Acorn Energy Inc.

Q3 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Bill Jones – *Investor Relations*

Jan Loeb - *President, Chief Executive Officer and Director*

Tracy Clifford – *Chief Financial Officer*

Walter Czarnecki - *President and Chief Operating Officer, OmniMetrix, LLC*

PRESENTATION

Operator
Good day, everyone, and thank you for holding. And welcome to Acorn Energy's Third Quarter 2018 Conference Call. All participants are in a 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 that this event is being recorded.

I would now like to hand the conference over to Bill Jones, Investor Relations. Please go ahead.

Bill Jones
Thank you, and welcome, everyone, to Acorn Energy's Third Quarter Conference Call. First, as a reminder, many of the statements made in today's prepared remarks or in response to your questions may be forward-looking. These statements are subject to various risks and uncertainties. For example, the performance of OmniMetrix and Acorn in 2018 and future years is subject to factors such as risks associated with executing its operating strategy, maintaining high renewal rates, growing its customer base, changes in technology, changes in the competitive environment, financial, and economic risks as well as having access to sufficient capital to support growth.

Such forward-looking statements are based on management's beliefs as well as assumptions made, which are based upon information currently available to management pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. There is no assurance that Acorn or OmniMetrix will be able to achieve their growth goals in 2018 or future years, and the company undertakes no obligation to disclose any revision to any forward-looking statements to reflect events or circumstances after the date made.

A complete discussion of the risks and uncertainties that may affect the company is included in Risk Factors on Acorn's 10-K, as filed with the Securities and Exchange Commission.

And with that, I'll hand the call over to Jan Loeb. Jan?

Jan Loeb
Thank you, Bill, and thank you all for joining us today. I have some overall remarks, Tracy Clifford, our CFO, will provide financial highlights, and Walter Czarnecki, the CEO of OmniMetrix, will provide additional color on the business and its growth trends.

To start, I would like to congratulate the OmniMetrix team for achieving an operating profit in the third quarter, its first-ever quarterly operating profit. Walter and his team have been striving to grow the business while also seeking to enhance its profitability--goals that are not typically easy to achieve at the same time.

As most of you already know, OmniMetrix monitors, manages, and protects high-value industrial assets for customers through its proprietary remote monitoring and control technology and related services. OmniMetrix remote monitoring solutions deliver substantial productivity increases and cost reductions to customers versus the alternative, which is regular physical on-site inspections, often across a variety of remote locations. The business consists of hardware monitoring equipment sales for new installations, ongoing monitoring service fees as well as custom reporting fees. The monitoring side of the business offers a very attractive combination of visibility from recurring service revenue, along with a very strong gross profit margin. All of Acorn's revenue currently comes from the OmniMetrix business, which remains on a solid growth trajectory with a promising outlook.

Since my involvement with the company, I believe that this was the Acorn subsidiary with the greatest growth potential, which is why we sold or liquidated other businesses in order to focus on scaling OmniMetrix from a strong foundation to realize its full potential. Although it wasn't profitable two years ago, we could envision that its growth and healthy gross margin would ultimately lead to profitability, which we were able to achieve in the third quarter.

Looking forward, there is increasing awareness by industrial customers of productivity increases, lower operating costs and risk management benefits that can be realized through IoT technology, such as remote monitoring. Walter can speak more to our strategy to build our leadership and capabilities in this space and how our services are very relevant in the real world today.

Earlier this year we sold our remaining interest in Israel-based DSIT to focus on IoT. During the third quarter, we recouped approximately $300,000 from Israel related to withholding taxes on the initial sale of a portion of our DSIT investment in April of 2016. We received the cash, and recorded a gain of $222,000 related to this payment during the third quarter. The cash is being held in our account in Israel until final review by the Israeli taxing authorities of tax returns through 2018, which we expect by year-end 2019.

On prior calls, we have discussed potential acquisitions in remote monitoring of industrial assets. In recent months, we have looked at several candidates and narrowed our focus. Our goal is to complete a complementary acquisition that would allow the team to scale the business and position us to accelerate and sustain profitability, and thereby benefit from over $60 million in operating loss carryforwards.

We seek businesses with both growth potential as well as recurring revenue models that would be similar and synergistic to OmniMetrix. We also plan to change our name from Acorn to something that is more representative of our forward focus. However, that decision will be influenced by our efforts on the M&A front. Let me now turn to our forward-looking metrics and goals for the business.

For the full year 2018 we have guided to $6 million, or approximately 20% growth in cash basis sales, which represents revenue plus the increase in deferred revenue. Cash basis sales were $1.5 million in Q3 2018, an increase of 25% over Q3 2017. Through September 30, 2018, cash basis sales have increased 18% to $4.1 million compared to for the first nine months of 2017. We believe we're on pace to achieve our initial goal, and therefore, maintain our $6 million cash basis sales guidance for the full year.

In accordance with GAAP revenue recognition, we amortized our contract revenue over the estimated life of the contract and over the expected life of the hardware. As a result, while in growth mode recorded revenue is generally lower than cash basis sales and can mask underlying growth, particularly given that we typically receive cash payments upfront. For that reason, we believe that investors should consider cash sales as well as revenue trends in their analysis of our business.

Now I'd like to turn the call over to our CFO, Tracy Clifford, to go over financial highlights. Tracy?

Tracy Clifford

Thank you, Jan. Acorn's third quarter revenue, which is solely comprised of revenue from our 80%

owned OmniMetrix subsidiary, rose to $1.3 million, a 23% increase compared to the third quarter of 2017. The revenue increase was driven by growth in our pipeline monitoring segment, which grew 49% to $406,000 over the third quarter 2017, while revenues from our standby generator monitoring segment grew 14.5% over third quarter '17 to $931,000.

From a service versus hardware perspective, higher-margin monitoring revenues grew 26% in the third quarter of 2018, while hardware revenues grew 20% versus the same period in prior year. Gross profit grew 32% to $831,000 in the third quarter of 2018 compared with the third quarter 2017, reflecting an increase in gross margin to 62% in the third quarter of 2018 compared to 58% in the prior year period. This overall margin increase was principally due to the result of sales of next-generation monitoring products, which would improve functionality and also provide higher gross margins.

Despite the revenue increase, OmniMetrix's operating costs remained fairly stable, at $810,000 in the third quarter of 2018 and $811,000 in the third quarter of '17. With revenue and gross profit growing faster than operating expenses, OmniMetrix reported its first ever quarterly operating income of $21,000 in the third quarter of 2018 versus an operating loss of $182,000 in the third quarter of '17. This represents $203,000 of profit improvement on $252,000 of additional revenue, or a $0.01 contribution per additional revenue dollar—I'm sorry, or an $0.81 contribution per additional revenue dollar, which underscores the attractiveness of incremental growth on business performance.

Acorn's corporate SG&A decreased $98,000 in the third quarter of 2018 to $251,000, or approximately 28% as compared to the prior year period. As a result of improved performance in OmniMetrix and lower corporate overhead, Acorn's consolidated operating loss decreased 57% to $230,000 in the third quarter of 2018 from $584,000 in the third quarter of '17.

Including a gain of $222,000 from the recruitment withholdings from the Israeli tax authority related to our prior sale of DSIT, Acorn reported a third quarter 2018 net income attributable to shareholders of $4,000 with no contribution per share. This compares to the third quarter of 2017 net income attributable to shareholders of $236,000, or 1% per share. The prior year quarter benefited from Acorn's share of DSIT income in the period of $189,000 as well as $633,000 of net income from disc ops.

Turning to cash flow. For the first nine months of 2018, net cash and cash equivalents increased by $941,000. The company used $2.3 million in operating activities, including the repayment of $1.4 million of accumulated unpaid operating expenses previously funded by advances from DSIT. Acorn generated $5 million from investing activities on the sale of DSIT, and used $1.8 million in financing activities related to the repayment of $1.3 million in director loans, and $340,000 of funds from DSIT and some on short-term credit.

As of September 30, 2018, Acorn had cash and cash equivalents, including restricted cash, of $1.7 million. OmniMetrix had approximately $199,000 outstanding on its accounts receivable factoring arrangement.

Given the strength of OmniMetrix business, management let the company's accounts receivable factoring arrangement expire and paid off the balance in its entirety in early November. We're currently seeking to secure a new credit line with more favorable terms to execute in the near term. Importantly, based on its recent performance, we expect OmniMetrix to be both profitable and cash flow positive in 2019.

Now I'd like to turn the call over to Walter Czarnecki to provide some additional color related to our OmniMetrix business. Walter?

Walter Czarnecki
Thank you, Tracy. At OmniMetrix, we remain very excited about both the progress we've made and the market potential in front of us. As Jan and I have discussed in previous quarters, the IoT market remains large, and for the most part, untapped. In September of this year we learned of a new macro market trend for the power generation industry. At the most recent Electrical Generating Systems Association Conference, it was widely discussed that the installed base of backup generators is now at a level that will outpace the capacity of service technicians at generator service organizations. These service organizations, as many of you know, are one of our key sales channels for the Power Generation division. Thus, generator service organizations will need to adopt remote monitoring in order to maintain their current customer base and to expand. We will track this trend as it develops, and share more with you in future quarters.

We're also excited to tell you about AIRGuard, our newest product, which remotely monitors and controls air compressors. As many of you know, our product line in the Power Generation division is not limited to generators. It is for any industrial engine application. While we have focused on backup generators, given that market's size and growth, our long-term strategy has always been to expand horizontally to other industrial applications. As such, last month we shipped our first AIRGuards, all of which will monitor Ingersoll Rand compressors. The initial feedback has been positive, and we will continue to update you in future quarters as this market develops.

Finally, growth and progress also continues in our Cathodic Protection division. We installed our first products in Mexico during the quarter, and similar to the Power Generation market, there is a large potential with utilities and pipeline companies that are turning more to remote monitoring to better manage their pipeline networks.

Thank you, again, for joining us today. And I'm happy to answer any 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 telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two. At this time we will pause momentarily to assemble our roster. Once again, if you would like to ask a question, please press star, then one.

The first question will come from Richard Sosa, a private investor.

Richard Sosa
Hi guys. Leave it to Acorn, in this mess of microcasts that you guys have your best quarter since I have owned the stock in 2016. So congratulations to everyone. I had a few questions. One on the corporate expense. If you don't make an acquisition this year, do you see it in the fourth quarter and going forward at $250,000? Is that kind of a fair number? I see that that's lower than the prior quarters.

Jan Loeb
I would say—Richard, thank you very much for your comments, firstly. I would say it is our goal to have it lower than that. This year, in 2018, we still had DSIT for the first four months of the year. So we're now a cleaner company. So hopefully, we'll save some money on auditing expenses in the future. Our Board of Directors is a little bit changed versus last year, so we should have some savings there. So I believe it will be lower in 2019 than it was in 2018, ex any potential acquisitions.

Richard Sosa
And then, just two more questions. In the cash sales, you mentioned third quarter was $1.5 million. So that would lead me to believe that for the fourth quarter you're in the 1.85% range. Would that mean that the fourth quarter Acorn as a whole would be cash flow positive, or getting close, or am I off?

Jan Loeb
That is our goal.

Richard Sosa
Okay. And I guess the last question is for Walter. I noticed in 2017 that the Power Generation segment had been kind of static, and so far this year I feel that the trend's reversed and we've seen now four consecutive quarters of growth in the Power Generation market, with some very nice growth this quarter. And you had mentioned some of these trends, these macro market trends, do you think it has something to do with that? Or are there other things at play?

Walter Czarnecki
I think there are a few factors at play. Firstly, the growth in new generator sales from the OEMs and from the generator service organizations are a leading market indicator for us, and so we've always tracked pretty closely in terms of the growth of new generator sales. And what we heard across the industry in 2017 was that, while growth was continuing, it was a bit down from prior years. In 2014, '15, and '16, there was really quite a growth at the larger manufacturers, Generac, Kohler, and Caterpillar all saw. That tracked back a bit in 2017, and in 2018, year-to-date, we're seeing those growth levels return to what we saw a few years ago.

So that's been certainly one of the driving factors, and just further awareness across the market of backup generators. We're seeing incredible growth in the residential market, and that's becoming much more of a key part of smart home ecosystem that many more consumers are taking on.

Richard Sosa
And then just, Walter, this air compressor market, would that be going forward in the Power Generation segment?

Walter Czarnecki
It's across a number of segments. But primarily, we will be partnering, as we have in the Power Generation division, with the service organizations that are selling and providing preventative maintenance for the air compressors.

Jan Loeb
Yes, but it will be reported in our Power Generation line of business.

Walter Czarnecki
Yes. Yes.

Richard Sosa
Okay, great. Again, the quarter surprised me. So it's nice to be pleasantly surprised to the upside.

Jan Loeb
Hopefully, we'll do that in the future as well.

Operator

Once again, if you'd like to ask a question, please press star, then one.

The next question will be from Jack Mayer, a private investor.

Jack Mayer
Hi. Good morning. Congratulations to all on a beautiful quarter. The previous caller asked about what the projected revenue would be, or cash revenue, for the fourth quarter to get you your goal. And that sounds like a pretty dramatic quarter-on-quarter increase. Is there some seasonal factor to that? Or is that something you think you can sort of maintain for a number of quarters going forward?

Jan Loeb
I'll let Walter handle that. Walter?

Walter Czarnecki
Sure. Jack, thanks for the question. Yes, there are a few factors in play there in terms of seasonality and timing. Number one, historically, we have seen Half 2 higher in sales than Half 1, and that is, in part, due to the fact that generator dealers and installers are going out in the spring and summer, and so we don't see that those sales really pick up until later in the year. That's also the same to some extent for the Cathodic Protection division. And so historically, Q4 has been a particularly strong quarter for us, we've seen that the past several years, and we expect that again this year.

Jack Mayer
Okay. Great. And Tracy, I believe you mentioned before that in effect, you were getting something like 81% to the bottom line of the increased revenue. Do you see anything in the fourth quarter that would make your SG&A go up significantly, or could we expect something like that on the increased sales for Q4?

Jan Loeb
I would say that the 81% is quite a large percentage on incremental sales to drop to bottom line. I mean we do have a fairly high gross profit margin in our business, which has been improving over the last few years, so we do expect a big percentage to drop to the bottom line of our incremental sales.

But we are in a growth business and at all times we have to weigh investment in our business versus profitability. So do we want to hire another salesperson? Do we want to make investments in systems? So these are decisions we're making all the time. So I don't want to promise an 81% drop of incremental sales to the bottom line, but it should be a fairly large drop. And anything that doesn't show up is because we're investing in the business. And hopefully, that would show up in strong growth in later periods.

Jack Mayer
Okay. And getting back, if I may, to the seasonality. If you sort of normalize this in some sense and take out the seasonality, what type of growth are we seeing year-over-year? Do you see that accelerating right now in terms of the business, the way the business is running? Do you see that more or less as being, sort of staying on the same growth path, absent acquisitions for the next 12-to-15 months?

Jan Loeb
I think we are comfortable with what we've said in the past of the 20% annual growth in sales. We're obviously striving to better that, but I think we're comfortable with the 20% out into the future.

Operator

Once again, if you would like to ask a question, please press star, then one.

Bill Jones
There is a question coming from online, if I may read that?

Operator
Please proceed.

Bill Jones
So the question is basically, please discuss and explain the deferred charges and deferred revenue numbers on the balance sheet. These are significant relative to the total balance sheet. That's the question, I guess, for Tracy.

Tracy Clifford
Okay. Sure. So the deferred charges are the deferred cost of goods sold in accordance with GAAP, the hardware sales that we make, even though the revenue is received at the time of the sale, is amortized over the average life of that hardware piece, which was determined to be three years, previously it was two years and there was an updated analysis done last year, at the end of the year. So in 2018, we have been amortizing the hardware COGS over a three-year period.

Also along with that would be the revenue that we recognized on the hardware, so that's also amortized over three years. And then additionally, any monitoring revenue is amortized over the period from which it benefits. So if it is a 12-year monitoring that has been sold, then that revenue will be—I'm sorry, 12-months, that revenue will be amortized over 12 months. So that's what results in the deferred revenue, both current and long term, and export charges.

Operator
We do have another question from the phone. And that question will be from Bill Summitt with Golconda Capital. Please go ahead.

Bill Summitt
AIRGuard compressor market, how does that compare to the size of the power generation market? And I'm not asking for specific numbers because there's no way to know. But just compared to the power, how big is that market?

Walter Czarnecki
We see it relatively the same. We're going through similar analysis right now in terms of total addressable market in terms of not only equipment that is out there but equipment that would likely be candidates for monitoring. And so far, we're finding it similar to that of the power generation market, which is in the hundreds of millions of dollars in the US.

Bill Summitt
Okay. And competitors for compressors, is that kind of a same as for a power generation, the actual manufacturer of the compressors, other third-party monitoring?

Walter Czarnecki
So we will be learning that as we go. We've looked at the major compressor brands, because as with Power Generation, we absolutely plan to map to every major compressor brand to be flexible to our customers. Some of the major brands do have their own monitoring products, which we've seen in the power generation market. We've continued to be successful in that power generation market despite the competition, and so we feel confident, given the product and our customer experience that we

deliver to both the service organizations and the end users, that we can win in this market.

Bill Summitt
Okay. Are the dealers the one that will generally install the kind of the third-party monitors, like ours?

Walter Czarnecki
That is typically the case. Sometimes you will see end users that have their own team of folks that work with installations. But for the most part, it's the service organizations that are doing the installations.

Bill Summitt
Okay. And is there an advantage to the end customer to having a monitoring system that is not tied to the specific brand?

Walter Czarnecki
The main advantage there is that—well, I can tell you what we've seen in the power generation market, which is, it's very unusual to find, if you look at a large campus, whether it be a hospital system or university or a large national chain, it's very rare for them to have only one brand of generator. Because they'll install a few, they'll do it incrementally, and each year, they'll put a bid out for multiple brands and they'll take the one that fits the best.

And so what's more common is, we'll see a hospital system with a few Generac's, a few Kohler's, a few Cummins, and they'll need a solution that works across that campus. And that's another way that we compete and win in terms of having that flexibility and enabling both the end user and the service organization to have one platform from which they can monitor various brands. And so as we learn more about the compressor market and if we find that that is the case, then we feel comfortable operating in that type of market dynamic.

Bill Summitt
Okay. And my last question on this dynamic is, do the dealers have an incentive to want to kind of carry one monitoring brand? So if someone comes in and buys either a compressor or a power generator, does the dealer have an incentive to say, okay, we're always going to install this one monitor?

Walter Czarnecki
So certainly for simplicity it does. And some of our customers will only sell OmniMetrix equipment. Others will sell multiple brands, in part because there's a sensitive line that they need to walk with respect to the manufacturer of brand that they're representing. And so, there is some sensitivity there. But certainly for simplicity, it's easier to have just one monitoring system.

CONCLUSION

Operator
Once again, if you'd like to ask a question please press star, then one. Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Jan Loeb for any closing remarks.

Jan Loeb
We are now an IoT-focused company with an improved balance sheet and lower cost structure, and we are well positioned for our next phase. From here, top line growth and operating leverage should continue to drive bottom line performance, which is the driver of shareholder value. We would also like

to supplement growth at OmniMetrix with suitable and similar acquisitions.

I want to thank you all for your interest in Acorn. More than ever, I believe that Acorn represents an attractive platform for building value for shareholders. I'm grateful for the support of our investors, and I'm pleased to speak with anyone who ask specific questions about the company or our plans. Just contact our investor relations team to set up a call with me, to answer any questions you may have. Thank you again for your time today. And with that, operator, we can end the call. Thank you.

Operator
And thank you. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect. Take care.