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MANAGEMENT DISCUSSION SECTION
Operator

Good morning and welcome to TETRA Technologies Second Quarter 2023 Results Conference Call/ Today, all participants will be in a listen-only mode. After today's presentation, there will be an opportunity to ask questions.

I would now like to turn the conference over to Rigo Gonzalez, Manager of Corporate Finance & Investor Relations. Please go ahead.

Rigo Gonzalez

Thank you, Chris. Good morning and thank you for joining TETRA's second quarter 2023 results Call. The speakers for today's call are Brady Murphy, Chief Executive Officer; and Elijio Serrano, Chief Financial Officer. I would like to remind you that this conference call may contain statements that are or may be deemed to be forward looking, including projections, financial guidance, profitability, and estimated earnings. These statements are based on certain assumptions and analysis made by TETRA and are based on several factors. These statements are subject to several risks and uncertainties, many of which are beyond the control of the company. You are cautioned that such statements are not guarantees of future performance and that actual results may differ materially from those projected in the forward-looking statements.

In addition, in the course of the call, we may refer to EBITDA, adjusted EBITDA, adjusted EBITDA gross margins, free cash flow, net debt, net leverage ratio, liquidity, returns on capital employed or other non-GAAP financial measures. Please refer to yesterday's press release or to our public website for reconciliations of non-GAAP financial measures to the nearest GAAP measures. These reconciliations are not a substitute for financial information prepared in accordance with GAAP and should be considered within the context of our complete financial results for the period. In addition to our press release announcement that went out yesterday, we encourage you to also refer to our 10-Q that we also filed yesterday.

I will now turn it over to Brady.

Brady Murphy

Thanks, Rigo. Good morning, everyone, and welcome to TETRA's second quarter 2023 earnings call. Our historically strong second quarter results demonstrates the strength of our management team and our broader employees' ability to execute on our base business while also making meaningful progress on our longer-term strategic growth initiatives. I'll provide an overview of our second quarter highlights before turning the call over to Elijio to provide an overview of our financials and then we'll open the call for questions.

According to Spears and Associates, global E&P spending is still 55% below the peak year in 2014 yet in the second quarter, we delivered the highest quarterly revenue, excluding discontinued operations in the company's history. While doing so, we achieved the highest adjusted EBITDA in almost eight years without the benefit in the quarter of CS Neptune activity. Although both segments posted impressive year-on-year revenue growth, Completion Fluids & Products led with 31% growth year-on-year and 42% growth sequentially.

The recent capacity investments that we made in our key offshore and deepwater markets in Brazil, Gulf of Mexico, and North Sea have already contributed in a meaningful way while offshore activity continues to grow at an encouraging pace. Our strong Q2 results were achieved without the benefit of a TETRA CS Neptune job in the second quarter as the North Sea jobs we were planning for the second quarter have been delayed. One of these jobs is now scheduled for load-out to the rig this week.

As a larger percentage of the North America shale Tier 1 acreage is drilled and completed, we remain with our beliefs even more conviction that we're still in the early stages of a longer-term offshore and deepwater upcycle. TETRA's business model with sales to over 20 countries year-to-date as a full service fluids provider, including reclamations services, as well as a fluids product sales provider to the major service companies, gives us great flexibility in our ability to grow with increasing international activity.

Equipped with an extensive portfolio of high-value completion fluids and a family of environmentally-friendly solutions, TETRA is well positioned for this longer-term growth cycle.

In addition, our industrial calcium chloride business achieved its strongest quarter in history with year-over-year growth of 20% as we entered the Northern Europe seasonal peak with our improved supply chain driving favorable manufacturing variances and higher production volumes. As the largest producer in Northern Europe, we've invested to expand manufacturing capacity in the region while continuing to explore new opportunities. An example of this is the second order from a customer who is utilizing our high-purity calcium chloride in the lithium production process. We're following their progress closely and look forward to future developments.

For Water & Flowback Services, we previously announced that for 2023, our focus would be on margin enhancement over growth. And in the second quarter, we achieved the bottom end of our year-end 2023 adjusted EBITDA margin target, well ahead of schedule. Although revenue was flat quarter-on-quarter, our margins improved sequentially by 170 basis points to 18.4%. Our continued focus on innovation and automation is driving margin expansion within our Water & Flowback Services with more and more emphasis on moving and treating produced water, differentiated offerings, service quality, and reliability are driving customer decisions.
Demand for our fleet of TETRA Sandstorms remains strong as we continue to make enhancements to further automate the equipment and drive further efficiencies. While we have seen some signs of softness in certain US land segments, pricing has remained relatively stable for our differentiated offerings.

With regards to our produced water treatment for beneficial reuse, we continue to advance the engineering work required to achieve our goal of a commercial design by year-end. The customer interest level, driven by more and more challenges with produced water disposal options, continues at a very high level. And with our ongoing customer engagements, we believe we're in a very good position to capitalize on this future market.

For the overall segment, we will continue to execute on the initiatives we started this year, keeping us on track to achieve our margin enhancement goals while also achieving double-digit growth for our overall segment in 2023.

Moving on to our efforts with our Arkansas Smackover brine evaluation and potential development plans for lithium and bromine production, we achieved some very important milestones during the quarter. We recently entered into a memorandum of understanding with Saltwerx LLC related to a newly proposed brine unit in the Smackover formation in Southwest Arkansas. If approved by the Arkansas Oil and Gas Commission, this 6,138-acre unit is 48% larger than our original proposed unit and is with a partner that brings tremendous wealth of experience and financial strength.

We and Saltwerx have agreed to collaborate in key areas, including upstream design and development, to optimize long-term brine production, technology development for lithium extraction, and associated engineering studies required to develop the proposed brine unit. We will communicate further developments as we achieve certain milestones.

Also, during the second quarter, we completed the drilling of our second test well in our newly proposed unit with sampling tests underway to update the prior test results noted in the Inferred Resources Study for bromine and Lithium. We've contracted Hargrove and Associates to execute a front-end engineering and design study or FEED for a lithium production facility. The lithium plant design will be optimized to share the production wells, injection wells, and pipelines consistent with previously completed FEED for the bromine plant, which was completed during the first quarter of 2023.

With that, I'll turn it over to Elijio to provide some additional commentary and then we'll open it up for some questions.

Elijio Serrano

Thank you, Brady. Completion Fluids & Products segment adjusted EBITDA of $31.8 million increased 80% year- over-year and 77% sequentially. Adjusted EBITDA margins improved from 26.1% in the first quarter to 32.4% in the second quarter. We have historically always been above 30% adjusted EBITDA margins for this segment where we have had large TETRA CS Neptune projects. We believe pushing our EBITDA margins above 30% without the benefit of CSI Neptune speaks to the strength of our integrated business model and an exceptionally strong performance from our supply chain organization, sourcing key raw materials at attractive prices, in addition to our commercial team driving price increases.

Both revenue and adjusted EBITDA for the segment were the highest since 2015, when there were approximately 50% more active deepwater rigs operating globally. The exceptional fall-through was driven by higher production volumes and improved supply chain in industrial business, as well as high-margin Completion Fluids projects, including several large projects in the Gulf of Mexico and in Europe. We remain encouraged by the growth in deepwater projects, underpinning -- underpinned by rising flow water utilization rates in many regions.

Deepwater revenue for the quarter was approximately 28.8% of the total segment as compared to approximately 23% a year ago, indicating growth of more than 60% year-over-year. In the third quarter, we will see the seasonal drop-off of the industrial chemicals business. But the Completion Fluids business is expected to post another strong quarter as we ramp up deliveries for several large projects in Brazil and the Gulf of Mexico.

Shifting to our Water & Flowback Services segment. Revenue improved 17% year-on-year while remaining relatively flat sequentially, consistent with our focus on margin enhancement instead of growth via incremental capital investments. Adjusted EBITDA improved by 43% year-on-year and by 10% quarter-over-quarter. Adjusted EBITDA margins improved 110 basis -- 170 basis points from 16.7% in the first quarter of this year to 18.4% in the second quarter of this year, marking the highest margin since the fourth quarter of 2018, as the team continues to drive operational efficiencies and focus on margin expansion.

In the second quarter, we commenced our third early production facility in Argentina. We also secured a contract to expand one of the three early production facilities that we have in Argentina with an extended contract term with a customer prefunding the capital expenditures required for this expansion. This approach points to our focus on managing capital investments and working capital. We were also awarded a contract for production testing in the Middle East.

For the fourth quarter, we -- for the third quarter, we anticipate modest sequential growth in international and flat to slightly down revenue in the United States. Cash flow from operating activities was $28.4 million in the second quarter compared to cash flow from operating activities of $17.9 million in the second quarter of last year and compared to $9 million in the first quarter of this year. Adjusted free cash flow from continuing operations was $17.7 million after funding capital expenditures of $10.3 million net of proceeds. The high conversion of net income to cash flow from operating activities into adjusted free cash flow while achieving a revenue increase sequentially of 20% reflects the quality of the incremental revenue and the company's focus on managing working capital.

Working capital at the end of the first quarter was $107 million. Working capital only consumed $0.5 million of cash in the second quarter compared to use of cash of $5.2 million in the first quarter of 2023. Day sales outstanding improved by approximately five days during the quarter. As of June 2023, our trailing 12 months' return on capital employed or ROCE, our non-GAAP measure was 18.2%, materially above our average cost of capital.

At the end of the second quarter, unrestricted cash was $28 million, and availability under our credit facility was $71 million. Liquidity at the end of the second quarter was $99 million and improved to $102 million as of the end of the day yesterday. In addition to Friday's closing price -- in addition based on Friday's closing price, our holdings in Standard Lithium and CSI Compressco combined for a total market value of approximately $9.4 million. And our investment in CarbonFree is currently valued at approximately $6.3 million. Combined, these investments total almost $60 million.

During the second quarter, we booked a favorable $4.7 million adjustment to earnings to reflect charges and costs previously incurred and passed on to Saltwerx, consistent with the MoU that we recently signed. We agreed to share with Saltwerx our previous work and findings in Arkansas for the first and second test well, the bromine FEED Study, and the reservoir analysis. Saltwerx agreed to pay up to 51% of those costs, up to a certain amount. We expect to collect $4.7 million in the third quarter and will continue to pass on to them up to 51% of costs related to the Arkansas investment, up to a certain limit.

When reporting GAAP net income, this $4.7 million benefit is reflected in our results. However, when reporting adjusted EBITDA of $36 million in the second quarter, we did not reflect this favorable benefit in our adjusted results. Our adjusted results do not include the benefit of this $4.7 million of income from Saltwerx. Free cash flow and cash flow from operations in the second quarter also do not reflect this benefit and will be reflected in the third quarter free cash flow and cash flow from operations when we collect this cash in the coming quarter.

I'll turn this back over to Brady for closing comments before opening up to questions.

Brady Murphy

Okay. Thank you, Elijio. So, in closing, we're very pleased with our second quarter results, as well as the near- to longer-term outlook for both of our business segments, as well as the major milestones we continue to achieve with our longer-term strategic opportunities and projects.

So, with that, we'll open it up for some questions.

QUESTION AND ANSWER SECTION

Operator

We will now begin the question-and-answer session. At this time, we will pause momentarily to assemble our roster. Today's first question comes from Martin Malloy with Johnson Rice. Please proceed.

Question – Martin Malloy: Thank you. Congratulations on the strong quarter.

Answer – Brady Murphy: Thank you, Martin.

Question – Martin Malloy: Could you maybe take a -- take some time to talk about the Saltwerx MoU and what that might mean for the timetable to getting to the point where a production facility for lithium might be, assuming that the results from the second well come back positive?

Answer – Elijio Serrano: Good question, Marty. The MoU is that -- it's a memorandum of understanding outlining some areas that we want to work together collaboratively, and it also includes some limited binding agreements. One of those binding agreements, for example, is the sharing of cost and the sharing of data for the work that we have done to-date. Once we get an approval for our Arkansas unit for the 6,100 acres that Brady mentioned, then we will work with our partner to try to convert that MoU into a more definitive agreement.

So. at this point, we've got understanding with some key items to convert into a final term. And we filed, as part of our 10-Q, a redacted copy of the MoU that I would encourage you to take a look at it. It's attached to our 10-Q.

Answer – Brady Murphy: And, Marty, as I would add, as it relates to the timing, once our unit is -- moves forward and as Elijio said, we establish more definitive agreements with Saltwerx, we're continuing to move forward with the evaluation of our unit with the FEED study that we've kicked off in lithium. We would hope to have those things pulled together between now and end of the year or by first quarter of next year. And once we get a final investment decision made by our board and the Saltwerx Board, then we expect two years from that period of time, we will be in first production for bromine and lithium. That's our expectation.

Question – Martin Malloy: Okay. And then my follow-up question, I would ask about Neptune projects in the Gulf of Mexico. Could you give us an update in terms of line of sight on any potential projects there?

Answer – Brady Murphy: Yeah. So, we continue to have good success with Neptune. We did have some delays in the second quarter for some wells that we had planned. They were pushed to the right, as I mentioned in my comments, where we're actually loading out a Neptune job for the North Sea for later this week. And then we expect some of the other jobs to materialize in the Norway sector of the North Sea, as well as the UK sector later in the year.

For the Gulf of Mexico, as we've mentioned before, these are much bigger, longer-term plan. The projects, we have line of sight of several of those projects, working very closely with the customers. If we're fortunate, we may get a well in the fourth quarter of this year, but we still believe next year is more likely for some of the Gulf of Mexico projects to start materializing.

Question – Martin Malloy: Great. Thank you. I'll turn it back.

Operator

The next question comes from Stephen Gengaro with Stifel. Please proceed.

Question – Stephen Gengaro: Thanks and good morning, everybody.

Answer – Brady Murphy: Good morning.

Question – Stephen Gengaro: I think the first thing I wanted to ask about the quarter was obviously very good, right? And you had the normal seasonality from Europe, but it was very strong. And what I wanted to try to understand a little bit was, A, how the margins were impacted by the European chemicals business because the EBITDA margins were obviously excellent; and then B, as we think about the third quarter and when I sort of just think about the normal kind of progression we've seen historically, it feels like a high-20s EBITDA number is kind of in the ballpark. I was curious if you could comment on that at all.

Answer – Brady Murphy: Sure. Yeah. Thanks, Stephen. I'll handle the first part of that and then ask Elijio to comment on the third quarter. Yeah. The margins were very strong in the quarter. I would say, really, it's been -- it was across the board, we did have very good margins out of our European calcium chloride business. We're very pleased with the way the team has been managing the supply chain and the pricing for that business for us. But also remember, we had quite a few deepwater wells in the quarter. Although they're not Neptune jobs, they're still very, very good margin jobs for us and pretty high volume. So, I would say it's pretty even across the board as it relates to the quarter for the margin impact. I'll ask Elijio to comment on the third quarter.

Answer – Elijio Serrano: Yeah, good question, Marty. On the third quarter of historic -- Stephen, sorry. Historically, we've seen about a $14 million to $15 million sequential increase in revenue. So, let me give you some third quarter color, and what I'll do is I'll benchmark it to the first quarter, which doesn't have the seasonality in Europe. We believe that revenue in the third quarter is going to be somewhere between 5% and 8% higher than the quarter of this year. And, again, a reminder is that the second quarter's impacted by the seasonality for Northern Europe.

We think that third quarter adjusted EBITDA will be somewhere between 30% and 40%, above the $20.6 million from the first quarter of this year. And I think this demonstrates the continued growth in the offshore markets, margin expansion with the onshore business that we continue to benefit from. And the third quarter numbers that I called out are contingent on several significant deepwater projects that we are expecting in the third quarter. I mentioned some in the Gulf of Mexico and Brazil. And the expectation right now is that none of those slip from September into October or the fourth quarter to be able for us to deliver the numbers that I mentioned.

Question – Stephen Gengaro: Great. That's helpful color. Thank you. And then just so that I understand the -- you made brief comments on water revenue. Is -- it feels like there's some headwinds in US land, so the numbers you just provided, I think, would be in the backdrop of kind of a flattish water business?

Answer – Brady Murphy: Yeah. For Q3, I think you can think about our revenue as fairly flat. There is some -- obviously, activity has been impacted in some of the basins, so we're not immune to that. We will see some decline in North America, but we're going to be offsetting that with our international business. So, I would really think about, for Q3, fairly flattish in the Water & Flowback segment. But, again, as Elijio mentioned, our margin expansion progress is -- continues, and we would expect to be slightly higher on the margin side with that flattish revenue.

Answer – Elijio Serrano: And, Stephen, I'll add that, historically, we've grown by adding capacity and adding capital. And at this point, we're focused on returns on capital. We're focused on free cash flow and margin enhancement rather than growth through the addition of more CapEx.

Question – Stephen Gengaro: Okay. Great. Thanks. And just one more for me. The results you've seen have obviously been really -- they've really good without -- I think without any PureFlow in the second quarter yet. And I know Eos has been working towards this DOE loan, and I think it's their Z3 line coming on stream. Should we be or maybe a better question is are you thinking about the PureFlow impact really ramping in 2024? I mean, is that a good way to think about the impact of PureFlow on the fluids business or you think it's sooner or later than January 1?

Answer – Brady Murphy: Yeah. Stephen, look, we've continued to stay in very close contact with Eos, not only for the PureFlow, but also in discussions with them to provide their full electrolyte, which is a great opportunity for us. But as you know, they're transitioning to their new Z3 technology. I think until they have their automation equipment up and running, the volumes will probably be pretty slow. But once they have their automation equipment up and running, our expectation is the orders will really accelerate. And I don't want to speak for them, but we think that's probably more likely in 2024 than before the end of the year.

Question – Stephen Gengaro: And just to differentiate, am I -- are you differentiating between just PureFlow and the full electrolyte and how does that...

Answer – Brady Murphy: Yeah.

Question – Stephen Gengaro: ...what's the -- I'm not sure I understand exactly the difference and the revenue difference for you guys.

Answer – Brady Murphy: Yeah. So, the full electrolyte is made up of quite a few different chemical composition. Our PureFlow, the zinc bromide, as you know, has been the first real part of the electrolyte that we penetrated the zinc bromide batteries with. However, there is quite a bit other chemistry -- complex chemistry involved in the full electrolyte. And we are working with actually several of our customers, not just Eos, to understand the composition of that and to be able to manufacture that. And that's -- that is another step change in potential revenue for us out of that product line.

Question – Stephen Gengaro: Excellent. Thank you for the color.

Answer – Brady Murphy: Yeah.

Operator

At this time, we are showing no further questions in the queue, and this does conclude our question-and-answer session. I would now like to turn the conference back over to Mr. Murphy for any closing remarks.

Brady Murphy
Well, thank you very much. As I stated before, we're extremely pleased with the quarterly results that we had, but also, just as importantly, the progress that we make with our longer-term strategies, which offer tremendous potential for the company. So, thank you for joining us and appreciate it. That's all.

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