

Solaris Oilfield

Q1 2018 Earnings Conference Call

May 9, 2018 at 8:30 a.m. Eastern

CORPORATE PARTICIPANTS

Kyle Ramachandran – *Chief Financial Officer*

Bill Zartler – *Founder and Chairman*

Greg Lanham – *CEO*

PRESENTATION

Operator

Good morning, and welcome to the Solaris Oilfield Infrastructure First Quarter 2018 Earnings Conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question you may press star then one on your telephone keypad. To withdraw your question, please press star then two. Please note this event is being recorded.

At this time, I would like to turn the conference over to Kyle Ramachandran, Chief Financial Officer. Please go ahead, sir.

Kyle Ramachandran

Thank you operator, and good morning, everyone. I am joined today by our Founder and Chairman Bill Zartler and our CEO, Greg Lanham.

Before we dive into our prepared remarks, we would like to caution listeners that some of the statements today will be forward-looking statements. Such forward-looking statements may include comments regarding future financial results and reflect a number of known and unknown risks. Please refer to our press release issued on May 8, 2018, and the Form 10-Q filed yesterday, along with other recent public filings with the Securities and Exchange Commission that outline those risks.

I would like to also point out that in our earnings release and in today's conference call, we will discuss non-GAAP financial measures, which we believe can be useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with GAAP. Reconciliations to comparable GAAP measures are available in our earnings release.

With that said, I'll now turn the call over to our Founder and Chairman, Bill Zartler. Bill?

Bill Zartler

Thanks, Kyle and welcome to Solaris' first quarter 2018 earnings call. During the first quarter we continued to execute on our plan and drive supply chain savings and well site completions efficiencies for our customers. As highlighted by recent industry commentary, the first quarter witnessed significant sand logistics complexities that resulted in supply disruptions for the industry and delayed completions. Despite these dynamics, we saw continued demand growth for our systems in the first quarter as we delivered 21 systems to the fleet and remained virtually sold out for the entire quarter. We ended the quarter with 98 systems in the fleet and currently have 108 operating.

During 2018 we have continued to grow our market share as our customers require additional storage buffers throughout their supply chain. We continued to see interest in the 12-pack systems. We currently have three sets of 12-packs running and we had as many as five 12-packs running concurrently with three different customers during the quarter. Based on an estimated overall market of approximately 425 frac fleets, we believe we have about 24% market share today.

We believe our combination of highly efficient, scalable systems and supply chain data integration will lead to continued market share growth as we work hard every day to help provide a product and service that adds significant value to our customers and that will keep us ahead of the competition.

Our growth this year has been a function of both deploying additional systems with legacy customers, as well as adding new customers. For example, during the first four months of 2018, we have increased our number of distinct customers by about 33% and we've added 21% more systems with our current customers through April of this year.

The growing adoption of our technology speaks to the inherent efficiencies from our design, as well as our reputation for delivering high quality and reliable products and services. As we develop further integration of supply chain information through our Railtronix acquisition, we believe our value proposition will only continue to attract new and growing customers.

With that, I'll turn it over to Greg to discuss some additional operational highlights from the first quarter.

Greg Lanham

Thanks, Bill. Good morning, everyone. I am very proud of the work that our team did in the first quarter. Not only did we continue to grow market share, but we also reached a new manufacturing milestone when we delivered eight systems to the fleet in March. This is a testament to our manufacturing, operations and commercial teams.

The increase in our fleet size, growing customer demand and industry activity levels led to a record 7,673 revenue days during the first quarter, a 192% year-over-year increase, and a 25% sequential increase versus fourth quarter 2017. During the first quarter we continued to be effectively fully-utilized. Customer demand for our systems has risen due to the increased well completion activity, increased proppant usage, on average, per well, a challenging labor market and increased awareness of the advantages of our proven technology. Our most active operating areas continue to be the Midland and Delaware basins, followed by the Eagle Ford, SCOOP/STACK, the Marcellus/Utica, the Haynesville, the Rockies and the Barnett. We are helping our customers complete more stages per day by providing a large buffer at the demand location, and the digital data and tools to more efficiently manage their supply chain.

In addition, in the first quarter we commenced transloading operations at our Kingfisher facility and have advanced construction. We remain on track to have 30,000 tons of storage available beginning in August. Through April, our anchor tenant has increased month-over-month volumes since commencing deliveries to the facility in January, and a few weeks back we received our first unit-train from an additional customer that we are working with. Just as with our anchor tenant, our new customer is also a Solaris well site system user.

We have continued to make progress on the technology front. As discussed during our previous quarterly earnings call, the integration between Railtronix and PropView is facilitating full inventory visibility for our anchor customer at Kingfisher, starting with the visibility of product in railcars at the source mine, and all the way until it arrives at the well site, loading into our silos. We are currently developing extensive enhancements to the PropView platform that will allow customers to have visibility of their proppant inventory across the entire supply chain.

I'd now like to touch on what we are seeing in the market. As discussed by several other industry peers, shortages around labor and trucking capacity are two of the biggest challenges that we face the industry today. Our solutions are all geared towards improving the efficiency of each of these components.

Regarding labor, our system is very simple to operate and is operated by one individual who controls the system through a rugged-touch screens display. No ancillary equipment, movement or additional personnel are required to deliver sand to the blender once it has been offloaded into our silos, which makes for a safer and more organized well pad. For additional context, today Solaris is delivering a new system to the field every 3 ¾ days. If specialized training and equipment were required to operate our

systems it would be much more challenging for us to meet this delivery pace.

Regarding trucking, we are doing several things to drive trucking efficiency. First, pneumatic trailers are the most prevalent sand transportation method in the industry today. We are able to off-load up to 24 trucks in parallel, which provides for both an incredibly high throughput rate of more than 1.5 million pounds per hour, and second, a large buffer to handle the surge of trucks that arrive on the site together. Because we can off-load in parallel and without additional equipment, movement or personnel, we significantly reduce the challenges around demurrage and we increase well site safety.

Second, several of our customers are deploying next generation pneumatic trailers that have carrying capacity of 54,000 pounds of sand or greater, an increase of 12.5% versus traditional pneumatic trailers and a nearly 30% payload advantage over the leading box solution.

Third, PropView and Railtronix provide the real-time data to help our customer more efficiently dispatch trucks to various well sites and optimize sand delivery to locations where it is most needed.

I believe our leading market share and continued growth are testaments to not only our execution capabilities, but also speak to the differentiated and value-added offering that we provide. The cost savings and efficiency gains that our systems create have been proven by both our customers and us. We provide our customers with a capital light, rental model that creates a significant return-on-investment for them and provides the convenience of continual improvement, service and maintenance. As proppant intensity increases, the economic rent we generate for our customers will only continue to grow.

Lastly, we are focusing our R&D efforts on a next version of our well site inventory management system to accommodate other products that are delivered in bulk to the well site and we intend to drive supply chain efficiency there just as we have done in proppant management. We will continue to move the ball forward and drive innovation across everything we do.

Now with that, I'll now turn the call over to Kyle for a more detailed financial review.

Kyle Ramachandran

Thanks, Greg. In the first quarter we continued to grow our business, highlighted by a number of record operational and financial results, including more than 7,600 revenue days, \$36.0 million of revenue and adjusted EBITDA of \$21.9 million.

Revenue for the first quarter increased 43% quarter-over-quarter to a record \$36.0 million. This increase was driven by four factors. First, we added 21 systems to the fleet, driving a 25% increase in quarter-over-quarter system revenue days. Second, our implied average system rental rate increased by approximately 9% quarter-over-quarter. We have reset 2018 pricing for all customers at rates above 2017. Third, we had a full quarter of revenue contribution from our recent Railtronix acquisition. Fourth, we began transloading activity and revenue contribution from the Kingfisher facility in mid-January.

Circling back on the pricing comment, we believe that our customers are seeing continued increases in efficiency by using our systems, including completing more stages per day and reduced trucking and personnel costs. We believe our customers capture the vast majority of the economic rent that our offerings create.

Gross profit, defined as total revenue less the cost of proppant system rental, the cost of proppant system services, the cost of transloading services and the cost of proppant inventory software services, excluding depreciation and amortization expense, increased 34% to \$24.9 million, compared to \$18.6 million in the fourth quarter primarily due to higher revenues and operating activity discussed.

Selling, general and administrative costs and salaries, benefits and payroll taxes decreased to \$4.5 million from \$4.9 million in the fourth quarter. The decrease was primarily driven by a reduction in the 2017 bonus accrual and a reduction in third-party consulting fees as a result of insourcing certain administrative functions that took place in the fourth quarter. We would expect to return to a level closer to the \$5.0 million in the second quarter.

Net income for the quarter was \$13.4 million, an increase of approximately 45% versus the fourth quarter. Adjusted EBITDA increased to a record \$21.9 million, an increase of 44% versus the fourth quarter. Adjusted pro forma net income for the first quarter was \$14.5 million, or \$0.31 per share, versus \$8.9 million, or \$0.20 per share, in the fourth quarter. Our presentation of adjusted pro forma net income adjusts for certain items that we believe are non-recurring and also assumes a full exchange of all outstanding LLC Units and Class B Shares not held by Solaris Inc. for Class A Shares. By assuming the full exchange of all outstanding Class B Shares and Solaris LLC Units, we have presented net income and earnings per share that is more comparative with other companies that have different organizational and tax structures.

Total capital expenditures for the quarter were approximately \$41 million. During the first quarter, we added 21 systems to our fleet and continued construction at our Kingfisher facility. We believe these investments in our business will generate attractive long-term returns for our shareholders.

Regarding outlook, we expect to end the second quarter with 120 to 122 systems in the fleet, and we are now providing guidance on 142 to 146 systems in the fleet by the end of the third quarter of this year. We delivered 8 systems to the fleet in March and April and expect to maintain the pace going forward to meet continued customer demand for our mobile proppant management systems. We expect to use our operating cash flow, cash balance and modest borrowings under our credit facility to fund the remainder of capital expenditures in 2018.

At our current build-rate, we would expect to generate positive free cash flow beginning in 2019. While this timing is obviously dynamic and is subject to change based on opportunities that we find to deploy additional capital, we believe we could be in a position to generate meaningful free cash flow relative to our current market capitalization which could potentially be available to return to shareholders in various manners.

Speaking of liquidity, I'll wrap by outlining our current position. As previously discussed, in January of this year, we entered into a new credit facility that provides for a revolver of \$20 million and an advance term loan of \$50 million. Borrowings under the facility are subject to certain borrowing base calculations and the facility has standard financial covenants. Including the undrawn credit facility, our liquidity at the end of April was approximately \$90 million, including approximately \$21 million of cash.

With that, we would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

We will now begin the question and answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. If your question has been addressed, you may withdraw from the queue by pressing star then two. Once again, it is star one if you would like to ask a question. The first question will be from James Wicklund of Credit Suisse. Please go ahead. Mr. Wicklund, your line is open. It may be muted on your side.

And hearing no response, we'll move to the next question, will be from Martin Malloy of Johnson Rice. Please go ahead.

Martin Malloy

Good morning. Congratulations on the ramp up on the system deployment side during the quarter. My first question was on the—I was kind of curious about the cost of proppant management system services and the increase from the fourth quarter to the first quarter there. Maybe, could you talk a little bit more about what's involved there and is this transitory related to the ramp up in growth?

Kyle Ramachandran

Good morning, Marty. Yes I think you've hit it on the head in the sense that a portion of it I would say is transitory and really as we saw the ramp up in manufacturing cadence, we wanted to make sure we were ahead as far as hiring personnel to support our systems and so we did go ahead and hire some folks earlier on in the quarter to get ahead of that and make sure those folks had the right training and experience in place. We have a great reputation around quality and reliability of our systems and so it's paramount that we maintain that. So we are starting to see some of that catch up with our build cycle.

The other point, in a business like ours, you will typically see certain payroll taxes reset in the first quarter relative to fourth quarter so you always see sort of a pick-up in the first quarter from that perspective. The other thing that we did is we are now moving some of the restricted stock and bonus accrual for the field service folks into direct costs of operating rather than in G&A costs and so that will be a permanent shift so that will, in theory, reduce our gross margins there but will be offset by lower G&A.

Martin Malloy

Okay. So as you look forward through the course of '18 from what happened in the first quarter with the EBITDA margins, can you kind of talk about how you see that playing out?

Kyle Ramachandran

Yes, I think from an EBITDA margin perspective, we were pretty flat quarter-over-quarter and as we see additional contribution from things like Kingfisher, more volumes there as well as getting more scale from just having more systems in place, there's certainly upside to our EBITDA margin, but I would caution that at north of 60%, we do have quite strong EBITDA margins and sort of any noise quarter-over-quarter can be meaningful because those margins are so high.

Martin Malloy

Okay, thank you. I'll get back in queue.

Operator

And the next question will be from George O'Leary of TPH and Company. Please go ahead.

George O'Leary

Good morning, guys. I thought the larger pneumatic truck commentary was particularly interesting and you guys have been working on the belly dump system and pushing that into commercial sales mode. I guess these larger pneumatic trucks limit or reduce the need to do that. I realize it's probably good to have both solutions but I guess how do you think about pushing more belly dump versus these larger pneumatic trucks making these systems more economical versus boxes as it is?

Greg Lanham

Well, George, actually we are doing both. I think it was just important to talk about the pneumatics and the new vintage pneumatics and where they're going and how they benefit the industry and how we're

able to utilize them. We do have our belly dump option out there, our non-pneumatic option out there operating right now. It's been going extremely well, particularly on the pre-fills, so we think that it's best to be able to have optionality and to use both systems. We have that third non-pneumatic option going out this week, so they're out operating right now and we're rolling out others later in the year.

George O'Leary

Great. I thought that the pricing commentary was helpful as well. I think if I remember right, and correct me if I'm wrong, the thought was pricing for your systems, it would take another leg up in Q1, that did happen, and then kind of flatten out from there. It sounds like you guys have reset your customer base above 2017 levels based on your comments. How should we think about pricing for the rest of the year? Should we model that kind of flattish or model it in line with however we're modeling cost [indiscernible]? Just how do we think about that pricing dynamic through the last three quarters of the year?

Kyle Ramachandran

Hey, George. The way I would answer that is yes, I think the majority of the increase that we'll see in '18 did come in the first quarter. We may see slight increases as we roll forward here as we bring on new customers, call it the higher marginal rates, but I think the majority of it was captured in the first quarter so I wouldn't bake in a ton of increases from here.

George O'Leary

Great. And then maybe just one more if I could. We hear a lot from the pumpers and the E&Ps on sand per well but you guys are on the front lines. It sounds like there's more demand for 12-packs out there and also just a greater shift towards multi-well pads, so is the demand for 12-packs increasing or is it accelerating? And then, two, what are you guys seeing on the, I don't know how you think about it, sand volumes per day that flow through your system? And I realize it doesn't matter to your bottom line but just curious for your insights.

Greg Lanham

Hi, George. We are seeing continued demand for 12-packs. We have three out there operating today. That changes week to week, but certain customers certainly have expressed a large interest, some up to 50% of their configuration in a 12-pack, so I think that's a trend as we go forward, as we continue to see sand intensity increase. To answer your second question about the sand intensity, yes, we're still seeing increases per well, I'm just looking at numbers right now and just from year-over-year, it's up 30%, so it's continued to climb. So again, that drives demand for our system, drives demand for the 12-packs as well.

George O'Leary

Great, guys. Thanks very much for the color.

Operator

The next question will be from James Wicklund of Credit Suisse. Please go ahead.

James Wicklund

Sorry about that, guys. We're having telephone problems here at Credit Suisse. I think it's wonderful that we get to gripe and complain about EBITDA margins being flat at 60%. It's a rare treat. I appreciate it, guys.

The future, you're going to hit free cash flow mode in '19, you're at 24% market share now and outpacing everybody else so clearly you have room to go on market share, but you're taking that quickly. What's 2020 look like for you guys? You will either have bags of cash or you will have given back bags of cash and you will have a slowing growth rate. What do you do?

Greg Lanham

Morning, Jim. Well either one of those are not bad problems to have for sure.

James Wicklund

No, they're not. No they're not.

Greg Lanham

But we're continually looking at other options for our system. I kind of touched a little bit on our R&D efforts that we're going through right now, new designs of our systems to clean up part of the well site, which again, we think that there is a lot of efficiency to be put into. You look at current oilfield chemistry biocides, friction reducer, acid, there's still a lot of places there—

James Wicklund

Chemicals and water are still delivered in bulk. Yes, there's [overlapping voices] there.

Greg Lanham

That's exactly right and so as we look at the next gen systems, along with proppant profit well site silo systems, we look there, we look at what we're doing on the technology side and we're continuing to grow that out so we see a very bright future, but at the same time, there's still a lot of growth to have in our current systems. We're continuing to do that. We still have a very strong order book out there on our systems right now. As we looked at the board, we're well out, a quarter out in terms of orders right now so again, it's been a very busy time and we continue to try to meet—

James Wicklund

Oh there's no question, you're kicking a** and taking names with—no question at all. It's just the market's worried about when you're this good in Act 1, but your willingness, and Kyle, I love the tease on giving money back, but can you talk about that? Are you a special dividend kind of guy? Are you a regular dividend kind of guy? Are you an episodic buyback kind of guy? How do you return—what's your favorite methodology or thinking in giving money back to shareholders?

Bill Zartler

Well, I think there's a couple of ways we look at it. I think number one, we have been continually evaluating opportunities to grow the platform with M&A and other additions to it. We're quite particular on what we buy and want to make sure that it sits well which is why Act 1 was successful and Act 2 will be also. So we're very cautious and careful about that. I think if you fast forward and we have not located other than our internal R&D that maybe great opportunities to continue to grow and not located an M&A and still have free cash flow, a benefit, I wouldn't call it a challenge, but certainly a concern, we will look closely at a combination of some regular dividend—obviously it's not the most tax efficient use of cash—and stock buy backs that all will benefit our shareholders.

James Wicklund

Perfect. Guys, I appreciate it and like I say, it's a stunning job, 60% EBITDA margins are a rare thing in this market. Appreciate it. Good luck.

Operator

The next question will be from John Watson of Simmons and Company. Please go ahead.

John Watson

Good morning guys. Greg, could you provide us with an update on the number of the active systems that are under contract and just how the contract book looks for the balance of '18?

Kyle Ramachandran

Hi, John. This is Kyle. I'll actually take that one. When we look at our current fleet of about 108 systems, we have north of 80% of those under contracts in '18 and that's certainly up and closer to what we guided to in the last call.

John Watson

Okay, perfect. Any discussions on contracting for 2019 or not yet?

Kyle Ramachandran

We're not quite—I wouldn't call it in the heart of those discussions at this point. I think from our perspective we're seeing certainly positive momentum in the overall market as to the value proposition of what we're providing, i.e. opportunities to increase pricing as we roll into '19, so no, we're not really engaged in those discussions right now but I'd say come August, September, those discussions typically kick off as people start to get insight into their activity into the following year.

John Watson

Got it. Makes sense. The release talked about, and we've talked about on the call an additional customer at Kingfisher, can you give us an update on the potential for that customer or someone else to become another anchor tenant for Kingfisher?

Greg Lanham

John, we're not ready to talk too much about that customer just yet. We will say they're active in the area and just started up a new program there. They're an existing Solaris well site system customer. We are engaged actively with a lot of folks up there, and in terms of putting together another anchor tenant in place, we're not ready to announce that just yet.

Kyle Ramachandran

But I think it's important just to note how close we are to the heart of the play and the intrinsic benefits of being that close and what it does to your total delivered costs as well as being able to land a unit train in the example of our new customer here.

Greg Lanham

I'll just point out to brag on the guys at Kingfisher a little bit, that was a wheat field in Oklahoma back in July of last year and they got their first unit train delivery a couple of weeks ago and then they started moving volumes through there in January, so it's been a very big great operational feat to get that up and running in such quick and efficient fashion.

John Watson

Absolutely. Lastly, on the cost savings front, I guess, the release talks about the integration of PropView and Railtronix. Can you give us some additional color on the savings you're providing and the benefits that that presents for your current anchor customer?

Greg Lanham

Well John, it's early days but what we're able to do is give them a real-time view of their proppant delivery basically from the mine all the way to the well, so they can get an instantaneous snapshot of volumes per grade per area and be able to manage their supply chain a lot better. Again, we've just now had a full quarter with Railtronix as part of Solaris so it's really kind of coming together now but we've seen a lot of excitement around it, just from another way that we can help drive supply chain efficiency. Again, being able to be a one-stop shop for all this data is something that's very appealing to the customer base. Anybody else have anything to add to that? Okay.

John Watson

Well, I'll turn it back. Congrats on a good quarter and the continued growth plan.

Operator

The next question will be from Jason Wangler of Imperial Capital. Please go ahead.

Jason Wangler

Good morning, guys. Maybe kind of dovetailing or asking a previous question a little differently, as you roll out these new systems, obviously eight or so a month, are those going out into a spot market so to speak or are those being contracted through a year-end basis? Just wondering how you're setting those up as you roll them out.

Kyle Ramachandran

Well I wouldn't say they're going to a spot market. They're all allocated to customers. We have a dynamic board that we're constantly managing with different folks' frac schedules and our manufacturing timeline so it's not going into a spot market and we're not putting any for rent sign on it, if you will. Then, as far as if it's going to a customer with a term contract, I think it goes back to my comment around 80% of our systems today are with customers with term so it will be sort of in that range, 80%-ish are going to folks with term.

Jason Wangler

Okay. And you guys talked about labor and obviously on the systems side probably don't have a lot of impact given you don't have a lot of labor there, but in the manufacturing side and even as you guys are outsourcing quite a bit of that, are you seeing any impact on that side of it? Or if you are, how are you guys mitigating that?

Kyle Ramachandran

No, I don't think so. We've been able to ramp from four to six to eight systems a month pretty efficiently. We have relied on, or we are working with some third party folks to help us augment our internal capacity, but from a manufacturing cost perspective, we really haven't seen our costs creep.

Jason Wangler

I appreciate it. I'll turn it back.

CONCLUSION**Operator**

And ladies and gentlemen, that will conclude our question and answer session. I would like to hand the conference back over to Greg Lanham for closing remarks.

Greg Lanham

Well, everyone, I appreciate your attention today and your time on the call and I also want to thank the hard working employees of Solaris for their time and effort and again, you all have a nice day.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference call. We thank you for attending today's presentation. You may now disconnect.