Participants

Nathan Kroeker, CEO of Spark Energy (SPKE)

Nate Abercrombie, The Stock Podcast

Interview Transcript

Nate: Nathan Kroeker with Spark Energy, thank you so very much for joining the podcast.

Nathan: Thank you. It's good to be here.

Nate: It's good to have you, and I'm interested in your background. You've been with Spark for quite some time, and I'd be very curious to learn just a little bit more about how you came up to the industry and just anything you'd like to share about your time and experience with Spark Energy.

Nathan: Sure, Nate. I've been at Spark for a little over eight years. I've been in the industry for almost 15 years. My background prior to that was in public accounting, started with Arthur Andersen after college, then made a move to Ernst and Young in their transactions practice here in Houston. That was my first introduction to power generation and retail energy was with Ernst and Young. I was working on an acquisition that Direct Energy was doing when they bought their first combined-cycle plant here in ERCOT in 2004, working as a consultant, got on that deal, worked on it for about a week, and then the deal died.

Nathan: Then, started on my next project up in Philadelphia for two months, and two months of travel was wearing on me, and I got a call from the executive I had been working for Direct, asking if I wanted to come over and head up the finance function for their wholesale business. I said no about ... My preconceived notion was I did not want to work for a utility. I had a negative view of what it was like to work for a utility, so I just said no.

Nathan: After three or four weeks, he wore me down, and I decided to go for an interview, fell in love with the opportunity, took the opportunity, and four days after starting at Direct Energy, the power plant deal that I had worked on as a consultant was back on, so I spent my first several months buying that power plant, integrating that power plant, and then setting up a finance function for their wholesale business. That was in 2004. Since then, I've gone back and forth between the wholesale side of the business and the retain side of the business back both at Direct and then at Spark, so it's been a really good ride. Certainly, not boring, and it's a very exciting industry.

Nate: Yeah. I'm curious. Why did you have the negative view of working for a utility?

Nathan: I think growing up, and anybody that I knew, or had parents or family members that worked in the utility was unionized and had this mindset of like you start work at 8:15, you get a 13-minute break at 10:27, you got 40 minutes for lunch, and you're off at 3:20. That just did not sound appealing to me at all. I mean, I've always loved my jobs. I like to pour myself into them, and if that's what it was like to work for a utility, I wanted no part of it.

Nate: I see. Yeah. No, that makes sense.

Nathan: I can assure you, we don't quit at 3:20 at Spark Energy.

Nate: Yeah.

Nathan: Yeah. It hasn't been that at all.

Nate: Yeah, so could you tell me a little bit about Spark and especially the history. I am very curious to also hear a little bit about the founder and the relationship there.

Nathan: Sure. Spark was founded in 1999 by a gentleman named Keith Maxwell. Keith's background prior to that was on wholesale energy trading, had been doing that with several different companies prior to founding Spark in '99, and '99 was when they first started by buying gas in the Gulf Coast, moving it up on pipelines up to the Midwest, and selling it to commercial customers, and optimizing the transportation assets.

Nathan: 2001, when the electricity market opened up in Texas, they saw an opportunity to giving to that market. From 2001 to 2014, business really grew by entering one or two new states every year. As markets deregulated, they just expanded their footprint. It was definitely a build-and-operate philosophy. Keith is a classic entrepreneur, has half a dozen different businesses at any point in time, and really didn't have a history of M&A prior 2014, so that's the background.

Nathan: The business that we operate today that we talk about today really took its form in '14 after taking the company public. Took it public in '14, got that public currency, saw an opportunity for consolidation in the space, and from '14 to today, we've really grown largely through M&A and consolidating in the space.

Nate: The corporate structure, the ownership structure of Spark is maybe a little bit different for many investors out there. Could you just describe how the ownership of Spark is structured?

Nathan: Sure. It looks complicated on the surface. It's called an Up-C structure. It's modeled after the Up-REIT structure, which had some popularity in the real estate industry. There's actually quite a few energy companies that have gone public through an Up-C structure. Plains is one of the large ones. I believe Shake Shack, although not energy. It's one of the famous UP-C structures out there today, but what it is. We were always an LLC, and when you have a single member owning the LLC, that's the most tax-advantaged way for endowment.

Nathan: When you take that company public, we wanted to figure out what's the most tax-advantaged structure both for our majority shareholder as well as for our new public chair holders, so we created a new corporation, Spark Energy Inc., took 100% of Spark Energy Inc. public, took the proceeds from that IPO, and bought an interest in the LLC, the operating LLC.

Nathan: The way we are operating today, Spark Energy Inc. owns 38% of the LLC, and Keith Maxwell, our founder and chairman, owns the other 62% of the LLC. Both owners still get benefit on the tax side. Mr. Maxwell avoids the double taxation on his share of the earnings, and the public investors get the benefit of a step up in the basis for all the membership interests that they've acquired both at the time of the IPO as well as any subsequent membership interest they've acquired in the LLC since 2014, so both sides get the benefit of the low tax rate.

Nate: I see. Okay.

Nathan: From a reporting standpoint, it's a fully consolidated subsidiary, so everything that we report always has 100% of the consolidated entity. We operated as one business, so day-to-day operations, we'll just think about it as one operating entity.

Nate: Yeah. Okay, and how has Mr. Maxwell's percentage or stake in the LLC changed over time? Has it maintained that ... Did you say 64% interest in the LLC?

Nathan: When we originally took it public, he retained 78%. The public owned 22%. Instead of a number of small transactions, one secondary offering, today, he owns 62% and the public owns 38%.

Nate: Okay.

Nathan: He's always retaining the majority.

Nate: Yeah, and what are his plans? Just curious. If he's a big shareholder, then he obviously has a very vested interest in making sure that the company does well, but I'm just curious what his plans are longer term. Is he going to gradually sell down part or at least allow further dilution in his ownership?

Nathan: I can't speak definitively for what he intends to do over time. What I will tell you is, as I said earlier, he is an entrepreneur. He's got a half a dozen other businesses other than Spark. All in the energy business. Although, not directly related to what we do at Spark. They're all in various stages of growth. Some are pre-cashflow, some are post-cashflow, so it wouldn't surprise me if he elected to redeploy some capital at some point down the road. He's had an incredibly good run with Spark over the last 18 years, and I wouldn't be surprised if he decides he wants to reallocate. I'm not sure what that looks like. That might look like him selling down. I know he does not have any desire to be a small shareholder in the public company. I think if he stays in, he would like to have a significant portion of the ownership.

Nate: Yeah, so could you talk about your asset portfolio? What assets does Spark Energy own?

Nathan: Our primary assets are really employees, customer contracts, licenses, and then the systems in order to operate the business. It's a very asset-light business. All of my assets are primarily working capital type assets. We work with third-party vendors on the sales side. Now, we buy wholesale energy from wholesale counterparties, and we use third-party vendors for some of our customer care and billing operation, so it's a relatively asset-light business. We've got 170 employees approximately supporting over a million customers.

Nate: Wow. Could you talk about the markets that you're in? You're a retail electricity and natural gas provider, and so did you start out in Texas, and then you grew from there or?

Nathan: Started in gas originally in '99, got into Texas in 2001, and then from 2001, we've been adding one or two states in a year. Not every state is deregulated in the US, so we're currently in 19 different states, and what I would tell you is we're in all of the deregulated states that we want to be, and today, the one possible exception could be Georgia, which has a very healthy gas market. We're not in there, but otherwise, all of the states that have good regulatory environments for competitive retailers, we're currently in. We're behind 94 different utilities. There are a few utilities within our 19-state footprint that we could expand into, but broader market expansion is not a critical of our growth strategy going forward.

Nate: Yeah, and I would love to talk or hear more about your strategy going forward, but just to get a better sense for not only the markets that you're in, but market structure. Could you describe ... How would you characterize the retail market or just the retail space in general, and who are the big players?

Nathan: You have the Texas marketer ERCOT, and then you have everything else, and they operate differently. In Texas, when Texas became regulated, they created a pricing mechanism that would create these artificially high prices for a period of four years to incentivize customers to leave and switch to a competitive supplier. Since 2006, there has been no form of regulated in the market. Every retailer bills their own customer, has flexibility in how they price their products, and also, collects the transmission distribution charges from the end-use consumer and turns around or remits it to the poles and wires company.

Nathan: In Texas, every retailer owns the relationship, the monthly billing relationship with the end-use consumer. In virtually all of the other markets that we operate in, there is still an incumbent utility with the regulated rate, so rather than thinking of our competition as all the other small retailers in a particular market, we position ourselves against that incumbent utility, and the reason is in the majority of these states, the incumbent utility still has more than half of the customers, and that is on a regulated rate, so a lot of times, when we're going out with sales campaigns, we're positioning it as either a savings, or a stability, or some message relative to that incumbent utility.

Nathan: The Utility still bills in those markets. It's a utility-consolidated bill. We submit our rate information or our data to the utility. It goes on their bill. They bill. They collect. In most cases, they take the customer receivables risk, and they turn around and remit to us our portion of that bill, so in more than two-thirds of our revenue, I don't have end-use consumer credit risk. Theoretically, I've got credit risk from the investment grade utility, so that's a real positive from that standpoint.

Nate: Yeah. I'm curious what is ... How are things changing in ... Well, I guess everywhere else outside of ERCOT just in terms of the regulated utility's ability to ... I guess how sticky are customers in those other footprints, in those other markets where the regulated utility is just so much more involved in the retail process or owning the customer?

Nathan: If you look at our attrition percentages state by state, we don't publish this, but generally speaking, they're pretty consistent across markets. There's not a dramatic difference in customer attrition in the Texas market relative to our other markets, so a lot of our attrition is customers moving or other retailers calling them, and so there's not a material difference between markets.

Nate: Yeah. Okay.

Nathan: There's definitely a higher level of consumer awareness and consumer understanding in a market like Texas. It makes it more competitive. I think if you're a very, very informed consumer and you're fully engaged in the process of buying electricity for your home, I believe in Texas, you can be buying electricity at very, very low margins or even at cost if you're actively involved in it, so I do firmly believe that competition has been great for end-use consumers in the more mature markets. Now, if somebody is not engaged or not paying attention and doesn't fully understand, those are great customers too, but in order to really take advantage of those low prices, you need to be very involved as a consumer.

Nate: You mentioned customer awareness and how it's higher in Texas or in ERCOT. Is that because ... or why is it that you think customers there are just more aware?

Nathan: I'd say there's probably three reasons. One, it's been longer. Two, the commission in Texas in the early days, 2001, 2002, actually put a surcharge on everyone's bill to raise an education campaign fund, and they actually had a consumer awareness or consumer education campaign, whether it'd be TV commercials, billboards, magazine ads, et cetera, that were publicly funded in order to educate consumers on the fact that they had a choice, so there was a big push for that in the early days.

Nathan: Today, it's really ... You have dozens if not hundreds of different retailers with hundreds of different products available in ERCOT, and there's a lot of activity, a lot of advertising, a lot of switching, and people just fully understand it. I mean, it's just part of what you do. Just like you shop for a new insurance provider periodically in your state, people here shop for a new electricity contract periodically.

Nate: Yeah.

Nathan: It's different in the markets where there's an incumbent utility because somebody could just ignore the fact that there's competition and continue to pay their regulated utility bill and never be aware that they have a choice, and so part of what we do in those markets is we start the conversation with the potential consumer by explaining this, "Realize you have a choice. Here are the benefits. Here's the value proposition. These are the types of products that are available to you, and no, system or liability is not a concern. You're still going to get your electricity or your gas on the same distribution system that you otherwise would have received it." We do spend a lot more time educating consumers outside of Texas.

Nate: Now, that's interesting. You mentioned hundreds if not dozens of competitors, and I only bring this up because one of the things that ... Well, you may or may not know this, but I ... When I was on the buy side, I covered the IPPs, and I think energy was the first one to really start highlighting their retail business, the ability to generate cashflow from their retail business, and I think the pushback from at least some analysts was that barriers to entry in retail are extremely low, and it was just viewed as a potential headwind. There's no mote for a retail electricity provider, and so I would like to ask the question, what it takes to build an electric and natural gas retail business?

Nathan: Okay, and to your point, one of the things we often explain to investors is that the perceived barriers to entry are very low. The barriers to staying and growing are significant, and so if you look at what you're referring to in the early days with energy, I mean, I don't ... I'm guessing that conversation could have been 10 years ago, and here we are. Retailers are still realizing healthy margins, mature businesses, and the industry still continues and still throws off a lot of cashflow.

Nathan: I hear what you're saying, but to get back to your question, what does it take to build? I mean, you need a strong sales team. You need a way to get customers' attention. Like I said, outside of Texas, you got to explain that customers have a choice and start there. You definitely need a knowledgeable experience supply team that's very comfortable in the wholesales markets both on the term, the day-ahead, the cash markets, and others to protect the margins that you're selling.

Nathan: You got to have a balance sheet. You need plenty of capital, and a lot of times, this is what people underestimate. You need plenty of capital to provide the liquidity through the cash cycle, and then also, to manage then some of the adverse weather events that we have in the space. IT infrastructures or partners systems. There's massive amounts of data in this business. You need a strong customer service team either in-house or outsourced who can take care of customer questions and make sure that we don't have any complaints, and then obviously, an experienced legal and regulatory team dealing with the various commissions. All the rules that we abide by are all at a state-by-state level, so in a business like ours where we're in 19 different states, it keeps our regulatory team pretty busy.

Nate: Yeah, I would imagine.

Nathan: The notion is, "Hey, I've got a few million dollars and two buddies. I'm going to start a retail company." Yeah, you can do that, but you're going to be capped on how much you're able to grow that retail company unless you have these other building blocks that I just talked about.

Nate: Yeah, absolutely. What about trading? Do you guys do any trading? Do you have a trading group that is responsible for keeping an eye on prices and figuring out where to arbitrage or where to hedge?

Nathan: Yes and no. We have a supply group, and our supply group is primarily tasked with locking in the margins that we structured into the products at the time we sell those products. You mentioned the word "arbitrage." We're not looking for arbitrage opportunities. We're looking to lock in the margins we sold to our end-use customers. In the course of doing that, I have guys there in the market every day buying and in some cases, selling electricity and natural gas, but they're not doing that to make a profit on spec trading or proprietary trading.

Nathan: What they're really trying to do is make sure that they've got the best match between the hedge portfolio and the retail portfolio accounting for customer attrition, new sales, weather events, seasonality, and that sort of thing. We call them traders internally, but if you ask them, they don't do anything near what the traders do in some of the wholesale trading shops around town.

Nate: Yeah. Okay. Could you talk about the retail business? There's a lot of hedging involved, and I would really appreciate hearing you describe how hedging works in your industry, and you're talking about locking in margins, so let's just assume that Nate Abercrombie went out and signed a contract, won your contract for a fixed-price price per kilowatt hour for electricity with Spark. What is then your responsibility or your team's responsibility to lock in that margin?

Nathan: Okay. The first thing for people to understand is that electricity prices in the wholesale market are not consistent around the calendar year. They vary by season. They vary by days of the week, and they vary by hours of the day. When I'm turning around and selling you a 12-month fixed-price contract, I'm buying that supply for next to nothing on nights and weekends. I'm buying it for less money in the spring and the fall than what I would be paying for it in the winter or the summer, and I'm paying a lot more for it at 4:00 in the afternoon in Texas in the summertime than I am at any other time of the day or the calendar of the year.

Nathan: A lot of people, even friends of mine, don't understand that. They think, "Well, I'm paying one rate all year long. It must cost the supplier that same rate all year long." It doesn't at all, so what we do, when we go sell that 12-month fixed-price contract, we go out into the wholesale market and we will buy 12 months of electricity at the time we make the sale, and it's not feasible to do it on an individual customer basis obviously, but we get hundreds of customers signing up every day, and we do it in blocks.

Nathan: Theoretically, we're buying the supply at the time we make that sale, and then as we get closer to the season, let's say I signed you up today, I know exactly what your usage profile looks like. As we get closer to the season, I'm going to continue to refine the shape. Meaning, I might sell off some of the mornings and buy more afternoons, or I might buy some nights and weekends or that sort of thing. I'll change the shape of that hedge over time by selling pieces back and buying different pieces, and then I get into the cash month or the flow month. At that point, I'm actually looking at daily weather forecasts, and I'm going into the day-ahead market, and I'm buying hourly power or selling hourly power to try to get the best match that I can to how I believe you're going to use electricity for tomorrow. Whenever I'm off on that day-ahead forecast gets settled in the real-time market at whatever the real-time clearing price is for the market.

Nate: Okay, and what are the differences between physical ... and I bring this up just in case any of the listeners take the opportunity to tune in to some of your earnings calls, but you do mention physical and financial hedges. Could you just describe ...

Nathan: Yes.

Nate: Could you describe what those differences are and what they also mean from a collateral and cashflow or I guess working capital perspective?

Nathan: Sure, so really, we use physical and financial hedges almost interchangeably most of the time. Certain markets have more liquidity on physical. Other markets have more liquidity on financial, so we'll use whatever is best. They do have some different characteristics as you've pointed out. A financial hedge is nothing more than a derivative instrument that we buy on and exchange where we fix the supply costs of buying that commodity at a future price, and if the price settles above or below that mark, there's a cash payment that we either make or receive with the counterparty of that derivative contract. The financial hedges, because it's just a derivative contract, I actually end up buying the physical commodity or the electricity from the ISO ...

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Nathan: ... or commodity, or the electricity from the ISO, at whatever the price is at that point in time. I've locked in my margin because of derivative contracts, but when actually I'm buying the physical, I'm paying whatever that they had, or the prices at that point in time. Because of that, I have to post collateral with the ISO, based on how much physical I'm procuring from the ISO.

Nathan: What I said on the last earnings, or couple of earnings calls ago, is we had the majority of our load in New England, hedged with financial contracts. Because contracts tend to trade more efficiently than physical, so I can avoid a little bit of that physical premium. The downside is, they have higher collateral requirements to the ISO. And so, what we did last winter, you'll recall, one of the things I said was, "Okay, we're unwinding physical and ... I'm sorry, unwinding financial and replacing with physical."

Nathan: A physical hedge is where I'm buying physical power directly from a counter party and I'm taking delivery of that energy, or of that electricity at a future date, and that provide to my customers. By doing it directly with the counter party, I've got collateral exposure with that counter party as opposed to the ISO. The vast majority of cases, we're buying physical commodities from counter parties, with which I have open lines of credit. So, for me, there's very little collateral requirements, because I'm utilizing open lines.

Nate: I see, that makes a lot of sense. So, you mentioned the winter that we had this past December, in 2017, and, obviously, the polar vortex, that was another period where there were really high prices because of extreme demand, because of the cold weather. Could you just talk about this pricing dynamics during ... call it extreme weather events, and what that means for Spark's margins and cash flows?

Nathan: Sure. When you have those extreme weather events, what's happening is, the system ... The electricity is pretty much generated from natural gas, in those markets, or at least natural gas is on the curve, or on the margin for setting prices. When you have extreme cold like that, you need additional gas to come in, both for heating load as well as for power generation. You see price spikes due to system constraints.

Nathan: So, you have additional volume that consumers need because of the cold weather exacerbated by the fact that the system constraints are causing price spikes in the market at the same time. The ideal scenario for us is a winter that is a few degrees colder than normal, or a summer that is a few degrees warmer than normal, so that customers have the additional consumption, but not so much more that it puts those ... strains the physical infrastructure to the point to get the price spikes.

Nathan: The polar vortex, in 2014, a bomb cycle that we just had here in 2018, those were extreme weather events. Consumption went way up and prices spiked in the market at the same time, which was a double whammy.

Nate: Yeah. And as you think about how you structure your contracts and agreements with customers, do you incorporate ... I guess, how do you plan for extreme weather events? Is it completely on your supply team that has to deal with those types of events, or is there some way that you can structure your agreements with customers in such a way that might protect you?

Nathan: On the commercial side, you can have swing provisions in your contracts. Meaning, if you got 10% swing, 25% swing, here's your price if your consumption is plus or minus 10% from normal or plus or minus 25% from normal. If you fall outside of that band we have the ability to pass your incremental cost to you. So that's a very common structure in the industry. The residential side, I don't believe anybody has that structure on the residential side. If you sell a fixed price contract to a residential customer the onus is on us to manage the weather risk.

Nathan: We always like to have a portion of our customer base on variable price contracts. Fixed price contracts provide us with a little more predictability and stability of cash flows, more ability to go out and hedge and lock in those margins, but variable price contracts allow us to pass through any of those unanticipated price spikes. So from a risk standpoint or a diversification standpoint, we like to have both in the portfolio.

Nate: And what's the ideal mix in your opinion between fixed and variable? And if you don't mind, I would appreciate just an explanation of what ... fixed makes sense but the variable price contracts is it just purely, you earn a set margin or how do you determine what the variable price is?

Nathan: On the residential side it's a month to month price that's based on our underlying costs and the profit that we need to make on that customer. We don't tie it to a specific index, there's just too much data on the residential side. On the commercial side we do have some index plus contracts on the commercial side but on the residential side there's more flexibility in terms of how we price those contracts.

Nate: Okay. All right. And then is there an ideal-

Nathan: And the ideal mix, there are certain markets, historically I would have told you 50-50 or 60-40, fixed to variable. There are a couple markets like Connecticut now, that we're not allowed to do variable price contracts anymore so we only do fixed price contracts. What we do in markets like that is we have shorter term fixed price contracts, maybe three months or four months. So we'll do it four months fixed and then if there was some sort of an event I can just adjust the price for the next four months so that now we consider that to be fixed price but it behaves a little bit more like a month to month contract. In an ideal scenario I would like to have at least 40% of my book on contracts that give me the ability to pass through price increases within a 90 day window. So I'll take a three month fixed, that gets you there.

Nate: Yeah. We've talked about weather, that obviously impacts prices but then ... I'm fascinated by power markets and just the electric power industry and one of the other big components is supply. I would love to hear what your current thoughts are on the, call it mid to longer term outlook on electricity supply and demand, and just how that translates into how you're thinking about the longer term outlook for margins and cash flows for Spark Energy.

Nathan: Okay. I think it's very positive. If you look at historically, we saw a big run up in gas prices in 2008, 2009. Then when ... with horizontal drilling and fracking in that time period all the sudden gas prices went from 14 dollars to four dollars within about one year. That was transformational time in the electricity industry and in most markets electricity prices follow natural gas prices. So you saw electricity prices fall, dramatically in about a one to two year timeframe. Most of the utilities that we compete against and have procurement strategies that require them to buy electricity one, two or three years in advance, and it's all regulated. So in a declining commodity environment like that, we have a multiple year period of time when we get to go in and undercut the utility just because we're able to but at prices that are already lower and the utility's still stuck with the higher priced long term contracts that they have.

Nathan: That's the ideal scenario as a retail energy company. A lot of competitors got in, made a lot of money in that period of time. What we've seen in the last five to seven years is a more prolonged period of lower stable commodity prices. And we've demonstrated that we can make very healthy margins in that period of time as well, can't grow quite as quickly, but definitely can have strong unit margins and strong profitability in that period of time.

Nathan: I would love to see some more volatility come into space. With electricity price volatility, I can demonstrate value to consumers and when there is volatility in electricity prices, utilities have to change their price because it's formulaic. New York as an example changes its price every month. So when there's a cold weather event and a price spike in New York, consumers in New York see a price spike on their bill from the utility. If they signed up with us they get twelve month fixed price, we hedge it and they get a benefit. So the more volatility, the more I can demonstrate value.

Nathan: The next piece, I don't think everybody fully understands, is with all of the push to get rid of coal and nuclear, all the baseload generation this country, and have it replaced with wind and solar, it increases volatility in the markets. A lot of people assume wind and solar is free, well, wind doesn't blow all the time and the sun doesn't shine all the time. So if you're relying on wind and solar and all of a sudden the wind quits blowing you'll see an immediate price spike in that market. ERCOT or Texas this summer was a classic example of that. There was a lot of fear in the market because reserve margins were tight, a lot more wind and solar in the generation stack, and so people were anticipating huge price spikes in the market. And that was already reflected in wholesale pricing back in April-May-June timeframe leading up to the summer.So in situations like that I think we can really demonstrate value to consumers and I think that's good for us long term as an industry.

Nate: Yeah. Now that's really interesting to hear because one of the things that I fairly, consistently heard from some of the operations guys from the independent power producers that I covered was that once you see a lot more volatility in wholesale power prices, you'll probably also see quite a few pure play retail electricity providers struggle because, maybe they're not as big as a company like Spark Energy who has the ability to ... and the balance sheet to deal with price swings like that. But it's interesting to hear you say that you know the volatility is something that you're anticipating and looking forward to because over the mid to long term it will be ... it's an opportunity for you to demonstrate the value that Spark Energy provides. From your perspective is that more relative to other retail providers or is that also to the incumbent regulated utilities?

Nathan: Well, so two thoughts. The incumbent regulated utilities have a formula for how they set their rates. Some of them change their rates on a monthly basis, some are on a quarterly basis, some are a couple of times a year, each one is different. They're governed in terms of how they set their pricing. That's why I gave you the example of New York which changes on a monthly basis. We're able to come in if they've had a high priced month, we can go into their market and say, "Hey, listen, you could have been with Spark Energy and had a fixed price for the last twelve months, and not had the price spike that you had from your utility." So that's really what I'm saying on that front.

Nathan: The other piece of your comment though, price of volatility makes it difficult for the small retailers. Following the polar vortex in 2014 we saw a lot of retailers get acquired. In a lot of cases they had run out of collateral, their sleeve provider was not willing to extend them any additional credit, they underestimated the level of financial resources it was going to take. A lot of them were either forced or voluntarily decided that they didn't have the stomach for that business and went out and sold their businesses.

Nathan: Frankly a lot of acquisitions that we did were exactly that story. I think if you have the balance sheet and you have the credit support, you can really realize good value in that scenario, but to your point, if you don't have the balance sheet, it's going to be difficult.

Nate: Yeah. Did you see a lot of smaller struggle after this past winter?

Nathan: We are just now starting to see it. We're just now in the last, probably three to four weeks starting to see companies come up for sale. It takes a little while for that to work its way through the system. But I can fully appreciate it. We explained on our earnings calls that weather event was was a tough one for Spark to get through. We managed to do it, and we're going to be a stronger organization forward, but it was a five standard deviation weather event in some of the markets in which we operated, it was big.

Nathan: Wow! Five standard deviations. I didn't realize it was that severe. So one of the other things that ... again sorry to go back to the independent power producers but, one of the things that they touted was the fact that they had the generation and the retail business which created, I don't know if you could call it a synergy but they were complementing businesses. Do you think that there is ... I mean is there any need ... I guess, what are the benefits of having generation in your perspective and you know would you ever own a generation facility?

Nathan: So there's ... I think there are benefits. I get a lot of questions on this. I don't believe there's any reason to own generation from a supply perspective. There's plenty of liquidity in all the markets in which we operate. First to hedge our exposure in the wholesale markets. So from that standpoint, no reason at all. We're not big enough, none of the retailers are big enough to need to own generation from a supply standpoint. The main benefit I see from pairing generation with retail is the reduced or offsetting collateral requirements. So there is some efficiencies there particularly around capacity markets and things like that. But in terms of Spark going out buying generation, it's difficult for us to do. If you look where the generators are trading in terms of EBITDA multiple, and you look where Spark is trading in terms of EBITDA multiple, it's very difficult for me to buy generation. Would be much easier for a generator to buy a retail book at a lower trading multiple and tuck that into their portfolio. But I do think there are benefits from having those two businesses together for sure.

Nate: Yeah. Okay. That makes sense. So we've talked a lot about electricity and we haven't talked about natural gas and it's a quarter, roughly a quarter of your business. Well, could you talk a little bit about just the natural gas retail business, and is it ... should I think about it just along the same terms of the same way that I think about retail electricity? And if not, what are the differences and what are the benefits for Spark to have a growing natural gas business?

Nathan: So, it is similar in the context of, it's a commodity that we buy wholesale and sell retail. One of the big differences in natural gas is you can store it, so you're not as exposed to the short-term price volatility. We do manage a lot of transportation and storage assets, so, it's a little bit more labor intensive from that standpoint. But we also are able to optimize that and realize some additional value.

Nathan: I think the real benefit for us is, for whatever reason, gas is a lower interest category for consumers. And it's a smaller share of any individual consumer's wallet, so it's harder to get the customer's attention for a gas sale. But once we do get it, we see lower customer retention and higher customer lifetime value. So, a lot of what we're doing is, we lead within electricity sale, but in our dual fuel markets, we try to get both commodities at the same time, to share that apparent selling cost, and then have two contracts with the gas contract typically being more valuable to us, over the life of the relationship.

Nathan: That's why it's complimentary, and it enhances the profitability of that customer relationship significantly if we can have the dual fuel. Some of the acquisitions that we've done were electricity only in some markets. So, one of the instant benefits we got is by taking those electricity customers and pairing it with the Spark Gas contract at the time of the sale, and increasing the value of those relationships.

Nate: Are the margins similar between natural gas and-

Nathan: The margins are better.

Nate: Oh, they are.

Nathan: The margins are better on the gas side. If you look at the margins on a per RCE basis, which is the best way to normalize across the two commodities, the margins are definitely better on the gas side.

Nate: I see. Okay. So, your proportion of natural gas to retail electricity has come down a little bit, and is that because you've just been acquiring more not retail electricity companies, or is there another reason?

Nathan: No, that's exactly right. That's exactly what it is. There's a lot of retail energy companies that are out there, that are up for sale, there's very few natural gas company that are out there and not for sale.

Nate: And that's probably because margins are better and attrition is lower?

Nathan: Exactly, it's not as noisy, right? It doesn't get the same regulatory focus, doesn't have the same collateral requirements, doesn't have quite as much price volatility. You know, the reasons that we talked about earlier, for why companies came up for sale in '14, and are starting to come up for sale now in '18, all driven by the extreme weather events and the collateral requirements, and squeezing some of these players out. You just don't see the same thing on the gas.

Nate: Yeah. So, you have been talking about, recently, in your earnings calls, the integration initiatives you've started. Could you just frame up at high level, how many companies have you acquired, and what you're doing to integrate those companies?

Nathan: Sure. We've gained 13 acquisitions in the last four years, since we went public in '14. For us, when we buy a company, the first thing that we do is, we take out the supply agreement, or the credits leave agreement. That's an instant synergy that we can realize. We'll take over the treasury function, and the accounting functions pretty quickly. We then move into the operations and we get all of their billing data into a common data warehouse, which feeds into load forecasting and accounting.

Nathan: The pieces of it that will take a little longer to integrate would be the sales and the marketing piece, as well as the actual billing system. And the reason we don't touch the billing system, or haven't, historically, is, that's the piece that touches the customer, and we don't want to disrupt that customer relationship, because it's so valuable.

Nathan: So, with 13 acquisitions under our belt, as you can imagine, we have quite a large number of different billing systems and different sales, and marketing activities out there. So, with the natural pause in the M&A market that we saw in late last year, coming into this year, we said, "Let's take a look internally at the deals we've already done, and see if we can realize additional value out of that."

Nathan: We're very confident that we're going to be able to get an additional $20 million worth of savings out of the acquisitions we've done today. Which $20 million would be a significant M&A opportunity if we were going to go out and buy a company throwing off $20 million. So, that's how we're looking at it, which is the same level of effort to get the cost out, is to buy another one, let's go do it and get the benefits.

Nathan: To where that money's going to come from, or where most of it has come from, we've already realized 15 of the 20, and we're working on the last five, with a number of discrete initiatives. But a lot of it is shutting down physical office locations, letting some of those employees go, and consolidating all of the operations on the decision making here, at our head office in Houston. That was, just the headcount reductions alone was about $11 million. We've been renegotiated, based on just volume discounts, with some of our key vendors, that was another $4 million.

Nathan: So, there's $15 million that we are going after. The remaining five is going to come through consolidating all these different billing platforms, spend a few other service providers, but a lot of it was on the billing platforms. And we're in the process, right now, of consolidating our billing platforms, and that's probably a two year initiative, but we're going to be going from largely 13 different instances of billing platforms, down to two or three, by the end of '19. And that is going to simplify our business immensely, and going to result in additional cost savings.

Nate: Yeah, $20 million is significant for a company that generates $100 million dollars of EBITDA, I mean, it's 20% of your EBITDA, right?

Nathan: Yup, yup. No, you're right, it's a big number, and that's why we're going after it.

Nate: Yeah, okay. So, M&A, you mentioned the depressed multiples today, and I would like to get your thoughts on valuation of your own company. But at, roughly five times EBITDA, what are the valuation multiples that you pay when you're considering buying another retail business out there?

Nathan: The first thing that I think you need to understand is that most, if not all of the M&A transactions that we've done, have been some sort of a distressed situation, or motivated seller. I don't believe any of them have been in auction processes or bidding processes, they've all been in situations where we're working bilaterally with a seller, to try to untangle some complexity, or move quickly enough in order for them to salvage some value in a distressed situation.

Nathan: What we've seen is that, we've paid somewhere between three and four times EBITDA, on on the situations where it's more of a platform purchase. Where we've bought books of customers, we don't even look at it on an EBITDA multiple basis, because it would be so small. We look at it on a per customer basis, and we just do individual discounted cash flows models for those. In those situation, where we're paying three or four times, the synergies that we realize in the first 90 days, typically bring that purchase price down, about one turn.

Nathan: So, from three to four turns, we're taking it down to two or three turns. Post synergies, or post initial synergies, that's what we're seeing now in the marketplace. If you were to compare that to how I think Spark is valued, first off, some of my competitors have paid significantly more than four times, for some of the transactions that have been done over the years. But those are more competitive bidding process. I can't comment on how they're realizing the value on this.

Nathan: I think, when you look at a company like Spark, or where we trade, I mean, we're a platform that's poised for consolidation in the space. There's a lot of economies of scale to be realized, and we can continue to grow. Most of what I've bought to date has been some sort of a-

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Nathan: Most of what I've bought to date has been some sort of a distressed seller. Like I said, but we're able to get it for a significant discount.

Nate: Yeah and just longer term, what does the landscape look like in M&A land. Is the sky the limit? I saw a couple of slides where you were showing essentially what sparks market share, at least your percentage of the consumer's who are in deregulated markets and you showed a very small number, low single digits if I remember correctly.

Nathan: Yep.

Nate: And so I guess just what is the longer term outlook from an M&A perspective? Horizon is just endless?

Nathan: Keep in mind there used to be a significant number of what I would call mid-sized retailers out there. Mid-sized retailers being 20-40 million of EBITDA 200 thousand, 400 thousand customers, some place in that range. We bought several of them. We bought several of them. We bought Provider, we bought Verde, we bought Major. Zoom, US Gas and Electric, North American those were other names out there that you'll see have been recently acquired by some of my competitors. So a lot of those mid-sized companies now have been acquired. You still have a long list of smaller players out there that are perfect for doing tuck-in acquisitions right now and realizing the economy's a scale. Some of those small guys will continue to grow and be mid-sized companies in the next couple of years. We are seeing some significant growth in some of those players.

Nathan: I think the M&A opportunities are going to be out there. They are cyclical. You see them come in waves. Our view is that it has slowed down right now and that's why we're focused internally on getting more efficient and stabilizing the platform to support the next round of growth and it's a welcome break frankly for the team, but I think there'll be another round of consolidation in the next couple of years and we're ready for it and looking forward to it.

Nate: Could you talk about organic growth?

Nathan: Sure. For the last couple of years, we had pulled back on organic growth just because we saw such an opportunity to go after the M&A and we were conserving capital dollars on the organic side to focus it on the M&A side. What we said publicly here in the last couple of quarters is we're shifting back to some organic growth and we're actively doing that now. We're ramping up our sales channels, expanding across footprints, in addition to all the consolidation efforts we were previously talking about. So we're going back to focus on the mass market, organic side of the business which is really the core business. It's what we were prior to a few years ago when we shifted to doing more M&A.

Nate: Yeah and what has organic growth been just call it the last 12 to 24 months?

Nathan: We've not been growing the business organically over the last 12 months.

Nate: Okay.

Nathan: We've actually been shrinking from an organic standpoint, like I said, focused on the M&A side, but I would anticipate in the next several quarters you'll hear us talking about organic growth once again.

Nate: Could we move to financials and talk about, I guess first off the balance sheet, and I'd love to hear what balance sheet metrics you pay the closest attention to.

Nathan: Obviously I pay attention to the ones that my banks care about. As I said earlier, we've got a very asset-light model, very low leverage. We're well below two times levered on this business and I think if you think through that it gives us a lot of flexibility in terms of being able to be creative in how we deploy capital going forward. I think the business could stand to lever up a little bit more. I'm not afraid of a little bit more leverage, but again, it's always going to be a fairly low leverage model for us.

Nathan: The primary capital needs for us is really around funding our working capital and funding our organic sales activities. We're committed to paying our dividend. We've been paying it for the last four and a half years. We continually signal to the market that we don't anticipate any changes in that dividend policy. For the last three years, we've been making significant sellers' note payments or earn out payments. All of those will be behind us by June of '19. This business will really start to throw off cash flow from that point forward just because all those payments and sellers' notes and things will be behind us and all that cash starts to accumulate.

Nathan: The good problem that we're going to have next year is figuring out as a board where do we want to allocate that excess capital and that'll be ... We'll be coming out with more updates on that over the coming quarters.

Nate: How much do you pay in earn outs and other payments to acquisitions that you made?

Nathan: It varies by month and it varies by deal, so over the last several years we've paid out several million dollars a quarter probably on average. It's all been publicly disclosed. I can't sit here and tell you exactly just because it's pretty lumpy. Some of them are annual payments, some of them are monthly payments, but it's been a pretty significant number over the last three or four years.

Nathan: Provider, I want to say, was five and a half million. Major was seven in the first year, less than that in the second year. Verde had a million dollars a month seller's note which I want to say was 20 million. We then restructured it and added another six or seven million dollar not to it. So there's been a significant amount of financing and earn out payments over the last three years if you just add those numbers up.

Nate: Yeah. Wow. Okay.

Nathan: And like I said, the last one will be completed in June of '19.

Nate: Yeah. Okay that's helpful. Actually do you mind talking about what maintenance capex is and I'm just curious what working capital ... What should your investors and the listeners be conscious of when they see working capital as ... Should we think of it as a percentage of revenue?

Nathan: First off, revenue fluctuates with commodity prices. We really focus on the gross profit line in this business just because that's what we're always managing towards. So revenue can go up or down based on commodity prices so we don't spend as much time thinking about that although to your point it does impact working capital. When we think about maintenance cap X, when you look at our customer acquisition cost line, a large portion of that is maintenance cap X. A small piece of that is growth cap X and that's how I think about it.

Nate: Okay.

Nathan: I'd churn off roughly four percent of my book every month. I've got to go out and acquire customers to replenish that. That's what we think of as maintenance cap X.

Nate: Okay. That's helpful. So you mention the dividend. You've paid it consistently for four years and you're now at I guess almost a nine percent yield.

Nathan: Yeah.

Nate: I wanted to ask you just about your thoughts on the cyclicality in the retail power space and obviously where there is cyclicality because your stock price was much higher this time last year and you're now at a nine percent yield which I think ... So, just a little bit of background, I also covered MLPs and there were quite a few MLPs, still are quite a few MLPs that have distributions that are in the double digits and I think investors when they see a high yield, they think distress. They think there's a problem with the business. I would be very curious to hear what your thoughts are on the cyclicality in the retail power space, but then as it pertains to the dividend, would love to hear how you're thinking about capital allocation longer term.

Nathan: I think the first thing, and part of this challenge is the fact that our name is Spark Energy. Everybody assumes we're an energy company and we're going to be cyclical with all the other energy stocks out there. MLPs, any of the E&P companies, those are highly cyclical businesses. Really our business is much, much less cyclical than either of those two, and we're fairly agnostic to commodity prices. We've got normal seasonality in the business just from summer, winter, spring, and fall but it's predictable every single year. We've demonstrated we can make money in high commodity environments, low commodity environments. We basically buy wholesale energy, tack on an acceptable unit margin, and that's what we sell retail. So, much, much less cyclical than what you're seeing in some of your other energy stocks.

Nathan: I think if you look at what's happened to our yield over the last 24 months, their stock has not traded efficiently for the last two years and the beginning of '17 there was some rumors out there about Spark getting acquired that ran the stock up significantly. I think it peaked in June of last year, and then started to trend down in the second half of the year when the market realized there was nothing out there in terms of an M&A transaction.

Nathan: Then you've got in the beginning of this year, we were trading in the nines, kind of bottomed out I want to say at 860, and we actually did announce that we had some inbound interest and we had engaged Morgan Stanley and we saw the stock run up into the 12s. That trended back down again to August. Around the time of the August earnings call, we were back in the mid eights again. We've been in this eight, nine percent yield several times over the last several years when there hasn't been a lot of rumors or sale premium built into the share price.

Nathan: We get about an eight percent yield. We did that to appeal to retail investors. That's what the underwriters wanted to sell at that time. We did tell the market that it was going to be a growth stock, but given that we were relatively unknown from an industry standpoint, we went in with a hybrid model. I think we've demonstrated over the last couple of years that we have the ability to grow this significantly so that yield or that dividend is much less important than it was in those earlier days.

Nathan: But that said, we've got the cash. We've got the capital. We do have investors that count on that dividend and so we have no intentions of changing it. I'm not going to make any promises that we're going to grow it, but on the other hand I don't see why would we reduce it either. We like the current capital allocation approach that we have.

Nate: It's very encouraging to hear. I think I have quite a few yield investors who listen to the podcast so thanks for that.

Nathan: In my mind, we've tested that floor at eight and a half bucks a few times now and there seems to be a natural floor there just in terms of the yield. And like I said, we've had a significant amount of cash going out the door for earn outs and seller's note payments over the last two years, and those are almost behind us now, and so the long term outlook from our free cashflow standpoint, I think, is very positive.

Nate: So what are your thoughts on share buy backs?

Nathan: We've talked about them. If we determine that's the best return for our investors, we'll do that. We could talk about what to do with the dividend. We could talk about accelerating organic growth. I will tell you that right now what we're seeing in terms of organic growth is a very good return for our investors, so that's where we're focused any incremental cashflow right now, but our board will revisit capital allocation as we get closer to the middle of next year.

Nate: Okay. For me personally, I think this is a really interesting story. I guess I'm just curious what you've been hearing from your current investor base and maybe those current investors who aren't happy with the share price performance. What are you hearing as a concern, and which, if any, of those concerns are valid?

Nathan: I don't think we get a lot of concerns. I get some investors that are frustrated because they bought us at the peak last year and they lost money on the story, but the underlying business hasn't change. The underlying business is strong. We had unit margins in the mid $20 range last year. We did a lot of M&A. Since then, we've been taking costs out of the business. We had a significant weather event. Any business that has any weather sensitivity is going to have that at some point in time. The question is how healthy is the underlying business and we managed to get through it. It definitely left a mark. I'm not happy about it, but we managed to get through that. It's behind us. We feel much, much better about how the business is going now.

Nathan: We've gotten some favorable weather. If you're following the weather in Texas and the northeast in the last two months, it's been very favorable. We're enjoying that at the moment. While my unit margins are going to be depressed for calendar '18 because of some of those physical hedges we talked about a little while ago, my outlook for '19 and '20 hasn't changed in terms of the ability to realize unit margins and free cashflow and to grow this business. We're taking this down near, if you will, to clean up the house, get our systems and our platform in order, become more efficient, and be ready to take advantage of that next opportunity when it presents itself going forward.

Nate: But I mean from your perspective, if you haven't heard any concerns from investors ... I guess a better way to put it is just what are some of the head winds that you're wary of and you're paying attention and maybe you just don't feel as certain about for 2019, 2020?

Nathan: So let's go back to your first question. When of the questions that we get from investors is, "Help us understand the majority share holder, the related party transactions, and that alignment." There's this belief that there must be some benefit in here to the majority shareholder otherwise why would we go through this complexity. And the one thing that we have to explain pretty regularly is look at the alignment. Sixty-three percent of this business is owned by one individual and it represents a significant piece of his overall business portfolio. He's willing to do things to help us just to protect his investment in this business. All shareholders benefit from that. There's no reason for him to do something to this business that somehow disadvantages the minority shareholders because that's only going to hurt himself. So that is one that we have gotten questions about in the past, and just the lack of understanding of that relationship, but I will tell you it's a very good relationship. We speak on a regular basis, and he's very, very aligned with our minority shareholders in terms of things that we're doing to manage this business.

Nathan: The next piece of your question was head winds, tail winds. Little bit of additional volatility in this business, as I said earlier, I think is going to be good for us. We're in the process of realizing a lot of synergies on the M&A transactions that we've done to date. That'll improve the amount of contribution margin that flows through to the bottom line from every incremental customer that we sign up. I think some of the regulatory noise that's been out there for the last couple years, I see that getting resolved. I see the regulatory environment getting better. I think that's a real opportunity for us as an organization.

Nathan: So actually, I feel very good about what the future holds, but for me the head winds are more the things that are unknown. If there were to be an additional regulatory change, another weather event, some significant change in the commodity markets, but again, we've been at this a long time and I don't know what they would throw at us that we haven't seen at least once before.

Nate: Knowing what you know about your business, and assuming you weren't a shareholder, what do you think that you would need to do to get most comfortable with an investment in Spark Energy?

Nathan: We talked about the word energy. I would want to be sure I understand what does this business do. We're not cyclical like most energy stocks. We're a business that provides a service to end use consumers and that throws off a lot of cash. I would want to make sure that I understood that, and as i said before, we're fairly agnostic to commodity prices. That's a little unique for somebody that has the word energy in their name. Second one would be the corporate structure, the dual share class, and just making sure that I understood what appears to be a bit of a complicated structure and understand it's really not that complicated. I've got a majority shareholder who's strongly aligned with public investors and is doing everything to support the business so that's a pretty simple one to put away.

Nathan: The other thing I think is, we didn't touch on it yet, but earnings per share, EPS, net income, mostly irrelevant to this business. My earnings per share might, my net income can fluctuate dramatically from the mark to markets gains or losses on my hedge portfolio and it doesn't matter to me. When I sign a retail contract, I lock in those unit margins with the hedge. If wholesale prices go up or down and I've got unrealized mark to market, it doesn't matter. I've lock in the unit margins on that end use customer which is why we don't spend any time talking about net income or EPS on earnings call. We focus everything on adjusted EBITDA which is our proxy for cashflow.

Nathan: So that's the other piece of it that I would want to make sure that I understood. Like I said, it's a fairly ... There's a lot of data and there's a lot of moving parts, but at the end of the day, I'm buying wholesale energy and I'm turning around and I'm selling it to end use customers at a retail price point. Any business that's relatively low in terms of assets and low leverage but throws off a lot of cashflow and has demonstrated an ability to pay a very strong dividend over the last four or five years and in my mind with the seller financing going away, that dividend's only that much stronger going forward.

Nathan: Those are some of the things that I would think about.

Nate: That's super helpful. I'm very curious what you would like Spark Energy to look like three to five years down the road.

Nathan: I think there's going to be new technology or some sort of innovation that comes out in the next three to five years. I know we've been talking about it for a very long time as an industry. We haven't seen it yet. There's been a lot of people dabbling in it and spending dollars trying to figure it out, but nobody that's making significant money off it yet, so my thinking is get the platform as efficient as possible, automate as many processes as possible, and I'll be sitting here with a very profitable, retail portfolio and continue to grow that and there will be, whether it's on the energy efficiency side, the distributed generation side, the demand response side, energy storage ... I don't know what it's going to be yet. There's going to be some technology out there that's a game changer in this space and I want to be positioned to take full advantage of that in the next three to five years.

Nathan: I think Spark Energy can look very different three to five years from now than it does today, and I'm very excited about what the future holds for us in that regard.

Nate: So last question and this is one that I try to ask all of my guests. I'm just curious whether or not you have a funny story or an interesting story to share from a shareholder interaction or meeting.

Nathan: I've several but one that stands out, we sell, a large percentage of our business is renewable energy or carbon neutral natural gas and so when I explain to shareholders that we sell green electricity and we do it through the form of renewable energy credits, but when I start to get into the discussion around green electricity and how it's wind and solar, I had an investor stop me and ask me, "So who do you get the wind to the end use customer? Do they shut off the grid and allow you to move the wind electricity to the consumer and then turn the grid back on?" He said it with a straight face, dead serious, and it was all I could do to bite my tongue and not chuckle at that question.

Nathan: There's definitely a lack of understanding of how this business works by some of the potential investors that we talk to.

Nate: It's funny because I used to work in power as well. I used to be a wind developer and I remember in just speaking to friends I would get similar questions just about, "How are you sure that this renewable energy that goes to the house that decides to purchase it?" It's a complicated system to describe. I don't even know it extremely well and it is a fascinating subject. I can't certainly appreciate that question from that shareholder. Thank you for sharing that.

Nathan: My pleasure.

Nate: Well thank you very much, Nathan, for coming onto the podcast. It's been a really, really great pleasure to have you on, and it's been really fascinating to hear about your business.

Nathan: Thanks, Nate. It's been my pleasure as well.

Nate: Alright. Well you take care now.

Nathan: Thanks, Nate.

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