of a previously leased domestic property for approximately $7 million during the period. The capex outlook for the Pressure Control business remains unchanged for 2023. With the addition of the FlexSteel business, we have revised our full-year capital expenditure budget to $45 to $55 million.

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

Scott Bender
President, CEO and Director
Thanks Steve. I'll now touch on our expectations for the second quarter based on our new reporting segments.

During the second quarter we expect Pressure Control revenue to be down in the low single digits percentagewise versus the $195 million reported in the first quarter as softness in rig activity may well extend to regions beyond the gas-weighted basins. We expect, however, more resiliency in production tree sales during the period relative to wellhead equipment. Additionally, we expect to gain some market share in our frac rental business, which should partially offset overall industry activity declines.

Customer indications point to Cactus' onshore rig activity down 3 to 5 percent sequentially on average in the second quarter depending on the timing of rig releases. From Q1 exit to Q2 exit we are expecting an 8 to 10 percent drop in our rig count.

Note that we are not planning to officially publish market share on a go-forward basis given that our new reporting structure will combine the legacy Cactus business lines into one segment. During the second quarter, we expect to make additional product shipments into Europe following an award in the region. This highlights the traction we continue to gain in various international locations. Regarding our planned expansion efforts in the Middle East, we continue to work and evaluate ownership structures in the region. Testing and trials remain the goal for 2023, with approvals to follow.

Adjusted EBITDA margins in our Pressure Control segment are expected to be 33 to 35 percent for the second quarter, inclusive of Pressure Control SG&A and general corporate expenses. This Adjusted EBITDA guidance excludes $3.5 million of stock-based compensation expense within the segment as well as transaction-related fees & expenses. Total depreciation expense for our Pressure Control segment during the second quarter is expected to be approximately $9 million.

Switching over to our Spoolable Technologies segment, we expect revenue of $100 to $105 million during the second quarter, an increase of approximately 15 to 20% versus the full first quarter total, including the two months prior to the acquisition close. This highlights the benefits of the product diversification achieved with the acquisition. Customer demand for FlexSteel's unique technologies remains robust as FlexSteel continues to replace stick-steel pipe and competing products. As previously disclosed, our Spoolable Technologies segment was working through some higher cost inventory during the first quarter. With the majority of this headwind behind us, we expect Adjusted EBITDA margins in this segment to increase to between 32 and 33 percent for Q2. Note that this margin guidance excludes the non-cash impact from the step-up in the value of inventory on-hand associated with purchase accounting, which is anticipated to be approximately $13 million in Q2 and $2 million for the second half of 2023. We expect stock-based compensation in our Spoolable Technologies segment to be approximately $1.3 million.

During the last month we have had the opportunity to introduce FlexSteel's spoolable technology to select legacy Cactus customers, and we've already had success. I'm confident that this trend will continue as we further showcase this superior technology to additional clients. As with Cactus, there is potential to add more large accounts that can move the needle on a go-forward basis.

Looking forward, we are excited about the opportunity set for the combined business. The capital light-structure and strong margin profile should enable the Company to generate continued free cash flow this year and rapidly pay down debt. We hope to return to a net cash position this year, which will enable the management team to further evaluate return of capital strategies.

While the recent pull-back in commodity prices is expected to pressure domestic land activity, we expect our business to outperform general domestic industry activity. Customer balance sheets remain in much better shape today than they have in years past. Cactus remains well positioned to deliver for shareholders amid the current market environment. Finally, I want to personally thank our management team and advisors for their herculean efforts in transitioning FlexSteel to a Cactus company. 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. At this time, we will conduct the question-and-answer session. [Operator Instructions] Our first question will come from Dave Anderson with Barclays. Go ahead, Dave.

J. David Anderson
Barclays Capital
Hey. Thank you very much. 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'm doing great. You just said the rig count weakness you think is extending beyond the gas space. And I was wondering if you could expand on that a little bit more. Is that really a reflection of the lower oil prices on the privates? Is that what you're seeing? We haven't really heard the larger E&P majors pulling back at all. Just wonder if you could, kind of, talk about how you see those customer bases shifting in the second quarter. And also, maybe what's your sense on the back half of the year. Do you think that second quarter will plateau or, I don't know, obviously, gas is sort of its own thing, but maybe just kind of, your broader thoughts on the market for the rest of the year, if you wouldn't mind?

Scott Bender
President, CEO and Director
David, you always ask such easy questions. So, let me say that, it just stands to reason that with lower gas prices, that translates into lower cash flow for our customers. And because our customers are so focused on returns for their shareholders, I can't help but think, although I don't have any objective evidence, that the pullback will extend beyond privates. So to be sure, I think the privates will be affected, as you all know, more than the publics, but I don't think the publics are going to be totally immune from the pullback.

I think, in addition to that, we have to recognize that oil is at $70, $72, I didn't actually look this morning but the low $70s, and that has got to have probably an outsized impact on privates, but to some extent on publics as well. I also think, though, that when OPEC has another opportunity to evaluate their production cuts, you'll see production cuts that are going to be supportive of tightening supply.

Looking – I think that the rig count could possibly bottom out towards the end of the second quarter, and I think that the bottom could be in the range of 650 to 675, although David, I don't have any objective evidence other than having been in this business for so long. I would – I think you know that sentiment is not exactly right now very supportive, but I don't think it's going to fall below that. And that's – it's not a terrible – that's not a terrible area. We can certainly enjoy very good returns at that level. But I think that you're – everybody is sort of kidding themselves if they think that we're only going to see another 30 rigs pulled back.

J. David Anderson
Barclays Capital
Good. Some wisdom, I think, for the markets, very well heeded here. If I could shift over to your FlexSteel acquisition here, can you just talk a little bit about the overlap today with your wellhead business and FlexSteel? In other words, could you give me maybe a sense – I'm not asking for a number, but just a lot of wellheads today currently then go into FlexSteel or is that – obviously that's got to be one of the opportunities. I would think the selling point would be on reducing installation time for customers. But is there much of an overlap today? And can you just talk about how you see that moving forward in terms of – is that the same – are you talking to the same person with the customer? Obviously, it's an E&P, but are

you talking the same people there? How does that work? It's not really a business we've had a lot of exposure to, historically.

Scott Bender
President, CEO and Director
Okay. So the first point I want to make is that everybody who buys a Cactus production tree ultimately has to buy a FlexSteel product or stick pipe or a product competitive with FlexSteel like from NOV, or from Shawcor, or from Baker. So everybody's got to run some sort of transmission line from the end of our choke. In terms of Cactus customers, if we look at FlexSteel's major customers in the US, they're also Cactus customers. So, having said that, Cactus has about 5 times the number of customers as FlexSteel, so we're taking this opportunity to introduce the FlexSteel product line to those customers, knowing that they've got to buy something. And so it's logical, we think, to extend – to expand our wallet size with those customers. Does that help you at all?

J. David Anderson
Barclays Capital
No, that helps a ton. If I could just squeeze in one more question, I guess I don't know a ton about how the inner workings of FlexSteel, but how does pricing typically work here? Are steel prices kind of a driver like it is in OCTG? Just kind of loosely, just how does the – how do conversations come about? What are the sort of the drivers of pricing?

Scott Bender
President, CEO and Director
So, I'm going to – TS is with us. I'm going to let TS offer his comments.

Thirucherai "TS" Sathyanarayanan
CEO, FlexSteel
So in terms of pricing, pricing is set with the intention of providing the best value to the customer. We sell our products – FlexSteel's products primarily on safety and quality. And in that regard, we're very similar to Cactus, and the legacy Cactus business. And that's why we have also similar, sort of, overlapping customer base amongst large customers as well as in privates. Although like Scott said, we have lots of opportunities to get into these legacy Cactus customers to grow our top line.

Scott Bender
President, CEO and Director
So, David, let me just expand upon that. To be fair, TS is by nature, sort of, a modest person, but steel prices, clearly, steel is a large component of this input, but the way they've marketed their product has been without an eye towards steel prices. So that means that when steel prices went crazy, beginning, of course, with the war in Ukraine, FlexSteel did not respond with commensurate increases in their product prices. So they don't base their selling price on their cost of steel.

J. David Anderson
Barclays Capital
Okay. Great. Thank you very much. Appreciate it.

Scott Bender
President, CEO and Director
Thank you, David.

Operator
Thank you. [Operator Instructions] Our next question comes from Kurt Hallead with Benchmark. Please go ahead, Kurt.

Kurt Hallead
The Benchmark Co.
Hey. Good morning, everybody.

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

Kurt Hallead
The Benchmark Co.
Doing well. Doing well. Thank you so much. A great – appreciate all the outlook, and the commentary, and providing a perspective around how you think things are going to evolve. I think everybody's, kind of, grappling around elements of the business right now, so it's all incrementally helpful.

I guess, my question is, it sounds like you got a lot of momentum, and a lot of runway here and began to pull FlexSteel into what you've been doing obviously with 5x the customer base. I know you also looked at the opportunity to leverage FlexSteel on the international front and understanding that's still probably maybe a year away to seeing some real significant uptick. But just kind of curious, Scott, as you see that unfolding, what are some of the hurdles you may have to overcome to see that international business grow to the extent you think it can?

Scott Bender
President, CEO and Director
You're talking about hurdles in both product lines or...

Kurt Hallead
The Benchmark Co.
Well, yeah. Yeah. Just, maybe overall. Again, I know this is not your first foray in building an international business, right. But just want to try to get a sense as to what you see happening in the pipeline, the kind of feedback you might be getting from customers right now? And the kind of reception, and how does that make you feel? And do you think there's going to be any roadblocks to expanding your business internationally?

Scott Bender
President, CEO and Director
I think the major roadblock remains those countries that require indigenous manufacturing. And I think by now you know which countries those are. The rest of the world doesn't have such requirements, and frankly, I think that while FlexSteel has historically done a much better job internationally than Cactus has, FlexSteel's attention turned towards the domestic market as they tried to just – they had a similar commitment as we had during the supply chain challenges, and that is their commitment to take care of their domestic US customers. And when you do that, it's just logical, it may not be appropriate, but it's logical that you back off in terms of your focus on international markets.

For FlexSteel, in particular, projects, international projects can be more disruptive to their manufacturing process than for Cactus. And so, as a result, they really couldn't chase the big international projects to the same extent. Capital for us, fortunately, is not an issue, and so we are combining our marketing efforts, FlexSteel and Cactus together, to take that sort of approach to the international markets. So we'll be calling on customers with a single individual in many of the markets in hopes of getting some interest.

To be fair, purchasers on the FlexSteel side are mostly facility engineers, whereas on our side, they're mostly drilling and completion engineers. So even though same company, different set of decision makers. So the major roadblocks right now have just been a lack of exposure. And so, ask me this question in a year as we begin to ramp-up our efforts internationally.

There's no reason. You know, historically, TS, international, you've had years where international was 30-plus percent of your business?

Thirucherai "TS" Sathyanarayanan
CEO, FlexSteel

That's right. Yes.

Scott Bender
President, CEO and Director
There is no structural reason why we can't return to that.

Thirucherai “TS” Sathyanarayanan
CEO, FlexSteel
Yeah. And I'd say just add to that, any kind of growth that we're going to expect in international markets, especially in the offshore segment, will be a really big benefit for FlexSteel because FlexSteel's got those asymmetric upside nodes to grow in the shallow water offshore segments.

Kurt Hallead
The Benchmark Co.
Okay. Thank you. Appreciate it. That's it from me.

Operator
Thank you. [Operator Instructions] Thank you, everybody, for your participation. I would now like to turn it back over to Alan Boyd for closing remarks.

Alan Boyd
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.

Operator
Thank you for your participation in today's conference call. This concludes the program. You may now disconnect.