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USAC.N - Q4 2023 USA Compression Partners LP Earnings Call

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PRESENTATION

Operator

Good morning. Welcome to USA Compression Partners fourth quarter 2023 earnings conference call. (Operator Instructions) This conference is being recorded today, February 13, 2024. I would now like to turn the call over to Chris Porter, Vice President, General Counsel and Secretary.

Chris Porter - *USA Compression Partners, LP - President, General Counsel & Secretary*

Good morning, everyone, and thank you for joining us. This morning, we released our operational and financial results for the quarter and year ending December 31, 2023. You can find a copy of our earnings release as well as recording of this call in the Investor Relations section of our website at Usacompression.com.

During this call, our management will reference certain non-GAAP measures. You will find definitions and reconciliation of these non-GAAP measures to the most comparable US GAAP measures in our earnings release. As a reminder, our conference call will include forward-looking statements. These statements are based on management's current beliefs and include projections and expectations regarding our future performance and other forward-looking matters.

Actual results may differ materially from these statements. Please review the risk factors included in this morning's earnings release and in other public filings. Please note that information provided on this call speak only to management's views as of today, February 13, 2024, and may no longer be accurate at the time of a replay.

I'll now turn the call over to Eric Long, President and CEO of USA Compression.

Eric Long - *USA Compression Partners, LP - President & CEO*

Thank you, Chris. Good morning, everyone, and thanks for joining our call. I'm joined on the call today by Eric Scheller, our COO. This morning, we released our fourth quarter and year-end 2023 results. We are extremely pleased that we were able to deliver another quarter and full year of outstanding results. We continue to increase distribution coverage and decrease leverage.

Our results reflect our continued and incremental movement towards our previously mentioned leverage ratio goal of 4.0 times, providing us increased financial flexibility and positioning us well for when our senior notes mature, which is not until Q2 of 2026 and Q3 2027.

Of note, for both the full-year and quarterly results, we achieved many record results, including revenues, adjusted gross margin, adjusted EBITDA, distributable cash flow, distributable cash flow coverage, average revenue-generating horsepower, and average revenue per -- revenue-generating horsepower. We also reduced our leverage ratio to 4.1 times and saw common unit prices over $26 during the fourth quarter nearing all-time highs.

Finally, we were added to the VettaFi Alerian MLP Infrastructure Index, the AMZI, resulting in approximately 8.8 million common units added to index funds. I feel comfortable saying we had a great year. As we look forward, we are continuing to position USAC as a resilient player in the natural gas compression service industry, as we have always done.

2024 will be a year that we focus on improving internal operational efficiency, the continuation of converting idle units to active status, continuing price improvements, and maximizing returns on growth capital through opportunistic purchasing of equipment that enables USAC to capture margins in line with our fourth quarter results.

As we mentioned on last quarter's call, our customers and others in the industry have not yet begun to accept the pricing required for USAC to purchase new compression units. That statement continues to be true. We are also mindful of the near-term geopolitical and economic uncertainty ahead. The most recent reports from the Federal Reserve indicate that rates will be terminally higher than what we've experienced over the last decade.

The worldwide economy, including China, has slowed. We are continuing to see escalating geopolitical tension in the Middle East and then the ongoing Russia-Ukraine conflict. And finally, there is the never-ending US federal government budget fight and 2024 election cycle. We believe these factors suggest the prudent course of action is to remain financially and operationally flexible.

With that in mind, we believe one strength we have proven over time is our management's ability to weather the storm. If you review USAC's history, you will notice a common theme that has been core to our stable historical growth. USAC grows when the industry and geopolitical environment are supportive of that growth. In times of uncertainty, however, you will notice that USAC has reigned in growth, battened down the hatches, and focused internally on efficiency and productivity. It's easy to show high utilization and growth when you are the new fresh face to the compression space that is yet to experience significant lasting downturns.

USAC's management has a proven track record during those times, such as 2008 to 2010, 2015 to 2017, and most recently, during the COVID downturn. Throughout those cycles, USAC continued to maintain utilization, revenue, and adjusted EBITDA at levels strong enough to maintain our distribution while sustaining manageable levels of leverage.

While we do not expect the near term to be as dramatic as those prior cycles, we do see general uncertainty ahead, and believe our current 2024 plans match the USAC story that you have all become accustomed to, one of cash flow and financial stability through prudent capital spending at the right times. The uncertainty is not without some clarity specific to our industry. We still maintain a very bullish view of the long-term prospects of the natural gas compression industry.

As we have said before, our business is not directly tied to commodity prices, but rather production and demand. The future looks bright on both fronts. The EIA expects US production of natural gas to likely continue growing to meet rising global demand through the end of their forecast period, which is 2050. US natural gas exports are expected to continue growing in 2024, 2025 and beyond, especially as new LNG facilities, already approved and scheduled to come on stream in the US, increase current capacity from about 15 Bcf a day to more than 40 Bcf a day.

To be clear, that is incremental capacity not impacted by the recent announcement from the Biden administration to pause further approval of LNG export terminals. We believe these long-term dynamics will dovetail well with our current 2024 plans to focus on maximizing unitholder value through internal process optimization and efficiency, and less through capital expenditures, which we currently believe will be significantly reduced in comparison to 2023.

We believe this will allow us to continue improving our balance sheet, provide us the financial flexibility to opportunistically improve our capital structure over time, including potentially refinancing indebtedness at attractive rates, allowing us to further pursue capital cost improvement, leverage reductions and distribution policy changes.

One point I would like to mention in regards to our capital structure, in January, we had $40 million of the preferred units convert into common units. When combined with the common units issued pursuant to previous warrant exercises by the preferred unitholders, this resulted in an additional 4.9 million common units outstanding in the aggregate, at least 80% of which have been absorbed into the open market today.

The good news is that this increases our public liquidity with a de minimis impact on our distributable cash flow coverage, which we have highlighted in a recently published investor presentation you can find on our website. As always, we will continue to look for ways to maximize the capital structure, and the value that can be derived there from 2024 will be no different.

Switching gears, I would like to recognize our hard-working field employees. During the recent winter storm that swept across the country in mid-January, our employees were called upon to battle ice and sleet, keeping our compression units at the ready, as our customers' natural gas compression needs changed in response to the storm.

As always here at USA Compression, we are all about serving our customers and our communities, helping to keep the lights and heat on when it mattered the most. Our field employees' actions during this recent storm is just another proud example of our dedication to a high level of service. I'm very proud of this company and our employees' commitment to serving the baseload power generation that we all need during those times.

One more point before I turn the call over to Mr. Scheller. I'm pleased that our 2023 safety performance continued to outperform the industry average. As always, the safety of our employees, our contractors, and our customers' employees remain the number one priority of our organization. We are extremely proud of our employees' continued focus on being safe in all we do, each and every day.

With that, I will turn the call over to Eric Scheller, our COO, to discuss our fourth quarter highlights.

Eric Scheller - *USA Compression Partners, LP - VP & COO*

Thanks, Eric, and good morning, all. As Eric noted, we are extremely pleased with our full year and fourth quarter results, and I am extremely proud of our employees.

In addition to the record results, Eric mentioned, we continued to increase utilization during the fourth quarter to a near all-time high, all while continuing to capture contracts with extended tenure and enhanced pricing that we think generate strong, stable baseload cash flows, while providing opportunistic applied as market conditions evolve.

During the fourth quarter, our revenue growth trend continued. It was driven primarily by continued utilization and pricing improvements. Our revenue increased 4% in sequential quarters and 18% compared to the year ago period. The fourth quarter also saw an increase in our margins, bringing them back in line with historical averages since our initial public offering. This increase is the result of our steady determination to offset inflationary costs through both productivity improvement and contractual pass-through adjustments.

We believe the utilization of both the continued productivity improvement and the continued use of CPIU rate adjustments will continue to support our margins in line with current levels should inflation increase again in the near term.

Fourth quarter 2023 net income was $12.8 million. Operating income was $68.5 million. Net cash provided by operating activities was $91.6 million and cash interest expense net was $43 million. Cash interest expense increased by approximately $1.6 million on a sequential quarter basis, primarily due to higher average outstanding borrowings on our floating rate credit facility.

However, higher cash interest expense was mitigated by $2.5 million of cash payments received under our $700 million notional principle fixed rate interest rate swap, which we modified and extended in October and now locks in 30 days SOFR until December 2025, at 3.9725% compared to current 30-day SOFR that currently exceeds 5%.

Turning to operational results. Our total fleet horsepower at the end of the quarter increased by 1% to approximately 3.8 million horsepower, as we accepted delivery of 47,500 horsepower of new large horsepower units during the quarter. Our revenue-generating horsepower increased by 1% on a sequential quarter basis, primarily due to the addition of these new large horsepower units.

Fourth quarter 2023 expansion capital expenditures were $90.1 million, and our maintenance capital expenditures were $6.6 million. Expansion capital spending continues to consist of reconfiguration and make ready of idle units along with the aforementioned delivery of 47,500 horsepower of new large horsepower units during the quarter.

We currently expect to take delivery of an additional 52,500 horsepower of new large horsepower units during the first half of 2024, with almost all expected during the first quarter, plus additional and ongoing conversion of current fleet idle units to active status. The new units represent the remainder of our late 2022 order.

Additionally, throughout 2024, we anticipate the deployment of between 85,000 and 115,000 horsepower of existing uncontracted fleet assets at capital cost substantially below those of new organic growth equipment builds.

Finally, I am pleased to share that on February 2, we made our 44th consecutive quarterly distribution payment. The $0.525 per unit distribution was flat to the previous quarter's distribution. And with that, I'll turn the call back over to Eric Long for concluding remarks.

Eric Long - *USA Compression Partners, LP - President & CEO*

Thank you, Eric. Our 2023 full year and fourth quarter results again reflect USAC's commitment and ability to continue delivering meaningful value to our stakeholders. Over the past five years, our total unitholder return has been 236%, beating the S&P 500 up 107%, over the same time period.

We are grateful for the value we've been able to deliver to our stakeholders. We believe that our near-term reduction in capital growth, while focusing on internal efficiency and optimization will provide USAC greater financial flexibility and our stakeholders, a compelling value. While we are all facing some general economic and political uncertainty in the near term, we believe we are well positioned to weather this uncertainty and continue improving our financial metrics for further capital cost improvement, leverage reductions, and distribution policy changes.

To conclude, we are extremely pleased with our 2023 full year and fourth quarter results highlighted again by record quarterly revenues, adjusted EBITDA, distributable cash flow, and distribution coverage, which also featured continued improvements to utilization and contract pricing. We expect to file our Form 10-K with the SEC as early as this afternoon. And with that, we will open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jeremy Tonet, JPMorgan.

Eli Jossen - *J.P. Morgan Securities LLC - Analyst*

Hey, everyone. This is Eli on for Jeremy. Just hoping the team could provide updated color around lead times for Cat engines and overall compression equipment? How should we thinking about those lead times dynamics in the near and medium term? Thanks.

Eric Scheller - *USA Compression Partners, LP - VP & COO*

Hey, Eli, this is Eric Scheller. Lead times for Cat equipment now are exceeding 40 to 45 weeks, just to receive the engines. And then you still have packaging time that goes on top of that. We are always talking to customers as they're looking at their production profiles and checking out what the demand is in excess of the current forecast we have for our horsepower.

Eric Long - *USA Compression Partners, LP - President & CEO*

Eli, this is Eric. I'll give a little additional color, because there's more than just new engine sourcing from Cat and others. We continue to see supply chain bottlenecks. We've got subcomponent inventory issues. We've got manufacturing issues. So the misnomer that inflation had passed, and the supply chain problems are fixed, it is quite the opposite. As we continue to onshore more and more activities, as we continue to have some of these geopolitical conflict escalations worldwide, we see continued pressure on supply chain into the future.

So things are not getting better. They roll around. One day, it's a wiring harness and next day, it is bolts and nuts and gaskets. And next day, it's related to turbochargers or head gaskets -- heads and valves and various things that go into keeping our engine running. So I think that's one of the differentiators that some of the major players can bring to the table is long term, stable relationships with manufacturers or other alternative suppliers of equipment, so that we can make sure that our equipment continues to run.

So just -- I think it's important for everybody to keep in mind, it's not just the access to new equipment, but it's making sure you can keep your existing equipment up and operational and running. And that trust me, in this environment, it's not an easy task right now.

Eli Jossen - *J.P. Morgan Securities LLC - Analyst*

Got it. Yeah, totally understand that. And then maybe just if we could pivot to kind of some of the 2024 DCF guidance you guys provided. Recognize there might be reduced growth CapEx, you mentioned in the opening remarks, but just wondering if you could dive further into your latest capital allocation prioritization. How should we be thinking about deleveraging, especially as you approach your leverage target versus growth CapEx levels? And then how do you kind of equity shareholder returns fit into that I'm thinking about the dividend and what you guys might do with that in the near term?

Eric Long - *USA Compression Partners, LP - President & CEO*

Yeah. It's a really good question, it is probably front and center on a lot of our investors' minds, from retail as well as from our hedge funds and institutional investors (added by company after the call). So as we pointed out, we've got maturities coming up in '26 and '27 on roughly $1.5 billion worth of high-yield debt. We want to make sure that before we address our distribution policy that we've been able to go through the refinance cycle, that's coming up here in the coming years. You'll note that our distribution coverage was pushing 1.5 this time. You'll notice that our leverage is just a skosh over 4 and declining rapidly.

So we also, flip side of that, saw an increase in 10-year treasuries this morning. The probability of a rate cut in March that was almost 100% a few weeks ago is now less than 10%. So the 10-year treasuries today are back almost 4.3%, a dramatic increase. We had a net income hit of $10 million, which was due to swap valuation. Well, needless to say, that swap has increased in value here in the short term.

So what we're basically trying to do is fix our capital structure and improve our capital structure. We don't have any novated debt sitting up at the parent company that is an overhang. What you see is what you get with USA. And our intent is to work on our capital structure with those two tranches of high yields. We've got plenty of time to address those things.

EIG, recently, as we noted, converted roughly $40 million of preferred into common. We actually like that. It gives us some additional liquidity and float in the marketplace. We've had a couple of large institutions who've been holders of our securities since the IPO, who trimmed their positioned recently. So I think what we have going on here is a longer-term secular rotation from some of the folks that have been in for a long period of time to some new players, the index funds and some new institutions that have been coming into our securities.

And what we want to do is just continue to methodically de-lever the balance sheet, get some clarity in the marketplace, with a year lead time on sourcing new equipment and with the cost associated with this new equipment, we think we've got honestly, better returns for our shareholders and continuing to slow the growth, look opportunistically at some equipment sourcing opportunities that we have.

We continue to focus on the decarbonization world with dual drive and various other elements associated with that. Electrification is not a panacea that everybody expected it is in. You think the compression business has supply chain bottlenecks. All of the folks in the electric business have some very serious limitations and bottlenecks in equipment sourced from China and India and places that we can't control the supply chain.

So long-winded way to say, right now, we're focused -- laser focused on maintaining financial flexibility. Our Board, of course, makes the policy decision related to distributions. But I think from all indications of what I see, in my reading of the tea leaves, we're going to continue to be conservative over the coming quarters, continue to de-lever, build distribution coverage. We will get our capital structure fixed up for the next round of five to eight years or so. And at that point in time is when we will address what do we do next.

We've been through this rodeo many, many times. And when everything is from the bottom left of the page to the top right of the page and bluebirds and rainbows, it's easy to manage through. We've always pulled our horns in a little bit before our peers. And because of that, we've been able to weather and manage the inevitable downturns as it come.

I'd like to point (corrected by company after the call) out the fact that our unit price is near a record high. And we've been public for 10 years, and we bumped up $26 a unit here recently. So good times when they get here, short times till they're gone. So we want to make sure that we are positioned for stability. There are growth opportunities at the appropriate time we'll be able to capitalize upon. But for right now, a little bit of choppy waters ahead, and we intend to pull our horns in and make sure that we're here for the long haul.

What does that mean for shareholders? When you look at our total shareholder returns over the last five years, it has outperformed the S&P, outperformed our peer group. And we're here to tell you that if you look into the crystal ball five years from now and you look in the rearview mirror, we intend that our TSR will be at the top decile or quartile of performance versus our peers and versus alternative investments.

Eli Jossen - *J.P. Morgan Securities LLC - Analyst*

Got it, yeah, I appreciate all the detail. I will leave it there, thanks.

Eric Long - *USA Compression Partners, LP - President & CEO*

Thank you.

Operator

Gabriel Moreen, Mizuho Securities.

Robert Mosca - *Mizuho Securities, Co., Ltd - Analyst*

Hi, everyone. It's Rob on for Gabe. So there's been some consolidation in the compression space. Wondering how and whether you see that affecting the competitive dynamic in the space? And from your vantage point, are there bolt-on opportunities available out there for compression? And is that what you're alluding to in referencing equipment sourcing opportunities?

Eric Long - *USA Compression Partners, LP - President & CEO*

You know, Rob, we never speculate on M&A opportunities. We look at everything that's out there, anything that we do would need to be strategic, that would need to be accretive. We don't need to grow just for the sake of growth. We grow to enhance returns for our shareholders. So there are some things out there that we've looked at. There are things that we've passed on. There are things that we'll continue to look at.

So at this stage, I think it will be more opportunistically driven. Consolidation is a positive. There is, historically, we had an oligopolistic situation with two major players and now, we almost have a triumvirate with a new third. So it remains to be seen if the discipline that becoming a larger, more stable player in our industry brings that, that discipline remains there. We expect that it will because frankly, there's far more opportunities for those three large players to go around., than there is frankly, available equipment. So far so good. I think we'll stay the course. And If and when there's any M&A opportunities, you'll be the first to see in a press release.

Robert Mosca - *Mizuho Securities, Co., Ltd - Analyst*

Thanks. Appreciate that, Eric. And maybe if you could unpack in your prepared remarks, you said that those commercial discussions for new units still kind of at an impasse for customers not willing to commit on the rate or term. Maybe could you provide some more color into whether there's been some softening around that dynamic, or is it still pretty similar to what you saw last quarter?

Eric Scheller - *USA Compression Partners, LP - VP & COO*

Hey, this is Scheller. I think it's like the ice cube starting to melt. We're now in the middle of the first quarter. We are taking some inbounds and discussions as people are looking at their production curves, trying to figure out what available capacity we could shuffle around to optimize networks and to optimize flows into the pipe. So we always have these conversations on a continuous basis with our customers to figure out what that forward looks like, especially given that we're talking about a year out to get new units.

Robert Mosca - *Mizuho Securities, Co., Ltd - Analyst*

Got it. Appreciate the time, everyone.

Eric Scheller - *USA Compression Partners, LP - VP & COO*

Thank you.

Operator

James Spicer, TD Securities.

James Spicer - *TD Securities, Inc. - Analyst*

Hi, good morning. You spoke about the need to refinance the high-yield bonds at some point and wanting to address the capital structure. Another component there is the revolver. You ended the quarter with $872 million of revolver borrowings, that's about $260 million year-over-year. Maybe you can just speak a little bit about your comfort around that level of revolver utilization and how that factors into your overall plans for the balance sheet?

Eric Long - *USA Compression Partners, LP - President & CEO*

Yes, James, obviously, the revolver is our lowest cost of capital that we have in our capital stack. We've had a long relationship with our bank syndicate. Literally, we're talking 12 years, 14 years associated with to --I think, there, our first finance was 2006 back with that group. So we're in excess of 15 years, 16 years now. We've got a $1.6 billion commitment with, as you pointed out, 850, 875 drawn.

We've got plenty of capacity. When you look at the availability, we've got plenty availability to finance future growth to the extent we opt to do so. The bank group is very, very stable. We've actually had a recent entrant who was able to consolidate a couple of smaller players or some of the

European institutions in energy, who are migrating out of the domestic energy business. So we solidified that with a much larger, longer term strategic type of financing institution, who has an appetite to be in compression in and in energy in general. So we're very comfortable with that ABL facility.

I think our vision has always been, let's use that as a growth platform. And at some point when it gets large that it grows to a certain point, rather than moving that from all floating rate debt, we will term some of that up and move that into a high yield facility. So at this stage, we did put a $700 million notional float to fixed commitment in place. Our interim -- effective interest rate of some 4%, 3.9725% or so on that facility.

So it's an attractive cost of capital for us, and we just need to continually look to optimize and balance fixed versus floating. We do have capacity and do have access to capital, unlike frankly, most of the peers in the compression industry are pretty tapped out.

We've got the line to play with should we so desire. And I think this is what your management team's paid to do is every single day in every single quarter, every single year to look at that capital structure, figure out how we optimize that, how does that fit in with our growth plans and we will balance accordingly.

James Spicer - *TD Securities, Inc. - Analyst*

Okay. That's great color. I appreciate it. And one more, if I could. I was just curious about the drivers behind that preferred unit conversion and what your expectations are around additional conversions in 2024.

Eric Long - *USA Compression Partners, LP - President & CEO*

Yeah, that is something we really don't have a lot of insight or color into. I think there was -- it was probably done opportunistically. I point you to the public docs, you can figure out that they've got a conversion price of $20.01. And when the units are running in that $25, $26 range, clearly, there's some economic incentives for them to do so. They did have the warrants associated with the preferred when we put that together. Those have all been cash settled and cleared out. Some of the -- there were some converted to common, and those have all been disseminated out into the public hands.

They did convert $40 million. Depends where the unit price is. If the unit price is -- you look at underwriter discount or the current strike price minus underwriter discount less than $20.01, if it is economic, they may continue to do so. There's some softness in the security price, probably not. So they're happy with the investment.

It's a 9.75% current pay, so there's no big incentive for them to exit the facility. And we got plenty of time and tenure associated with it. So I don't see them in a rush to exit. I see them like any investor being methodical and trying to optimize their financial returns over time. And with the EIG, I would expect nothing less than that in the future.

James Spicer - *TD Securities, Inc. - Analyst*

Okay, makes sense, thank you.

Eric Long - *USA Compression Partners, LP - President & CEO*

Thank you very much.

Operator

There are no further questions at this time. This concludes today's call. You may now disconnect.