USA Compression Management Discusses Q4 14 Results – Earnings Call Transcript –

February 17, 2015

Executives:

Eric D. Long, P.E. – President and Chief Executive Officer

Matthew C. Liuzzi – Vice President, Chief Financial Officer and Treasurer

J. Gregory Holloway – Vice President, General Counsel and Secretary

Greg Holloway

Good morning everyone and thanks for joining us. This morning, we released our financial results for the quarter ended December 31, 2014 and full-year 2014. You can find our earnings release, as well as a recording of this conference, in the Investor Relations section of our website at usacpartners.com. The recording will be available through February 28, 2015.

During this call, certain members of our management will discuss certain non-GAAP measures. You will find definitions and a reconciliation of these measures to GAAP measures in the earnings release.

As a reminder, our conference call will include certain forward-looking statements. These statements include projections and expectations of our performance, and represent our current beliefs. Actual results may differ materially. Please review the statements of risk included in this morning's release and in our latest filings with the SEC.

Please note that information provided on this call speaks only to management's views as of today, February 17th, and may no longer be accurate at the time of a replay.

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

Eric Long

Thank you, Greg, and good morning everyone. Also with me is Matt Liuzzi, our CFO. I am pleased to report that we finished 2014 on a strong note - this morning we reported record levels of revenue, Adjusted EBITDA and Adjusted Distributable Cash Flow for both the fourth quarter as well as the full year. During 2014, USA Compression deployed a record amount of capital, over $370 million, taking advantage of market conditions to grow our business and further strengthen customer relationships, all while maintaining our business strategy – providing compression services on a take-or-pay basis without taking on direct commodity risk. I'll get into the details of 2014 in a moment, but first let me address head on the elephant in the room: Just what impact has the volatility in oil prices had on USA Compression's business? While the headlines in the news are focused on oil price volatility and the reaction to lower oil prices by producers, the midstream natural gas industry has, so far, been weathering the storm. As our long-time investors and business partners understand, our business depends primarily on the domestic production of natural gas, which drives the bulk of our business. We like the intermediate and longer-term outlook for natural gas, both on a global basis as well as closer to home in the domestic market where it has a more direct impact on our business; I'll discuss this further in just a moment. As we get going into 2015, like many of our peers and customers, we are exercising a great deal of caution in terms of capital spending and how we pursue business opportunities. We will respond to customer demand for compression, but we expect to proceed through the year at a measured pace, and one that allows us the greatest flexibility to react to further market movements, whether positive or negative. At investor conferences and meetings, and on previous earnings calls like this one, you may have heard me speak to two key tenets associated with how we run our business and how the natural gas demand driven compression sector is fundamentally different from other commodity price, drilling-driven service providers. Those two tenets revolve around growth and stability. We grow, prudently and methodically, when market conditions dictate, like they did over the past several years and especially in 2014. In the current commodity price environment, though, I want to draw attention to the stability of our business that I have spoken about in the past, with our fee based, infrastructure oriented applications and contracts and what that means in the current marketplace.

It is not all gloom and doom in the energy patch. We are seeing customers continue with planned infrastructure projects and they are contracting with USA Compression for our compression services, since compression services like ours are required for large-scale, capital intensive undertakings to move natural gas to the marketplace. As an example, in the Marcellus shale play, our customer CONSOL Energy has announced a 2015 capex cut of ~20%. Yet they expect production for 2015 and 2016 to increase at a 30% CAGR. Marcellus shale peers Range Resources and Antero cut 2015 capex by ~45% and ~50% year-over-year while expecting production to grow at ~20% and 40% respectively. We are seeing this theme in other basins and with other customers as well. And to reiterate, rising natural gas production such as this is good for our business. As you'll recall, the vast majority of our business is focused on traditional midstream applications where our assets serve a critical role in transporting and processing natural gas. Our customers tend to take a long-term investment view in constructing these large gathering systems and processing facilities, and compression is a required component of getting those assets on line and moving natural gas to the marketplace. As a result, we believe that customers such as these will be moving forward in contracting our services. Our customer base is made up of counterparties with strong balance sheets who have the liquidity to continue to operate and grow, even in market periods like the current one. To provide a sense of the stability and strength of our customer base, our Top 10 customers, who represented about 46% of our revenues in 2014, have an average credit rating of investment-grade levels, at BBB+ / Baa1. We place importance on partnering with the right customers, and we are proud that we have developed a stable, loyal and long-term customer base of companies with substantial financial strength. This gives us further confidence in our ability to successfully execute and grow our business, even in softer market conditions.

So, reflecting the strong performance of our fourth quarter of 2014, we announced a distribution of $0.51 per limited partner unit, an increase of approximately 6% over the same period in 2013. We have increased the distribution every quarter since our IPO; the increase in our distribution reflects both the methodical growth and long-term stability of our underlying business. We believe that it is important to note that our all-in adjusted distributable cash flow coverage for the quarter was 1.11x.

For 2015, we will be prudent in our capital spending plans as we continue to manage both our cash coverage and total coverage as well as our leverage. Bottom line, our business is performing well. Matt will provide some more specific details on our operating and financial performance a little later.

Touching on the macro natural gas picture, as I mentioned earlier, there are some positive drivers going on in the market that are, and will continue to, drive our business. The supply / demand balance in the US is currently close to equilibrium – Raymond James suggests there is about 2-3 Bcf/D of seasonally adjusted over-supply right now and an excess of about 3% or 4% on a total domestic production base of about 81 Bcf /D. This base is up substantially since last year (about 7 Bcf/D or ~13% year over year) and is projected by the EIA to continue growing in 2015 and 2016 and beyond. Virtually all of this increase in natural gas supply will need compression to get into and through the pipeline infrastructure and move to the marketplace. With the impending completion of domestic LNG export facilities as soon as the end of this year, the continued conversion of coal-fueled power plants to gas-burning plants, and further expansion of gas exports south to Mexico, that balance is expected to tighten up in the near-term. We think the global export of LNG and the export of natural gas to Mexico alone have the potential to generate approximately 10 Bcf in demand in the intermediate term]. We would expect that supply/demand situation to lend support to the price of natural gas; if, as expected, overall domestic gas demand goes up, domestic producers will continue to produce in order to meet that demand, and the midstream operators will continue to invest in the infrastructure and the associated compression needed to transport, process and deliver that gas to the end user. The EIA projects that about 70% of the increase in natural gas production will come out of domestic shale plays. This fits in well with our business model of providing compression services through our flexible assets designed to handle a wide range of operating conditions. We have broad geographic diversity, yet we are focused primary on shale and unconventional plays, including the Utica and Marcellus shales and the Permian and Delaware basins. These, along with other areas of operation including the Eagle Ford shale, as well as the Barnett and Fayetteville shales, are where we expect to need to be to take advantage of the market opportunities we see coming in the near future. We have the geographic diversity so as to not be overly concentrated in one single play, yet we have a presence in the most active areas to be able to drive our growth.

As you know, a small portion - about 15% of our total fleet horsepower – consists of smaller horsepower units that are primarily used in gas lift operations. Given the recent volatility in the crude oil market, we are taking a cautious outlook and focusing on our biggest customers to best ensure that the units we have stay working. Contrary to popular belief, drilling, and more importantly, oil production, has not come to a screeching halt. Certainly, in oil oriented drilling programs, producers seem to be shifting their focus toward the most economical areas. But, as I said earlier, when you dig into the details, on a customer-by-customer basis, while headline capex budgets have been slashed, in many cases, actual oil production is expected to be up in 2015, in some cases meaningfully over 2014 levels. And so while we don't expect the gas lift part of the market to be growing at the rates we've seen in recent years, we do think there will continue to be demand for gas lift compression, especially in areas that are economically advantaged. Areas like the Permian and Delaware Basins and the SCOOP, for instance, exhibit attractive economics for producers, including rapid initial payouts and low lifting costs once the wells move into the stable, long-lived "tail" of production. When these wells go into a steady-state mode, requiring gas lift energy to move the oil to the surface is where our units can add value, keeping production going for these producers. While we expect to continue to see some near-term pricing softness as the market gets sorted out, we are also pro-actively engaging in discussions with some of our largest customers to ensure that their gas lift compression needs can be met throughout the year, and in some cases, contractually agreeing to exclusively provide their incremental gas lift compression requirements.

So, to summarize what we're seeing out in the marketplace: natural gas looks strong, and our customers continue to invest in infrastructure projects, supported by ongoing shale production and global factors driving domestic supply. And while the drilling of new crude oil wells has slowed, providing compression in these applications is a small part of our business. We are monitoring this activity closely and are taking a more cautious approach. Our fleet and, based on what we have seen in the market the fleets of our comparable peers remain highly utilized - so far we see continued need for the existing infrastructure oriented compression assets deployed in the field.

I mentioned earlier that 2014 was a record year in terms of capital spending for USA Compression – we invested over $370 million in new compression units throughout the year, most of which are on the ground generating revenue. Utilization is important in our industry, and we managed this significant level of capital spending while keeping our utilization at near-record levels – 94% at the end of the fourth quarter. So not only did we grow our fleet, we kept our existing assets deployed and earning a return for our unit holders. This level of activity is consistent with our long history of high utilization, and reflects the infrastructure nature of our business. We have been providing compression services since 1998 and have experienced multiple commodity price cycles, and the gathering systems and processing plants that our assets serve run 24 hours a day, 7 days a week. Our mission critical equipment is core to our customers' businesses – without compression, natural gas will not move into and through the pipeline infrastructure, and it is because of our expertise and quality assets that our customers put their trust in us every day.

The activity in the market and executing on our business plan resulted in strong financial results for the quarter. For the fourth quarter, I am pleased to report that total adjusted distributable cash flow coverage was 1.11x. Some of our major unitholders have continued to participate in our DRIP program, taking back additional units instead of cash payments. This provides our public common unitholders additional cushion, boosting our cash coverage ratio to 2.7x. Our aim has always been to provide our unitholders with attractive distribution growth, while balancing coverage and leverage. Matt will address leverage in his comments, but we still believe 3.5x – 4.0x is the right level for our business over the long term. We continue to be focused on managing the business with appropriate long-term coverage and leverage metrics.

During the 4th quarter, we added approximately 100,000 horsepower to the fleet, bringing our total fleet to approximately 1.5 million HP. The full year's additions were just over 352,000 horsepower for the year, a record for USA Compression. As discussed, we are deploying those units in active areas and earning attractive rates of return on that capital. We continue to spend maintenance capital for the upkeep of the fleet – that investment is necessary to maintain high utilization levels and runtimes. This has always been a priority for USA Compression, something our customers demand, and a meaningful part of our value proposition.

Looking forward, we expect continued demand for our compression services and have already placed orders for approximately 230,000 horsepower for delivery in 2015 primarily in the first three quarters. These units will go to serve producers and midstream operators as they continue to build out the country's infrastructure in the Northeast, West Texas, the Mid-Continent and elsewhere. Of that 230,000 horsepower, about 200,000 is expected to be large horsepower units, and we already have approximately 43% of these units committed to customers. Breaking that down a little further, we have approximately 63% of our Q1 deliveries committed, and at this point in time, approximately 42% of Q2 deliveries. We expect the 1st and 2nd quarters of 2015 to represent up to 69% of our total large horsepower spend for the entire year, and so we feel like we are in a good spot with regards to contracting new units. The remainder of our spend will be for the smaller horsepower units, which we also expect to be front-end loaded this year. As a data point, this level of smaller-HP units is about one-third of what we ordered in 2014. As you can see, by design, we are front-end loading our capital spending for the year, which provides us significant flexibility in the back half of the year as the market settles out and we get more visibility as to what our customers need. We expect to continue our focus on optimizing the financial returns for both our existing fleet and the units to be added in 2015, deploying units to where they can generate the highest long-term returns.

Summing up, I'm pleased to say that we have executed, and will continue to execute, on our business plan and deliver results for our unitholders. In 2014, we took advantage of favorable market conditions to invest in the long-term growth prospects of USA Compression and as we come into 2015, we are taking a more measured view of the marketplace, but one which we believe provides us both growth opportunities in the near-term and flexibility over the longer-term. The midstream sector is not shutting down, and we benefit from the same fundamental business drivers that the gathering and processing MLPs do, but without any direct commodity price exposure. The market continues to move forward, in spite of the recent weakness in commodity prices, but importantly, natural gas is increasingly becoming global, and remains a fuel of choice domestically, which is favorable for our customers and USA Compression's prospects.

Now with that, I'll turn it over to Matt to walk you through the details of our operational and financial performance.

Matt Liuzzi

Thanks, Eric. Good morning everyone.

As Eric mentioned, today USA Compression reported *record* levels of revenue, adjusted EBITDA and adjusted distributable cash flow for the fourth quarter of 2014.

Touching on fourth quarter operational highlights, we added approximately 100,000 horsepower of new compression units to our fleet during the quarter, and ended the year with approximately 1.5 million total fleet horsepower.

As we have discussed on previous calls, during 2014, we took advantage of market opportunities and took delivery of approximately 352,000 horsepower of new compression units, as compared to our initial expectations of 220,000 horsepower going into 2014. We spent over $370 million in growth capex for the year. Reflecting the cautious approach to the coming year, we have ordered approximately 230,000 horsepower for delivery in 2015, which we expect to be delivered primarily over the first three quarters of 2015.

Our revenue generating horsepower increased from 1.3 million at the end of the third quarter of 2014 to 1.4 million at the end of the fourth quarter of 2014 due to the additional units we placed into service. We continue to see initial contract terms of 6 months to 5 years, depending on application.

Turning to the financial performance for the fourth quarter of 2014, revenue increased 25% compared to the fourth quarter of 2013, primarily driven by an increase in our contract operations revenues as a result of adding revenue generating horsepower. Contract operations revenue in the fourth quarter of 2014 increased 27% to $60.0 million as compared to $47.4 million in the fourth quarter of 2013. The fourth quarter 2014 increase in our contract operations revenue over fourth quarter 2013 was driven almost exclusively by the organic growth in our revenue generating horsepower.

Average revenue per revenue generating horsepower per month increased 3% to $15.82 for the fourth quarter of 2014, as compared to $15.36 for the fourth quarter of 2013.

Adjusted EBITDA increased 30% to $33.0 million in the fourth quarter of 2014 as compared to $25.4 million for the fourth quarter of 2013.

Adjusted distributable cash flow in the fourth quarter of 2014 was $26.3 million as compared to $18.9 million for the same period last year, an increase of 39%.

Gross operating margin for the fourth quarter 2014 increased 28% to $42.1 million as compared to $33.0 million for the same period last year. The gross operating margin percentage increased from 67.9% in the fourth quarter of 2013 to 69.0% in the fourth quarter of 2014.

Maintenance capital expenditures were $3.4 million in the fourth quarter of 2014, which was consistent with expected levels for the quarter. Expansion capital expenditures, which were primarily used to purchase new compression units, were $109.3 million for the fourth quarter 2014. Cash interest expense, net was $3.0 million, compared with $2.7 million in the third quarter of last year.

On January 22, 2015, we announced a cash distribution of $0.51 per unit on our common and subordinated units, which represents an approximate 6% increase year over year. This is the seventh consecutive increase to our distribution since our IPO in January 2013. This fourth quarter distribution corresponds to an annualized distribution rate of $2.04 per unit.

Consistent with previous quarters, USA Compression Holdings, LLC, the owner of 42.0% of the Partnership's outstanding limited partnership units, and Argonaut Private Equity, an affiliate of George B. Kaiser, together with other related investors, the owners of approximately 16.3% of our outstanding limited partnership units, have agreed to reinvest all of the cash distributions they receive on their units pursuant to our Distribution Reinvestment Plan through the first quarter of 2015. Adjusted distributable cash flow coverage for the fourth quarter of 2014 is 1.11x and cash-based coverage for the actual distributions to be paid, as a result of USA Compression Holdings, LLC, Argonaut Private Equity and other investors participating in our Distribution Reinvestment Plan, is 2.70x.

Also during the quarter, we worked with our bank group to increase and extend our credit facility, and on January 6, 2015, the Partnership closed the Second Amendment to its Fifth Amended and Restated Credit Agreement. The amendment provides for an increase in the facility capacity from $850 million to $1.1 billion and an extension of the maturity to 2020. The amendment also provides additional flexibility under the financial covenants. Outstanding borrowings under our revolving credit facility as of December 31, 2014 were $595 million, resulting in a leverage ratio of 4.5 times on a trailing three month annualized basis.

We are providing our full-year 2015 guidance range as follows, we expect full-year EBITDA to be in a range of $130.0 million to $140.0 million, and we expect to generate Distributable Cash Flow of $91.3 million to $102.3 million. This guidance reflects the current market realities – given the overall industry uncertainty, we are proceeding with caution and prudence, planning for near-term stability and longer-term flexibility.

Finally, we expect to file our Form 10-K with the Securities and Exchange Commission in the next several days.

With that, we will open the call to questions. [Operator Instructions]