Solaris Oilfield

Q4 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

William Zartler – *Founder & Chairman*

Greg Lanham – *Chief Executive Officer*

Kyle Ramachandran – *Chief Financial Officer*

Kelly Price – *Chief Operating Officer*

PRESENTATION

Operator
Good morning. Welcome to the Solaris Oilfield Q4 2017 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, may press * then 1 on your telephone keypad. To withdraw your question, please press * then 2. Please note that this event is being recorded.

I would like to turn the conference over to Kyle Ramachandran. Please go ahead, sir.

Kyle Ramachandran
Thank you, operator, and thank you for joining Solaris' Fourth Quarter 2017 Conference Call. I'm joined today by our Founder and Chairman Bill Zartler, our CEO Greg Lanham and our Chief Operating Officer, Kelly Price.

Before we begin our call today, 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 March 6, 2018 and the Form 10-K filed yesterday, along with other recent public filings with the Securities & Exchange Commission that outlined those risks.

During today's 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 and the Appendix of the aforementioned supplement materials.

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

William Zartler
Thank you, Kyle. Welcome to Solaris' Fourth Quarter 2017 Earnings Conference Call. 2017 was a very exciting year for Solaris. We accomplished a number of significant initiatives. First, we increased our fleet of mobile proppant management systems by more than 2.5 times while practically being sold out the entire year. Second, we entered into a seven year contract with our anchor tenant at the Kingfisher transload facility where we're constructing in the heart of the SCOOP/STACK play in Oklahoma.

Third, we've advanced efforts to digitize the proppant supply chain through the acquisition of Railtronix, which expands our offering upstream and combines it with our last mile supply chain tool called PropView. It allows us to deliver supply chain information to our customers from the mine all the way to the well site, including rail, transload, trucking and well site inventory and consumption rates.

Fourth, we launched the Belly Dump Unload kit that offers more trucking flexibility for our customers. And finally, we completed our IPO in May and raised additional capital through a follow-on offering in November. We believe these accomplishments position us to continue to build upon our success and deliver innovative solutions to the industry.

Now, speaking specifically to the fourth quarter, we continue to grow our market share through the deployment of additional mobile proppant management systems to the field. We added 18 systems in the fourth quarter to end the quarter with 77 systems in the fleet, all of which were deployed to customers. That compares to 30 systems at the end of the fourth quarter in 2016. As of today, we have 91 systems in our fleet; all of them are deployed to customers. We believe this represents the industry's leading market share for next generation proppant handling solutions. Based on an estimated 415 operational frac fleets in the US today, we have approximately 21% market share.

The continued use of high volumes of proppant, the desire to frac efficiently and challenges in the trucking industry underpin the value-add that our systems provide our customers. Specifically, recent weather-related supply issues highlight the relative lack of storage capacity along the proppant supply chain. Among many other attributes, Solaris provides customers with high capacity, high efficiency inventory management solutions, along with the data to better predict proppant needs along the various points in the supply chain.

With that, I'll turn it over to Greg to discuss some of our operational highlights for the fourth quarter.

Greg Lanham
Thanks, Bill. Good morning, everyone.

We are very excited to walk through some of the highlights from the fourth quarter. Not only did we exceed previously provided system count guidance, but we also made significant progress with our Kingfisher facility and completed a highly accretive and strategic acquisition.

During the fourth quarter, we delivered 18 new systems to the fleet, ending the quarter with a total of 77 systems. The increase in our fleet size, growing customer demand and industry activity level led to a record 6,146 revenue days during the fourth quarter; a 188% year-over-year increase and a 35% sequential increase versus third quarter 2017.

During the fourth 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, and increased awareness of the advantages of our proven technology.

During the fourth quarter, we had a well-balanced customer mix. Approximately 50% of our revenue was sourced from operators and approximately 50% from pressure pumping companies. We are very proud of our blue chip customer base and we look forward to continuing to grow with our existing customers as well as adding new customers.

Our most active operator areas continue to be the Midland and Delaware Basins, followed by the Eagle Ford, SCOOP/STACK, the Marcellus/Utica and the Haynesville.

Now, turning to our Kingfisher facility. As previously announced, we commenced transloading operations through the facility in January of this year, meeting our original goal. Today, we are simultaneously advancing construction and providing our anchor tenant with manifest rail to truck service that significantly reduces trucking distances to their well sites.

Finally, I'd like to discuss our exciting Railtronix acquisition that we completed in December. As a reminder, Railtronix is a leading provider of real-time inventory management solutions for proppant mining, rail shipping and transloading operations.

We were introduced to Railtronix when evaluating different inventory management solutions at the Kingfisher facility. As we evaluated the different options, we determined that Railtronix offered the greatest insight across the supply chain and would be a logical extension of Solaris' strategy to digitalize the proppant supply chain. We were impressed by how much of the industry's proppant Railtronix touched, not only at the transload facilities, but also at the source mines. Today, we are providing real-time inventory through Railtronix across 60 facilities, including source mines and transloads.

Since closing on the acquisition in December, we have on-boarded Railtronix's existing customers and have integrated Railtronix and PropView data for our anchor tenant at the Kingfisher facility. We are extending this integration to additional facilities for customers seeking to enhance and optimize their operations.

I'd now like to touch on what we're seeing in the market. As I noted on our last call, the US oil and gas industry is rapidly adopting new technologies to handle the challenges associated with delivering ever-increasing volumes of proppant, while improving the health and safety at the well site. We have benefited from this trend, as have several other companies. While we continue to see new entrants in the proppant logistics, we believe our leading market share, internal manufacturing capacity, and differentiated offerings will support our continued market share growth. As an organization, we constantly focus on innovation and staying ahead of the competition.

To that point, we have spent a tremendous amount of time and effort developing PropView and integrating it with Railtronix to provide an integrated view for our customers across their supply chain. We believe the reliability of our systems and this differentiated data stream are fundamental in making sure our solution remains sticky with our customers.

In addition, we have developed our non-pneumatic loading system and it has been working in the field for several months. We have received positive feedback from our customers and significant interest from additional customers to use the non-pneumatic kit.

Since deploying the first non-pneumatic system in November, we have made several engineering modifications to version one and we expect to deliver two additional non-pneumatic kits in the second quarter. We believe our non-pneumatic system is truly differentiated from other offerings because our customers are able to maintain the integrity of our original design of having multiple pneumatic loading points.

Based on our experience of operating more than 90 well site systems, trucks tend to bunch up and arrive onsite in groups. In order to keep trucks moving, it is critical to be able to handle that surge through multiple unloading points.

I will wrap up my comments with an exciting milestone we expect to celebrate with our team very soon. Based on our manufacturing schedule, we expect to deliver our 100th system to the fleet in early April. We look forward to celebrating this milestone with our team. For some context, we celebrated the delivery of our 50th system only eight months ago, in August of 2017. This milestone is a testament not only to our operations teams' ability to accelerate production rate, but also speaks to commercial adoption of our solutions. We're excited about the outlook of our business in 2018 and beyond.

Now with that I will turn the call over to Kyle for a more detailed financial review.

Kyle Ramachandran
Thanks, Greg. In the fourth quarter we continued to grow our business highlighted by a number of record operational and financial results, including 6,146 revenue days, $25.2 million of revenue, and adjusted EBITDA of $15.2 million.

Revenue for the fourth quarter increased 36% to a record $25.2 million from $18.5 million in the third quarter. This increase was primarily due to a 35% increase in the number of revenue days driven by an increase in our fleet size and growing customer adoption of our patented technology.

Gross profit, defined as total revenue less the cost of proppant system rental, the cost of proppant system services, and the cost of proppant inventory software services, excluding depreciation and amortization expense, increased 33% to a record $18.6 million compared to $13.9 million in the third quarter, primarily due to higher revenues and operating activity.

Selling, general and administrative costs, and salaries, benefits and payroll taxes increased to $4.9 million from $4.1 million in the third quarter. This increase was driven primarily due to an increase in bonus accrual and an increase in headcount as we continue our transition to operating as a public filer.

Net income for the quarter was $9.2 million versus $7.4 million in the third quarter.

Adjusted EBITDA increased to a record $15.2 million, an increase of 37% versus the third quarter reflecting the factors previously discussed.

In our press release issued last night, we presented adjusted pro forma net income, a non-GAAP financial measurement, for the first time. Simply put, adjusted pro forma net income adjusts for certain items that we believe are non-recurring and importantly, assumes the full exchange of all outstanding LLC units and Class B shares not held by Solaris, Inc. for its Class A shares. By assuming the full exchange of all outstanding Class B shares and Solaris LLC units, we can now present net income and earnings per share that is more comparative with other companies that have different organizational and tax structures.

In addition, this presentation should simplify the impact of any exchanges that take place during a reporting quarter as well as provide a clean period-over-period comparison because it eliminates the effect of any changes in net income attributable to Solaris, Inc. driven by increases in its ownership of our operating subsidiary. With that said, adjusted pro forma net income for the fourth quarter was $8.9 million or $0.20 per share versus $5.5 million or $0.13 per share in the third quarter.

I would now like to briefly review the impacts of the recently passed Tax Cuts & Jobs Act of 2017 on our fourth quarter financials.

In the fourth quarter, the Tax Act had a net impact of approximately $700,000 of expense on our net income, primarily driven by the reduction in the corporate tax rate from 35% to 21%. This was addressed in two different line items on the P&L.

First, we recognized a benefit of $21.9 million as a result of a reduction in payables related to the tax receivable agreement. Second, we recognized $22.6 million of expense as a result of a reduction in the value of our deferred tax asset. This expense was recognized in the provision for income taxes on our Income Statement. We believe both of these are one-time items and they have been adjusted in our presentation of adjusted pro forma net income.

Total capital expenditures for the quarter were approximately $49.9 million for a total of $98.9 million of capital expenditures in 2017. During 2017, we added 47 systems to our fleet, made significant construction progress at our Kingfisher facility, and acquired Railtronix. We believe these investments in our business will generate attractive long-term returns for our shareholders.

Regarding outlook, we are confirming our previous guidance of exiting the quarter with 96 to 98 systems in the fleet, and we are now providing guidance of 118 to 122 systems by the end of the second quarter of this year. We delivered seven systems to the fleet in February and expect to deliver eight systems in

March. We have increased our manufacturing cadence in the first quarter to meet growing customer demand for our mobile proppant management systems.

Relative to the fourth quarter of 2017, we expect rental rates to increase mid-single digits in the first quarter of 2018. We believe the pricing increases indicate the value added differentiation of our offering. Our lean operating cost structure and the new pricing agreements support the maintenance of our strong operating margins.

The first quarter pricing increases relate to new agreements that we have entered into with the majority of our customers. We would anticipate more modest, if any, pricing increases for the remainder of 2018 as we bring on new customers.

Finally, I'll wrap up by outlining our liquidity position. In the fourth quarter, we completed a follow on equity offering and added approximately $44.5 million of cash to the balance sheet. We ended the fourth quarter with a cash balance of $63 million.

In January of this year, we entered into a new credit facility that provides for a revolver of $20 million and an advanced term loan of $50 million. Borrowings under the facility are subject to certain borrowing based calculations and the facility has standard financial covenants.

Including the new undrawn credit facility, our liquidity at the end of February 2018 was approximately $108 million, including approximately $44 million of cash.

With that, we'd be happy to take your questions.

QUESTIONS AND ANSWERS

Operator
Thank you. 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. To withdraw your question, please press the star then two. At this time, we will pause momentarily to assemble the roster.

The first question comes from James Wickland with Credit Suisse.

James Wickland
Good morning, guys. Congratulations. The growth has been nothing short of spectacular.

Let me ask you, on utilization, which hit 98%, when we first started modeling this company, utilization was actually a variable that mattered and now it seems that you guys have rolled all your contracts on to longer terms. Should we just be using 100% for utilization of the units from this point forward?

Greg Lanham
Good morning, Jim. I wouldn't go that far. We have rolled the majority of the contracts on to longer-term agreements, but I wouldn't say that 100% utilization going forward would be the right number there.

Kyle Ramachandran
You'll always have some amount of movement with customers. In other words, we may have a customer that has a work program for nine months and at the end of that program there may be two weeks where we're transitioning to a new customer, so you'll always have some amount of unutilized period of time. We take a very conservative measure in the calculation of utilization. It's really just the number of days

that the systems are available, so we don't take into account any downtime or anything like that.

James Wickland
And for the last six months you've averaged 97%. Is that a good number to use going forward?

Kyle Ramachandran
I don't think we're going to provide guidance on utilization, but I think—

James Wickland
That's alright. You've answered the question, basically. I understand. It won't be 100%, but it will be a lot higher than we originally assumed.

Kyle Ramachandran
That's right.

James Wickland
Okay. That's all I wanted to get to.

The second thing, you guys are obviously raving about Railtronix, and looking at their website it's a stunning business. How sticky does this get your business? I know you have PropView and everybody has an app on their phone these days for something, and I assume the logic is to get more embedded in the supply chain and making switching costs higher to customers. I understand your exuberance about it, but can you talk about what that really means for a customers' stickiness and their supply chain? How easy is it for somebody just to switch to another program?

Greg Lanham
We're really excited about it, as we've mentioned, and the reasons for that are basically, as you mentioned, being sticky. We add a lot of value to the supply chain of the customers because you're giving them full visibility across the entire supply chain, from source to destination. So you have customers who are able to aggregate what their proppant volumes are at the transload and then also with using PropView at the well site. So they're finally going to be have the whole value chain or whole supply chain model.

What we're seeing is we're getting a lot of excitement from customers. As we progress forward with the integration, we think that that's going to be very differentiating for us as we go forward.

Kyle Ramachandran
And specifically at Kingfisher, we are now providing to our anchor tenant information on several mines that are inbound into the Kingfisher facility, inventory at Kingfisher and then inventory at the well site. So that's the first example of us really integrating that into a package.

Greg Lanham
The way we see it, we believe that we'll be the only company that will be able to give them full visibility across that supply chain.

James Wickland
That's true. Last one, if I can sneak one in, you're obviously taking the cadence from 6 to 8 per month. There was some discussion of how much you outsource and how much you build internally without adding more roof line. What can you tell us, product quality deterioration, what warm and fuzzies can you give us that that won't happen?

Greg Lanham
Well, even though we outsource some components, we still bring everything back to the facility for final testing and assembly, so everything meets our same quality control standards as if it came out of our own manufacturing plant. So, we've been really diligent about that. And even though we've been able to up the cadence, we've done it in a measured way, we've done it in a way that we can maintain our quality control and, in fact, we've also maintained our cost discipline, too, by managing our own supply chain.

Kyle Ramachandran
And importantly, these aren't new suppliers to us. We've been using them for more than six months I'd say at this point, so we have history and experience there.

James Wickland
Okay. Gentlemen, thank you very much. I appreciate it.

Greg Lanham
Thanks, Jim.

Operator
The next question comes from Martin Malloy with Johnson Rice.

Martin Malloy
Good morning. Congratulations on the quarter.

Greg Lanham
Thanks, Martie.

Martin Malloy
In your presentation you talk about one of the bullet points is demand for the systems exceeding the fleet size. Could you maybe talk about how much of a view forward that you have in terms of how many months, if at eight manufacturing systems per month, that that cadence, how many months of demand you have good visibility on?

Greg Lanham
Right now we have good visibility into the second quarter and we've always maintained that. It's looking at about a quarter to maybe a little bit more ahead, and so that's how we made the decision to go forward is looking at that. We're not building these systems on spec. We have customers lined up as they come off the manufacturing floor and they go to straight to work and straight to a location.

Martin Malloy
And in terms of looking at the competitive environment and what's out there in terms of the older model proppant systems at the well sites, can you maybe give us an update in terms of what you think the addressable market is and what percent of the frac crews are still using older, not the latest generation proppant management systems?

Greg Lanham
It's hard to get an exact number on that, but I would say what I'll call old generation systems, probably still 40% to 50% of the market.

Martin Malloy

Great. I'll get back in queue. Thank you.

Greg Lanham
You're welcome.

Operator
The next question comes from Waqar Sayed [ph] with Goldman Sachs.

Waqar Sayed
A couple of questions. Number one, could you guide us on the cap ex for the year? And if not for the year for competitive reasons, then maybe for the first half?

Kyle Ramachandran
We haven't provided guidance beyond obviously the second quarter. I can quickly here pencil out while we're on the phone what the first half cap ex looks like if we, I'll just say, hit the midpoint of the 120 systems. So just give me a moment here and I'll pencil that out, so keep going.

Waqar Sayed
Okay. And while you're calculating that, could you talk about the penetration of two silos systems? One of your customers wanted about 20% of the silos, two silos systems, 20% of crews. Are you seeing penetration beyond one customer on that issue?

Greg Lanham
We are. There's been a lot of interest in it. Currently we do have one customer that has a 12 pack configuration, but I will say that we have several others going out in the near future. It varies a lot. We've seen a lot of good traction on it and anticipate that going forward, but it's something that we see, as proppant demand increases, particularly in certain areas, just forward staging makes a lot of sense to put the capacity on location. We probably will see up to four this quarter.

Kyle Ramachandran
Waqar, I'm comfortable with $85 million to $95 million in the first half of the year.

Waqar Sayed
Great. Then could you talk about any changes to the competitive landscape that you've seen the last several months?

Kyle Ramachandran
We've been consistent that folks are adopting new technologies, so we continue to see that. We have seen some folks rebranding some technologies around vertical storage, and I think that really speaks volumes to our belief that vertical storage is really the most efficient way to address this. Then when we look at vertical storage solutions, we believe we have the best product out there and a product that we continue to refine. One of the things that we've heard from customers is an interest in using belly dump trucks, and we've obviously developed a kit to adopt right into our existing system to use belly dump trucks. But importantly, and I think really what distinguishes us, is we're maintaining the integrity of the multiple unloading points. We're not solely reliant on being able to unload belly dump trucks.

Waqar Sayed
Does that system comply with all the new OSHA regulations?

Greg Lanham
Yes. We're constantly being tested. We're testing it ourselves. So in terms of our existing systems with

the pneumatic loading and the belly dump, yes, we're going through testing right now and we're getting very good results.

Kyle Ramachandran
This has been going on for more than a year as far as testing our customers. As Greg mentioned, we're testing. And it's important to keep in mind, because I think there's a general misconception around pneumatic trucks, but our system was designed to fix some of the traditional or historical issues with pneumatic delivery of sand. So we have a closed loop system that trucks unload pneumatically directly into the silos. There's dust collectors at the top of the silos. So that closed process does contain any of the dust issues historically related to the pneumatic offloading of sand.

Waqar Sayed
Then one final question. In the past you've given out the trends in [indiscernible]. Could you update on what you saw in the fourth quarter?

Kyle Ramachandran
We would say that we saw volumes on average in-line with what we've seen through the first half and the third quarter of 2017. We tend to see more sand pumped per well than I'd say the industry average, just given the fact that we provide so much more storage onsite.

Waqar Sayed
Great. Thank you very much.

Operator
The next question comes from John Watson with Simmons & Company.

John Watson
Good morning, guys.

Greg Lanham
Good morning, John.

John Watson
In late January, I think you all said that 40% of the fleet was on [indiscernible] for 2018. Can you give us an update on that figure? And are any fleets contracted for 2019 as of yet?

Kyle Ramachandran
In 2019, no. I think what we've done is set new pricing agreements through most of 2018. Today it's about 75% of our current fleet. In the coming days, I expect that to be closer to 90%. A couple guys who just need to wrap-up some paperwork. So that's sort of in terms of what's contracted, it's 75% today.

John Watson
Okay. That's perfect, thanks Kyle. We've heard lots of discussion about weather and sand delays impacting Q1 results. I wouldn't think that that impacts Solaris in the same way, but can you speak to that? And also speak to any potential delays on frac jobs that maybe don't impact Solaris results but impact some of your customers?

Greg Lanham
As you know, we're on a monthly revenue basis with all our customers, so any other impacts, any delays like that won't affect us from a revenue standpoint.

John Watson
Okay.

Greg Lanham
Does that answer the first part of your question?

John Watson
Yes, absolutely. The second part, are you seeing delays on jobs that aren't impacting Solaris' results, but might impact pressure pumpers?

Greg Lanham
No, honestly not really. We've seen some weather related issues up in Oklahoma, for the most part, there was an ice storm there and that impacted a little bit. But again, from a system revenue standpoint, it doesn't affect us.

John Watson
Perfect. Greg, I think you mentioned four 12 pack systems for Q1. Is that customer, do they have any interest in potentially moving to an 18 pack at some point and having even more storage onsite? Or is that not a possibility right now?

Greg Lanham
We haven't had that yet, so who knows in the future.

John Watson
Okay. I'll check back in a few quarters. Thanks, guys.

Greg Lanham
Thanks.

Operator
The next question comes from Jason Wangler with Imperial Capital.

Jason Wangler
Good morning. Kyle, I was just curious on your percentages you gave on the contracts. Are those for one year contracts or are those just for the pricing agreements for this year?

Kyle Ramachandran
It locks in term and there's a component of those contracts that have termination penalties.

Jason Wangle
Okay. Then as a follow up on the Railtronix PropView as you guys are integrating that system, I think you guys talked about during the acquisition that the customer base, there was not very much overlap in the customer base. Could you talk about picking up those customers, bringing them [audio disruption] your side and then just kind of how you see as that integration has been going for a couple of months now, how that's starting to go as you start to kind of roll the program forward, both for systems and probably with other customers that are outside of your systems right now?

Greg Lanham
There's a fair amount of overlap, but I'm really happy with the way the integration is going. We're doing all this stuff in parallel, bringing Kingfisher on, integrating Railtronix and PropView at the same time. We're in an ideal situation to use that as a test incubator and getting that right. So far it's gone very, very

well. Now, that's with a single customer. But again, we have a controlled environment, we feel good about that.

I think we mentioned, we have about 60 touch points from Railtronix. Some of those overlap. Some of them are sand companies, some of them are just certain transloads, some of them are a combination of the two.

Jason Wangle
I appreciate it. I'll turn it back.

Operator
Once again, please press star then one if you do have a question. The next question is a follow up from Martin Malloy with Johnson Rice.

Martin Malloy
Thanks for taking my follow-up. I just wanted to ask about Kingfisher, if you could maybe give us an update on the outlook for additional coverage contracts.

Greg Lanham
Sure. Good morning. It's going well. We hit our marks in terms of getting on, start moving manifest volumes through there in mid-January, which was right on schedule. The silo construction is on schedule and on budget as well, so we feel really good about that.

We're moving between 50 and 100 trucks on average a day through there right now, which was, again, the plan to start with. We don't have anything to announce in terms of other contracts yet, but I will say that we're actively discussing those right now and I'm hopeful we'll be able to talk a little bit more about that in the future.

Kyle Ramachandran
The only thing I would add is, I think now that we've reached the milestone of actually running railcars and trucks through the facility, we're seeing new interest from folks that were on the sidelines say at the end of 2017 now that we have something to show folks that there's new interest there as well.

Greg Lanham
Being a new facility, people are just now seeing it and seeing it up and operational, and we're getting a lot of traffic through there.

Martin Malloy
Thank you.

CONCLUSION

Operator
As there is nothing else at the present time I would like to return the conference back over to management for any closing comments.

Greg Lanham
I'd like to thank everyone for their time this morning. We appreciate your support of Solaris and the team. We're very excited about '18 and the progress we're making going forward. So again, thanks for your interest.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.