Target Hospitality
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PRESENTATION

Operator:

Greetings and welcome to Target Hospitality's Second Quarter 2019 Earnings Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the call over to your host, Mr. Narinder Sahai, Senior Vice President, Treasurer and Investor Relations. Thank you. You may begin.

Narinder Sahai:

Thank you, Operator. Before we begin, I'd like to remind you we will discuss forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those forward-looking statements as a result of various factors, including those discussed in our press release today and the risk factors identified in our SEC filings. While we may update forward-looking statements in the future, we disclaim any obligation to do so. You should not place undue reliance on these forward-looking statements, all of which speak only as of today.

We'd like to remind you that some of the statements and responses to your questions in this conference call may include forward-looking statements. As such, they are subject to future events and uncertainties that could cause our actual results to differ materially from these statements. Target Hospitality assumes no obligation and does not intend to update any such forward-looking statements.

The press release we issued last night and the presentation for today's call are posted on the Investors section of our website. A copy of the release has also been included in an 8-K that we submitted to the SEC. We will make a replay of this conference call available via webcast on the Company website.

For historical financial information that has been expressed on a non-GAAP basis, we have included reconciliations to the comparable GAAP information. Please refer to the tables in the slide presentation accompanying today's press release.

Now, with me today, I have Brad Archer, our President and Chief Executive Officer, Andrew Aberdale, our Chief Financial Officer, and Troy Schrenk, our Chief Commercial Officer. Brad will begin today's call with an overview of Target Hospitality's key operating highlights. Andy will then provide additional details on financial results and discuss our outlook. Troy will join us to open the call for questions.

With that, I will now turn the call over to Brad.

James Bradley Archer:

Thanks, Narinder. Good morning and thank you for joining us.

The foundational culture of our business is grounded in our belief of putting our customers first, empowering our employees, and driving continuous improvement throughout all facets of our business. Andy and I have been passionate about these values since day one. These values also formed an integral part of the decision made by the Board, myself, and Andy, to select the right person as our next CFO.

As we announced today, Andy plans to step down from the CFO position for personal reasons. He has commuted from Boston to Houston for several years and has expressed his desire for some time to be closer to his family on a full time basis. He has been instrumental to the growth and success of our well-structured business. His dedication to Target over the past decade, including his help in getting us public, has been invaluable to us. We thank him for his many years of service and wish him the best.

After a thorough search, we are thrilled to announce the hiring of Eric Kalamaras as our Executive Vice President and Chief Financial Officer. Eric is a proven operator with significant public company experience and strong financial acumen. We view him as an ideal fit to deliver a seamless transition as we continue to execute our strategic priorities. We are excited about the important role he will play in helping to drive sustainable and profitable growth. Eric will join us on September 3. To ensure a smooth transition, Andy will continue to serve in the CFO role until that time, and thereafter be available to us in an advisory capacity for the next year.

Now, moving to our results. During the second quarter, our team was focused on executing our strategy, delivering strong results, and winning with our customers. We drove exceptional growth during the quarter, including an 80% increase in Adjusted EBITDA. We produced higher pro-forma ADRs and utilization rates on a growing number of beds. In addition, we laid the foundation to continue powering our momentum through a range of expansion and acquisition initiatives, and for those of you that are newer to the story, our 2019 progress adds to decades of building Target Hospitality into the largest vertically integrated specialty rental and hospitality services Company in the United States. We serve the U.S. energy and government sectors by uniquely combining the most attractive elements of specialty rental

accommodations with hospitality and premium catering services. We also provide housekeeping, security, maintenance, and other services that are highly valued by our customers.

As of June 30, we owned and operated an extensive network of 22 communities, which provided an average of 11,401 beds for our guests during the second quarter. Our facilities, which are situated in some of the most attractive markets in the U.S., are the leading providers of flexible accommodations in the Permian and Bakken Basins, and on the government side, which makes up about 20% of our business, we are also exceptionally positioned.

Turning to Slide 5; the differentiated aspects of our business are worth reinforcing, as we believe our proven approach will allow us to further enhance the quality of our business. Specifically, it's our scale, premier customers, long-term exclusive agreements, and our Target 12 approach.

Who we do business with and the structure of our contracts are important for our business. This is especially relevant today given some of the recent headlines on the health of the energy markets, and specifically the curtailments of cap ex budgets. According to the Dallas Fed Energy Survey, roughly a third of energy executives are budgeting an increase in their firm's capital spending as of June. Another third expect their firm's capital spending to be stable year-on-year.

A significant majority of our contracted rooms are with the larger blue-chip companies. We typically represent only a small portion of our customers' operating budgets. Furthermore, even amongst the large companies, the customers that partner with us tend to take longer-term views on the market, and they view secured employee accommodations as part of their own competitive advantage. As recently as June, operators in our markets expressed the continuing need to attract qualified labor, so we are confident in the long-term prospects for our mission critical services.

With this in mind, I'd like to provide some perspective on where we stand today with the core portion of our business, which primarily includes large integrated producers and top tier oil field services companies. As a reminder, our core business represents approximately 86% of our estimated revenues under long-term customer contracts.

Our core business remains fundamentally strong and performing as expected. Our core customer utilization levels were essentially unchanged sequentially in Q2 versus Q1. Many of our core customers continue to invest in the Permian Basin, and their activity levels remain stable. In the Bakken, we are seeing more activity, which is translating into higher utilization levels, and finally, our contract renewal rates across our network remains above 90% as of the second quarter.

As a result, our confidence in the core portion of our business is intact. The remaining uncontracted portion is largely comprised of customers with less predictable workloads, and mainly stemming from our Signor acquisition. We continue to work on converting more of these customers to multi-year contracts. As we mentioned before, at the time of acquisition we estimated a 12 to 18 month period to synergize the business, including driving higher utilization and ADRs as we put more contracts into place. This plan remains unchanged.

Additionally, as we have done in the past, we will look to continue to further strengthen the resilience of our total business by pivoting even more of our portfolio to large customers that value quality accommodations for their employees over multi-year horizons.

On Slide 6; our Government segment is largely comprised of our South Texas Family Residential Center, or STFRC. This best-in-class property located in Dilley, Texas is a purpose-built facility designed to house, nourish, and provide critical services to asylum-seeking family units. We own and lease the facilities to

CoreCivic. CoreCivic holds the government contract to operate the STFRC. As a sub-contractor of CoreCivic, we are also responsible for providing professional catering services, as well as maintaining the cafeteria and employee facilities.

We take these responsibilities very seriously and carry them out in a manner that promotes a clean and healthy environment. The meals we provide are designed and approved by licensed nutritionists and prepared by experienced chefs in a custom-built commercial kitchen that is inspected daily by the U.S. government and CoreCivic. Importantly, we provide optionality relating to the meal choices by offering a wide selection of hot and cold entrees. We are committed to maintaining the highest standards of service and satisfaction.

This hard to replicate facility also provides good diversification for our business. The demand for beds has far exceeded the U.S. government's ability to supply adequate housing accommodations. In fact, the U.S. government has identified the South Texas Family Residential Center as the model for this type of facility. As a result, we remain well-positioned to support the U.S. government's needs in this category.

On to Slide 7; overall, in the past couple of years we have grown our bed count significantly while expanding our customer base to include some of the largest operators in our markets. Following our transformational acquisition of Signor in 2018, we have continued to build out the Target network while generating cash flow and preserving a conservative balance sheet.

During 2019 we have announced the addition of six communities through acquisitions and expansions for a total of approximately 1,540 rooms. These additional rooms reinforce the compelling long-term unit economics underpinning these growth investments. The purchase of three communities in June and one in July provided an attractive opportunity to grow our bed count and locations. We are already in the process of integrating those facilities into the Target network. Combined with our sharp focus on execution, we remain well-positioned to continue to deliver value-enhancing opportunities for our business.

I will now turn the call to Andy to provide additional details on our results.

Andrew Aberdale:

Thank you, Brad. I've truly enjoyed my time and experience at Target and appreciate what we've been able to accomplish over the years. I look forward to continue serving Target to ensure a seamless transition with Eric and the entire Target team, and with that, please move to Slide 8.

Our second quarter results were strong year-over year and in line with our expectations. Customer renewals, network new builds, expansions, and operational enhancements drove improved financial and operational performance. Total revenue increased 79% to $81.4 million. Adjusted EBITDA grew 80% to $41.2 million, while expanding our Adjusted EBITDA margin to 50.7%.

This growth was driven by good operational momentum with our overall Company utilization increasing 2% to 86%. Also, average daily rate of $80.90 improved year-over-year on a pro-forma basis, which excludes the impact of the Signor mix.

With the completion of the recent acquisition and the other new build and expansion investments, we're pleased to end the quarter with our net leverage ratio within a manageable range of our long-term target of around 2 times.

Moving to Slide 9; in the second quarter, approximately $13 million of the increase in Adjusted EBITDA to $41.2 million was due to Signor's contribution. I'll point out that our pro-forma prior-year figures only include our transformational acquisition of Signor and are unchanged for subsequent bolt-on acquisitions.

With that in mind, second quarter 2019 Adjusted EBITDA of $41.2 million increased 14% when compared to pro-forma second quarter 2018 Adjusted EBITDA of approximately $36.2 million. The growth in Adjusted EBITDA on a pro-forma basis was primarily a result of higher sales. We produced $1.8 million from an increase in ADR, plus $2.8 million from higher utilized beds. Efficient cost management of operations contributed a $1.6 million improvement, although a higher mix of revenue from our All Other segment limited some of that benefit. These collective increases more than offset incremental SG&A of $2.1 million, primarily associated with the investment in our people, processes, and technologies to support the build out of our corporate infrastructure as a public company and scale our business in the future.

Overall, we grew our business year-over-year and invested in our corporate platform while generating an attractive Adjusted EBITDA margin above 50% in the second quarter of '19.

Moving to Slide 10; looking at our operating performance, our as-reported results are heavily influenced by the addition and mix impact from Signor. I'll again focus on pro-forma for better comparability. On a pro-forma basis we are pleased to achieve stronger ADR and better utilization on a higher bed count.

On a pro-forma basis, average available beds increased by 5% to 11,401. This increase was led by new community additions and expansions in our network in the Permian. On a pro-forma basis, we increased ADR by 2.4%. This reflected favorable customer contract renewals, in part driven by our offering of an overall larger community network to our customers, as well as facility upgrades and the addition of vertically integrated services at all Signor communities.

On Slide 11; looking at our key segments on an as reported basis, the Permian is our growth engine, the Bakken has been right sized, and the Government segment remains firm.

In the Permian Basin, which is our largest segment, revenue and adjusted gross profit more than doubled, helped by acquisitions, community expansions, and better overall performance at most of our communities. Permian adjusted gross profit margin, down 366 basis points to 62.6%, primarily reflects the mentioned mix impact of Signor communities, and to a lesser extent, the higher number of communities under construction or expansion.

In the Bakken, which is a relatively smaller region for us, adjusted gross profit margin increased to 47%, compared to 40.7% in the prior-year quarter. We tightened our footprint in the Bakken late last year which drove the expected decline in sales while significantly improving utilization rates and cost efficiencies.

In the Government segment, revenues were consistent with prior year. We are in the middle of a seven-year agreement, which provides relatively stable ADR, utilization, and revenue. Adjusted gross profit margin in the Government segment improved mainly due to reduced occupancy when compared to utilization.

Moving to Slide 12; adjusted free cash flow remained strong. Year-to-date in 2019, capital expenditures were approximately $79 million, compared to $46.2 million in the prior-year period. Maintenance cap ex was below 1% of sales with the remainder of the capital spending almost entirely for revenue-enhancing investments, including our community expansions and the high-grading of acquired communities. As a reminder, our capital expenditures also captured our $30 million purchase of three communities from Superior Lodging in the second quarter.

Adjusted free cash flow improved to $75.3 million in the first half of 2019, compared to $32.1 million in the first half of 2018, primarily driven by higher Adjusted EBITDA. As a reminder, our adjusted free cash flow represents Adjusted EBITDA less maintenance cap ex and deferred revenue. Our conversion of 91% of Adjusted EBITDA to adjusted free cash flow in the first half was in line with our historic levels near 90%. We expect to continue generating meaningful adjusted free cash flow for the balance of this year.

On Slide 13; looking at our cash performance on a GAAP basis, during the second quarter, we saw a healthy increase in operating cash flow of $25.5 million. We mostly invested this cash in organic expansion initiatives such as our two communities under construction. We also continue with upgrades at our Signor communities to better drive rates. Our $30 million acquisition of the Superior communities was fully funded with borrowings from our ABL facility.

We plan to continue spending our cash on attractive investments to expand and improve our networks. Our strong cash flow and strong balance sheet provide us with significant financial flexibility to accomplish this objective. This is aligned with our broader capital allocation priorities to invest in growth, maintain a strong balance sheet, and deploy capital into other value-enhancing initiatives. We have a history of prudently allocating capital and we've generated exceptional returns, and this will continue going forward.

I'll now turn the call back to Brad to provide our outlook update and closing remarks on Slide 14.

James Bradley Archer:

Thanks, Andy. Our 2019 financial outlook remains unchanged for revenues to be in the range of $340 million to $350 million and Adjusted EBITDA to be in the range of $175 million to $180 million. The strength of our relationships with core contracted customers continues to provide us with visibility for the balance of 2019. While we are mindful of the cautious market outlooks for North America land drilling and completions activity, the structural advantages of our business model and our significant weighting towards large, longer-term focused customers provide us with confidence in achieving our 2019 goals. On the cost side, our outlook includes incremental SG&A investments in our corporate infrastructure to scale our business for the future.

Keep in mind, our two planned communities in the construction phase are not included in our outlook and represent incremental contribution to our financial outlook, once operationalized. Additionally, our outlook excludes the four recently purchased communities. They are in process of getting integrated into our network and are expected to be accretive to earnings within the first year. We will provide an update on the financial impact of all six new communities next quarter.

We look forward to achieving another year of solid results through our focus on producing strong margins from our leading network of communities.

In summary, on Slide 15, our relationships and contracts with our core customers underpin the stability of our business. This forms a solid bedrock to continue driving growth, high margins, and attractive returns on our healthy pipeline of new opportunities.

While we cannot control the market, our value proposition to shareholders is the confidence that we have in the structural advantages in our businesses. We maintain a line of sight on a significant majority of our revenues, and we are actively working to further increase our mix of business from high-quality integrated producers and large oil field service companies.

Our team is committed to executing on our strategy in delivering exceptional results and winning in our markets. We are excited to accomplish our key objectives in 2019 and beyond to continue generating value for our shareholders.

Thank you again for your interest in Target Hospitality.

Operator, you may now open the line for questions.

Operator:

Thank you. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. To allow for as many questions as possible, we request that you each keep to one question and one follow-up and invite you to rejoin the queue.

Our first question comes from the line of Stephen Gengaro with Stifel. Please proceed with your question.

Stephen Gengaro:

Thank you and good morning, gentlemen. I guess the first question is around the Permian, and I just wanted to understand the dynamics there, and when I look at the sequential performance in utilization and average daily rates, what caused the slight drop off and how do we think about that in the back half of the year?

Andrew Aberdale:

Hey, Stephen. Thank you. This is Andy. The Permian overall utilization and ADRs performed as expected in Q1 and Q2, and actually if you look at this more over a year timeframe, like year-over-year, you'll notice that you'll see a nice utilization uptick of roughly 3% or so at the same time when we had an uptick in ADR, as well as available and utilized beds, so we really try to look at this on a more of a long-term basis, but to your point, when you look at the sequential quarters, you can see some noise.

You will see a little bit of an adverse impact from the Signor acquisition, and that really boils down to probably two major areas. The adverse impact boils down to what we call timing and mix. The timing is really around when customers—when we planned to move customers in and out, and when I say in and out I mean move them out of a facility and into a new or newly-built facility or an expansion, so the utilization really is impacted by timing, and the mix is really what's driving any quarter-to-quarter, month-to-month noise in ADR, and what we mean about mix is we talk about a spot market, so our plan is to not have too many customers utilizing our beds at the spot market rate.

We like long-term, take-or-pay customers, so as we transition away from those higher ADRs, those higher average daily rates on the spot market, we transition them into long-term contracts which has a lower ADR, so that's what you see when you look month-to-month or quarter-to-quarter. You can see a little bit of noise, but when you look year-over-year, you'll see the trend that we're really pleased with.

James Bradley Archer:

Yes. Hey, Stephen. This is Brad. Just a little bit of color on when you look at Signor too and the acquisition, what we've always said is it takes about 18 months to start really getting into all of these contracts. Some of them, they don't come off for a year or whatever, but they had lower rates. Some of them didn't have full turnkey type as far as the catering and other things like that, but when you—on a pro-forma basis, when

you look at those combining with Target, there's some impacts there, and it is on timing. We started to work through those.

As you know, in December we re-signed several contracts for some long-term take-or-pays, which helps in that, but there's others as we go through that'll take several more quarters just to filter out, so what I wouldn't do is look at this as a trend going forward, if you will. On the downward side, this will start to pick back up and that's actually what we're looking at in the back half for ADRs going up, as well as utilizations going up, and really, this goes back to the strength of our business, right?

We always knew that this was going to be part of the Signor acquisition, but when you looked quarter-over-quarter if you want to, what's been great about that is our—the contractual level at 86% has continued to hold up. Our margins have been there, so that's the way I look at the business, and we keep going on that.

Stephen Gengaro:

Thank you, and as a follow-up, it sort of leads in a bit to my second question, which was your second half guidance includes—it basically implies a mid-teens sort of first half versus second half EBITDA growth, and I was curious, in an environment where oil field service activity seems to be slowing a bit, what gives you confidence in those numbers, and then I guess also, as part of that, you're not baking in the new expansions yet, and I assume that's potentially accretive to the guidance in maybe later in the year. How do we sort of think about those two issues?

James Bradley Archer:

Sure, and a couple of questions there, so let me take your first one on back half. Very good question, especially with the backdrop on the energy sector, but it really gets—goes back to the strength of our business model. It's our long-term contracts, top tier customers, and it matters who you do business with and where you do business. Troy and his team, including myself, we have met with all of our largest customers; feel very good about the back half of the year in conversations with them, how they're performing, what they're projecting for us on the back half.

When you look and see how we have migrated our business over the years and the customers that have a longer-term investment horizon, this is what gives us the confidence we will perform full-year 2019. I mean it really is—I know that sounds simple, but it is that. Our business model is pretty simple. It's the long-term contracts. It's who you do business with and where you do the business, and we're always in communication with them. We didn't put this together in a vacuum; definitely in with our customer.

Troy Schrenk:

Hey, Stephen. This is Troy. Good morning. Hey, just to add a little bit of color to that, appreciate the comments on the backdrop on oil field services, and I think just to reiterate, who you do business with—as we've told you before, the blue-chip investment-grade customer base really leaning into the integrated producers in the majors as evidenced by those two announcements in the first half of the year for new greenfield facilities. Look, we have a good level of confidence as we move to the back half of the year, as their investment continues in the Permian Basin, and we're seeing that tracking here in July already in line with the expectations for the back half.

Stephen Gengaro:

Okay. Thank you, gentlemen.

Operator:

Thank you. Our next question comes from the line of Kevin McVeigh with Credit Suisse. Please proceed with your question.

Kevin D. McVeigh:

Great. Thank you. Hey, just want to start out congratulating you, Andy. Definitely sad to see you go, and welcome Eric.

I want to get just any initial thoughts, Eric, from a strategic perspective, but before that just following up on the guidance a little bit, I guess Andy or Brad, just any thoughts on the seasonality in the business? It sounds like there's pretty good visibility with the larger customers, but just seasonality within the context of what gets you to kind of the midpoint of the range as opposed to the higher end of the range.

James Bradley Archer:

Yes, so this is Brad, and I'll let Andy jump in here too.

Kevin D. McVeigh:

Hey Brad.

James Bradley Archer:

How you doing? Truly, I go back to our business. We've always said this is a highly visible business. That's what's great about the long-term contracts, who we do business with, so that gives us the look out into the future. We feel very good about the back half for sure, and truly, I put it back to just our business. The contracts, the networks, the exclusivity gives us that visibility. I would add one piece. As I sit here today and look a little bit at July and what we're seeing and how that's trending, that also gives us a lot of comfort looking into full-year '19 on the guidance.

Andrew Aberdale:

Yes. Hey, Kevin. Andy here, and thank you for the—thanks. I appreciate it. Your question about seasonality is a good one, and we've always looked at our numbers to see if there's seasonality in the numbers, and we really don't see much seasonality, and it's sometimes also masked by our large growth. We have double-digit growth, so we don't really see it if it's there. It's also heavily taken care of because of our long-term take-or-pay contracts, so it's pretty stable overall, and as Brad said, it's—our Q3 is—July's numbers are shaping up to allow us to affirm guidance, so we're feeling really comfortable about 2019.

Kevin D. McVeigh:

Got it, and then just with this Signor integration, and then Midland and Superior, did those deals close, because I just—I'm a little confused why those beds aren't reflected in your numbers yet or the utilization, anything like that. It's not in the guidance, even though they closed, or I guess just the mechanics of that. Could just maybe clarify that a little bit?

James Bradley Archer:

Yes. This is Brad, and again, if Andy wants to jump in, in a minute, he's welcome, but look, we're very excited about the expansions of the network. These acquisitions, they're nice tuck-ins for us. As we have indicated, the financial contribution—and you're right, these acquisitions is not yet included in our 2019 outlook. What we are planning to do is give you more details on this next quarter, and here's the biggest reason we decided internally to not give guidance.

The fact is we're actively renegotiating some terms of contracts and service offerings at these communities, so for competitive reasons we prefer to provide you with an update on the financial impact, again, next quarter. In the interim, what we have provided is the number of acquired beds, the timing of the deals, and the building blocks of our revenue model, which we believe are reasonable tools to really get you an estimate of 2019 impact and run rate of these acquisitions.

Andrew Aberdale:

Yes. The only thing I would add, Kevin, is, as a reminder, you know us well. We're a growth story. We've historically doubled the Company every two or—roughly three years or so, so we're aggressively pursuing that same strategy with organic and inorganic work, and so we have to be very careful about disclosing too much information while we're in the middle of negotiations. To Brad's point about competitive reasons, we really don't want to share too much publicly, but you do have the model, the unit economics. I think it's Page 19 of the PowerPoint, the unit economics for everybody to make their own assumptions.

Kevin D. McVeigh:

It makes sense, Andy, and then just to clarify, there was—was there any revenue contribution in the quarter from these, or appreciating it's not in the guidance, but was there any impact from the deals in the quarter or they just closed too late?

Andrew Aberdale:

It was not meaningful at all, so we closed very late.

James Bradley Archer:

At the very end.

Andrew Aberdale:

I think it was June 30 or something (inaudible).

James Bradley Archer:

Yes.

Andrew Aberdale:

(Inaudible) the other closed in Q3, the beginning of Q3.

Kevin D. McVeigh:

Okay. Awesome. Thank you.

James Bradley Archer:

Thank you.

Operator:

Thank you. Our next question comes from the line of Scott Schneeberger with Oppenheimer & Co. Please proceed with your question.

Scott Schneeberger:

Thanks very much. Good morning everybody, and Andy, congratulations on your next step.

I guess I'll pick up where Kevin left off. I appreciate the financial guidance on the new addition not coming until next quarter. Could you please just give us an operational update though; kind of a progress report of each of the six new communities announced this year and procured however way, of where they are relative to what you were expecting? Just kind of give us a feel for where you are in the timing of each, and I don't know if you want to go this far, but when you think each might be ready for inclusion in the (inaudible), fully functioning, revenue-generating. Thanks very much.

Andrew Aberdale:

Yes. Thank you, Scott. Appreciate it. Again, thanks for the thanks. The new beds that we've announced, one was a 400-bed community, the other was a 200-bed community, and then we had also announced two 100-bed expansions of each one of those communities. We fully expect the beds for the new builds, which is the 200 and the 400-bed announcement, to come online late in Q3, and then the additional 100-bed and 100-bed expansions of each of those, the 200 total beds, on in late Q4. I'll leave it to everybody to make their assumptions there, but definitely with the proper ramp up of customers and bringing them into the communities, we want to at least indicate to you that it'll be late in the quarter, Q3, for the new builds, and then late Q4 for the expansion, and the key there—just a concept not many of us have talked about. The concept there is there's always a little bit of a ramp up, so even though a customer may know they want to open on a certain day, people—400 people don't show up on that day, and there's always a little bit of...

James Bradley Archer:

There's an operational ramp up for sure.

Andrew Aberdale:

There's always a little bit of a ramp up, and again, back to our growth story, we're really excited about opening these up. These are new nodes in our network, and as you can see, very similar to the past, and we're on the path of doubling these facilities, which is what we usually do.

Scott Schneeberger:

All right. Thank you. That's what I was looking for. I appreciate that. Shifting gears a little bit, the adjusted gross profit margin increase though, the ballpark of 300 basis points year-over-year over in the Government segment, and that was on the reduced occupancy compared to utilization, could you discuss that dynamic a little bit, talk about how frequent something like that occurred, the dynamic that you addressed, and how we should keep that in mind as we model going forward? Thanks.

James Bradley Archer:

Yes, Scott. This is Brad. I look at this business—this part of our business, it is the easiest to predict. There is a little movement up, but also down of a couple of basis points on a quarterly basis, and the reason is we don't—we get—as you know, we don't control, if you will, the occupancy there, but we get a set cost, so if it's a little higher, it's a little bit more food costs. If it's a little lower, we get a little bit of uptick there. What I would tell you, if you look at this as we look at the business on a full-year basis, it pretty much evens itself out if you look at history on this, so you'll get an up, you'll get a down, but it's pretty dang flat across year-over-year when you look at it.

Scott Schneeberger:

All right, so Brad, this would not be the quarter to extrapolate? Perhaps first quarter would be the better quarter to extrapolate as we model forward?

James Bradley Archer:

Absolutely. Yes.

Scott Schneeberger:

All right. Thanks guys. Appreciate it. I'll turn it over.

James Bradley Archer:

Thank you.

Operator:

Thank you. Our next question comes from the line of Jeff Grampp with Northland Capital Markets. Please proceed with your question.

Jeffrey Grampp:

Good morning, guys.

James Bradley Archer:

Good morning.

Jeffrey Grampp:

Was curious if you guys could talk high-level, or with any granularity you're comfortable with, second half cap ex expectations, obviously understanding it was presumably pretty front-end loaded, but just trying to narrow down how we should think about capital spend in the back half of the year, and part and parcel with that, just talk about your comfort level with the current liquidity position and any ability or interest in expanding the ABL. Thanks.

Andrew Aberdale:

Yes. Hey, Jeff. Andy here. We've given you the rough opening dates; late Q3 for the new beds for the 400-bed community and the 200-bed community, and then the additional 100 beds in December or late Q4. That's probably how you need to think about the capital spending. According to our unit economics, you know roughly a budgeted or a rough price per door per room, and you just need to spread that out 120 days before opening, roughly four months before opening, and you could spread it out however you assume you need to, but probably evenly is okay.

To your second question about ABL draws, we did an ABL pull for the Superior acquisition, and we don't expect to have to do any ABL pulls associated with these new builds or expansions.

Jeffrey Grampp:

Got it. Okay. Appreciate those comments, and my follow-up, was curious, it sounds like maybe this is kind of ongoing already, but to the extent we can peel the onion back on this topic a little bit more, conversations you guys are maybe having with some new customers that you may have acquired with the recent acquisitions, I'd imagine that there's maybe some opportunities to sell them into Target's broader network, so was just curious what the opportunity set is there and if those conversations have started yet?

Troy Schrenk:

You bet. Jeff, good morning. Troy here. Look, we're excited about the expansions in the network, and really expanding our exclusivity zones. As a reminder, we've—I think we've told you in the past that we look at those exclusivity zones as a potential high growth and low-risk catalyst for the business, and clearly as we have added several new nodes, we are in conversations with the existing customer base there, very similar to Signor where I would set the expectation that it's going to take some time to convert some of those customers that were on the spot market to longer-term Target Hospitality contracts, multi-year contracts, and those preliminary conversations are going well for those new acquired locations, so with that, again, Brad mentioned that we're in conversations with our customers in the Permian Basin, and—which gives us confidence for the back half of the year. Our core customers quarter-on-quarter have performed very well; very pleased with their performance, and expect to see more of that in the back half of the year as we now have new nodes to service those customers.

Jeffrey Grampp:

All right. Sounds good. Thanks for the comments, Troy. Appreciate the time, guys.

Andrew Aberdale:

Hey, Jeff. Andy here again. I just wanted to add something to the comments about the ABL availability. I think everybody knows, but I'll just remind you, good growth story, a lot of our Adjusted EBITDA converts to discretionary free cash flow; roughly 90% of it converts. Year-to-date we're probably roughly around $75 million of adjusted free cash flow, so we can support quite a bit of—quite a few of our growth initiatives organic or inorganic, and we're always exploring obviously the organic and the inorganic, but we're also exploring other opportunities like buybacks. We certainly can't go without noticing the stock prices certainly undervalued, so with our capital discipline we will always look at organic opportunities, inorganic opportunities, and other value-enhancing opportunities.

James Bradley Archer:

I think just to reiterate—this is Brad—I mean when you look at our business, just amazing free cash flow, great margins. It continues to trend nicely there, so just to Andy's point, we'll be disciplined in the capital,

but the way our business model works is it allows us to be very opportunistic in driving shareholder return for Target.

Jeffrey Grampp:

All right. Understood. Thanks for the comments, guys.

Operator:

Thank you. Our next question comes from the line of Ashish Sabadra with Deutsche Bank. Please proceed with your question.

Ashish Sabadra:

Hi. Thanks for taking my question. Maybe just a follow-up to a question asked earlier in the call around utilization. When I just looked at the utilized beds, multiplying the total number of available beds by utilization, I see the utilized beds was down modestly from first quarter to second quarter. I was just wondering if you could provide any color on that, and maybe it's (inaudible) but any color on that.

Troy Schrenk:

You bet. Ashish. Good morning. Troy here. Good question, and as a follow-up to what Andy said earlier, really performed as expected. I think it's important to point out there's really a fundamental strategic shift. On the Signor side with the Target side, we have always had tremendous visibility on our business, specifically revenues and earnings, as a result of having multi-year take-or-pay contracts, so when we acquired the Signor assets, they did not have the long-term visibility.

While they had contracts, they did not have the long-term take-or-pay contracts that would allow them the visibility, so over the last several quarters we have worked feverishly as a team to convert those customers that were shorter-term for Signor into long-term take-or-pay contracts, so that, as Brad said earlier as well, that can take upwards of anywhere between 12 to 24 months, and we still have work to do there, so as expected, we've seen the utilization tick down, as you say, and we're—and we continue to make good progress on converting those short-term contracts.

A couple of other things to think about, we've also added more beds. We've added more capacity to the Permian Basin, and I think Andy said it earlier, it's a function of really timing and mix, so while we're focused on converting these short-term contracts, there's also a timing—there's some timing nuances or noise related to customer movement from certain Signor lodges to other lodges, so look, overall, I think it's important to point out I'm very pleased with our ability to convert these short-term contracts into long-term contracts thus far. Yes, we have more work to do, and we feel confident about our ability to do that in the back half.

James Bradley Archer:

Let me add one piece to that, and Troy really hit on it. This is the Signor piece. I think, just so everybody remembers, we also were putting close to $20 million into these facilities. There was upgrades that were going on. There is one of those—we knew there would be a transition to get the contracts to longer-term where some of this would, if you will, one step back before you take three, four, five steps forward. That was expected, and I think it's a good thing. We're resetting our contracts at that—those Signor locations. The great thing is, when you look at it, it hasn't affected the margins. The contracted 86% is still holding in strong, so lots of good things there as well to keep taking us into the second-half and beyond.

Andrew Aberdale:

Ashish, real quick, this is just some additional color on this. I think it's important to point out, especially given the backdrop on some of the oil field service noise; this is not market-related. As a reminder, our business is secular, not cyclical, right, so as we think about this, this is really a function of being able to execute on integrating Signor into the Target model.

Ashish Sabadra:

That's very helpful color. In terms of the pipeline going forward, obviously you have a very good, robust six communities coming online in the back half of the year, but can you just talk about pipeline for more communities or further acquisitions going forward? Any color on that front?

Troy Schrenk:

You bet. Look, we're pleased, again, with the progress that we've made. Since the beginning of the year, we've brought on almost 2,000 total rooms across our network thus far, and that's a combination of new builds, organic—expansions organically, and as you know, some of the acquired properties, so look, I think we're tracking nicely against our goal of doubling the size of the Company once again over the next three years.

With that, our pipeline, both inorganic and organic, remains very much intact, and I will say that, look, as we think about the timing of these new communities either through acquisition or through build, it's prudent to say that the—as we've told you in the past, that they can move to the right. The good news is we've got a strong core customer base that continues to invest in the Permian Basin, and we've seen tremendous success by leaning into the integrated producers, as evidenced by the two announcements earlier this year with both a major and an integrated in the Permian.

Andrew Aberdale:

Ashish, Andy here. If I could just add something, as a reminder, as I said earlier, we're a growth story. Historically we've attempted and we've delivered on doubling the size of the Company every three years or so, so we have 11,401 beds available. Troy just mentioned us bringing on roughly 2,000 beds in probably the last six months or so, so we are driven by doing that, and that kind of leads me to a point on SG&A. We've really built our SG&A properly for the Company of today, but also the Company of tomorrow, so we know exactly where we're going.

We brought on the right talent. Our SG&A may be slightly inflated, even though I have to admit at under 10% it's probably at a world-class rate, but for the size of the Company today, we've spent an extra $2 million year-over-year, which, if we didn't spend it our $41.2 million of EBITDA would be $43.3 million, but we chose, knowingly, to spend that extra $2.1 million in the quarter to prepare us for where we're going over the next 12 months, or 24, 36 months.

Ashish Sabadra:

That’s very helpful, and thanks for the color, and congrats, Andy, for the next steps

Andrew Aberdale:

Thanks Ashish.

Operator:

Thank you. Our next question is a follow-up from the line of Stephen Gengaro with Stifel. Please proceed with your question.

Stephen Gengaro:

Thank you. Two quick ones; one, I know that you addressed this a little bit earlier. The cap ex needs in the back half of the year outside of the maintenance cap ex, and understanding sort of the unit economics of what you're adding, what are the other dollars that are associated with sort of updating and getting the Signor and other properties up to sort of the Target level?

Andrew Aberdale:

Hey Stephen. Andy here. That project is concluded, so the $20 million spend to upgrade the Signor communities to the Target standard, that was concluded in Q2.

Stephen Gengaro:

Is there incremental dollars to upgrade sort of the Superior Lodging facilities or others to...

Andrew Aberdale:

No.

Stephen Gengaro:

No? Okay.

Andrew Aberdale:

Sorry to interrupt you. Sorry. No.

Stephen Gengaro:

No, no, that's fine. That's good. Thank you, and then the other follow-up just quickly, can you give us just a quick update on the—I think the average contract duration was about three years, and the percentage of those which are under exclusivity going forward as we start to think about how the next couple of years unfold?

Troy Schrenk:

Yes. Stephen, this is Troy. Good morning. Look, our average weighted duration has—is unchanged. We still have tremendous visibility on a go-forward basis given the contract tenor.

Stephen Gengaro:

Okay. Thank you.

James Bradley Archer:

Thank you.

Operator:

Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I'll turn the floor back to Mr. Archer for any final comments.

James Bradley Archer:

Yes. In closing, I would just like to remind you that while Target Hospitality is a new public Company, we are very seasoned when it comes to operating our business. We have proven to be resilient in any type of market. The business, we believe, is a great one. It's battle-tested, but our people and our customers are even better. It is the combination which gives me full confidence that we will continue to deliver on our 2019 plan and beyond.

Again, thanks for joining the call today. We look forward to delivering on our third quarter results on our next call. Thank you.

Operator:

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.