



Transcript of initial interview with Mr. Rick Hoffmann



VP Administration of WaterFurnace Renewable Energy Inc.



Toronto Stock Exchange: WFI

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**Smallcaps.us: Hello and welcome to another Smallcaps.us interview. We're excited to have Mr. Rick Hoffmann with us today, the Vice President Administration of WaterFurnace Renewable Energy Inc. WaterFurnace is a profitable, green energy Company, which specializes in ground source heat pumps for heating and cooling residential and commercial buildings. The Company is listed on the Toronto Stock Exchange with ticker symbol WFI and in the US with ticker symbol WFIFF. Rick, thanks so much for taking the time to join us today. Welcome.**

**Rick Hoffmann:** You're welcome. I'm glad to participate.

**As this is our initial interview, can you please give us a brief introduction of WaterFurnace and its activities?**

WaterFurnace Renewable Energy is the Canada-based parent company of these component companies: WaterFurnace International, the leader in geothermal heat pumps sold through our U.S. Direct-to-Dealer network; GeoStar, our product brand offered through our Distributor channel in both the U.S. and Canada; Hyper Engineering, our manufacturer of software-driven soft starters for the air conditioning industry; and WaterFurnace International, the Company's joint venture with Shenglong in China.

Since its inception in 1983, WaterFurnace International has built and installed over 350,000 WaterFurnace units in the United States and other countries around the world. While WaterFurnace built its reputation as the leader in both the U.S. and Canadian residential markets, the employees and channel partners of WaterFurnace are making significant inroads in the commercial and international markets with a robust line of products that offer clean, sustainable heating, ventilation, and air-conditioning solutions.

Based near the Great Lakes in Fort Wayne, Indiana, WaterFurnace has market capitalization of well in excess of \$200 Million (Canadian); our shares are currently selling near a 52-week high of well over

C\$18. WaterFurnace has achieved significant market share growth over the last year despite challenging economic headwinds, driving record sales revenue for the 1<sup>st</sup> quarter of 2013, and near record net income and earnings per share.

**Rick, I have to say this is really a fascinating technology. It's readily available, there's an infinite source of it, it can be used to both heat and cool your house and you can significantly save on your utility bill with it. So how does a ground source heat pump work exactly?**

A geothermal heat pump (GHP) taps into the nearly limitless source of solar energy stored in the ground to provide reliable, incredibly efficient heating and cooling to residential and commercial buildings. It's one of the few solutions where everyone wins.

It allows HVAC contractors to offer a state-of-the-art, environmentally friendly technology whose demand increases every year. It gives homeowners a low-maintenance, long-term way to reduce utility costs. Additionally, it's a big win for the environment.

In 2012 alone, the WaterFurnace units sold represented the environmental equivalent of planting 12.8 million trees. According to the United States Department of Energy and the U.S. Environmental Protection Agency, geothermal systems are the most environmentally friendly way to heat and cool your home. Our systems emit no carbon dioxide, carbon monoxide or other greenhouse gasses, which are considered to be major contributors to environmental air pollution.

**Great. Because it has so many advantages, governments worldwide support geothermal systems through tax incentives. Can you explain that and maybe give a few examples?**

The U.S. Economic Recovery Act legislation that was passed in 2009 provides a 30% uncapped tax credit to residential homeowners who install an Energy Star rated geothermal heat pump system from 2009 through 2016. This tax credit will continue to motivate homeowners to evaluate the economic payback of a geothermal heating and cooling system for their home. Since this homeowner benefit is

embodied in the tax code, it is not likely to be revised prior to its legislated phase-out of January 1, 2017 unless a radical change to the tax code occurs.

In 2008, geothermal heat pumps that use the ground or ground water as an energy source for heating and cooling a commercial building in the U.S. became eligible for a 10% tax credit through an accelerated depreciation schedule for construction begun prior to the end of 2016. For a corporation in a 35% tax bracket, this depreciation schedule provides additional tax savings equal to 33.25% of the energy property spending within the first 5 years, with the greatest tax benefit at the beginning. Conventional heating and cooling systems, by comparison, usually depreciate over a 39-year straight line basis and would only provide 4.5% in tax savings over the first 5 years.

Many states and utilities are recognizing that geothermal heat pumps are both efficient and renewable. They use thermal energy to provide a dramatic reduction in power usage. That reduction in power usage has been nicknamed “negawatts!” Utilities can reduce their capital expenditures for new capacity through their support of clean renewable energy solutions such as geothermal; these savings or “negative” outlays of capital for new capacity are cleverly referred to in the utility industry as “negawatts.”

Because of its power-saving benefit, many state governments are working on creating incentives for electric utilities to promote ground-source heat pump adoption. In fact, 43 of our 50 states provide homeowners with financial incentives through state-level legislation. Tom Huntington, our President & CEO of WaterFurnace and Chairman of GEO, our industry’s government lobbying alliance, is encouraged by GEO’s lobbying successes with state legislatures. GEO will continue to focus its efforts on state legislatures, as well as the Federal government.

While these new legislative efforts will prove beneficial to the entire industry, we believe that our single biggest opportunity to accomplish quantum growth in our revenue is through local alignment with utilities. In fact, over the last year, WaterFurnace

has brought in top sales talent with proven abilities to focus on the development of new partnerships with utilities to promote geothermal.

Today, a growing number of U.S. electric utilities now offer “thermal services” to homes, thereby removing the up-front cost of the ground loop that I described earlier. The loop that maintains a 30 degrees Celsius heat exchange year around and that’s situated in the ground or in a pond. This removes nearly half the initial cost of a homeowner’s geothermal investment. Two new “thermal utilities” were recently formed in the U.S. to provide not only the ground-source loop but also the heating and cooling unit itself to homeowners, in fact the entire system with “on-bill financing.”

To give you a sense of perspective as to the future potential of our partnership with electric utilities, about 74% of all coal-fired power plants are at least 30 years old, and the average life of such plants is just 40 years. As aging coal-fired plants are replaced by new natural gas plants, geothermal heat pumps offer utilities the greatest potential to reduce generation requirements and infrastructure costs. Again, the benefits will be measured in “negawatts!”

Of the various “green” or clean energy value propositions, ground source heat pumps are the least tax credit-dependent of the renewable energy alternatives and the most economically viable solution for residential and commercial applications. To reinforce our leadership position and to ensure that WaterFurnace continues to provide its shareholders and customers with an array of high-quality, high-value choices for heating and cooling, we are busy with the development of innovative solutions that will broaden our portfolio with aligned products. We are confident that these products will offer customers a unique solution, and quality that is consistent with the WaterFurnace reputation.

**Over to the financial side of the business. A few weeks ago WaterFurnace announced record first quarter sales. Can you give us an overview of those results? And what does the rest of the year look like?**

We’re encouraged by our first quarter results. WaterFurnace posted record sales revenue for the

period at \$29.15 million, an increase of 5.5% over the first quarter of 2012. As Tom Huntington said in our quarterly release, we were pleased with our consistent residential market share growth, lower year-over-year expenses, and both the revenue and profit results from the China joint venture.

A few noteworthy items about the 1st quarter include our 4% price increase, due to rising costs in the areas of health care, general inflationary pressures and materials; and a change in our accrual for warranty expense, which in the past had been booked during the 1st quarter but is now normalized over all four quarters.

The combination of the yield from late winter consumer home show presentations by our dealers and a steady increase in volume due to the ramp up of the residential construction give us reasons to be optimistic about the balance of 2013. New homes are in short supply, so the conditions are ripe for slow but steady, sustained improvement in new home starts, providing a tail wind for sales. Our outlook for the second half of the year remains positive.

**Also looking at the balance sheet, the Company is in great condition. More than \$12 million in cash, no long term debt and a current ratio of almost 5.**

Earnings were driven by increases in our residential market share in 2012 as reported by the Geothermal Exchange Organization (GEO). WaterFurnace also increased its market share in commercial applications as reported by the Air-Conditioning, Heating, and Refrigeration Institute (AHRI). In addition, gross margin as a percent of sales continued to rise. Gross margin increased 0.9% from 34.8% in 2011 to 35.7% in 2012 due mainly to our product cost reduction efforts. Sales were down in the U.S. by 11.3% versus the prior year, due to slow new housing starts and low consumer confidence. Sales to Canada were down 24.3% for 2012 due primarily to the termination of the residential Canadian federal rebate program for geothermal applications.

While year-over-year sales, total comprehensive income, and earnings per share were down in 2012,

WaterFurnace continued its efforts in new product development, sales channel expansion and strategic business development activities to ensure it is well positioned for growth as the economy recovers and eventually expands.

While the recovery in single-family construction appears to be well underway, we believe that most measures point to a steady but gradual recovery in the housing market that will complement what have been reliable revenues from the residential replacement market.

Our balance sheet includes no long term debt, and a strong cash position. Our cash reserves increased year-over-year by \$3.6 million before joint venture expenses, generating \$11.9 million in cash after dividends and JV start-up expenses during the latter portion of 2012.

At the close of the 1<sup>st</sup> quarter of 2013, our cash position, including short term investments, compared favorably to Q1 of 2012 at \$22.3 million. Even with our available cash, WaterFurnace has demonstrated the wise use of our cash, establishing supply agreements with both our OEM customers, JCI's China supply chain in particular, as well as strategic agreements for key components such as sheet metal and heat exchangers with regional suppliers. These agreements, alternatives to joint ventures, have preserved our cash for other uses, including future acquisitions.

**Thanks to the Company's solid results and excellent balance sheet it's able to pay an attractive dividend. What can you tell us about that?**

That's right! As a reflection of our confidence about the future, the Board of Directors announced at our Annual Shareholders Meeting an increase in the dividend from 24-cents per share to 25-cents per share, driving a five- to six-percent dividend yield for our Shareholders. As Tim Shields, our Chairman of the Board has stated, the investments we've made in our people, innovation and strategic partnerships have increased the company's potential and shareholder value. With these dynamics in play, our dividend strategy is certainly appropriate.

**Excellent. You already mentioned it, mid 2012, WaterFurnace formed a joint venture in China, so that it could offer its products to the vast Chinese domestic market. How has the joint venture developed since and does it offer additional benefits for WaterFurnace, other than more sales?**

We're pleased that sales generated by WFI, the Ningbo-based WaterFurnace / Shenglong Joint Venture, exceeded our forecast for the 1<sup>st</sup> quarter of 2013. Profit results were in step with this good pace, thanks to the efforts made to control variable expenses during this seasonally slow time of the year. Thanks to the success of team efforts by our key senior executives in Finance, Supply Chain and International Sales, disciplined efforts in planning, the application of key performance indicators, and business reviews have yielded early and satisfying progress.

Support of the JV's sales force has been expanded at the strategic level with proven talent in both sales and engineering, to ensure reliable delivery of equipment that suits the customer's application. Currently, the Commercial Market is our primary focus, with government building being the strongest revenue stream.

**And does WaterFurnace have plans to expand into other regions in the world?**

Outside of China, our International Sales will focus on growth in Europe through our London-based distributor, GI Energy. We're optimistic about sales during the seasonally strong 2<sup>nd</sup> half of 2013 from our established distributors, as well as pipeline progress with our new and developing distributors.

Our established distributor relationships are generating strong sales in both South Korea and Japan. In South Korea, Innergie has been productive in Commercial sales. Our efforts to win U.S. supplier contracts for Government / Military projects in South Korea have resulted in steady sales for the last few years, with prospects for continued awards. We're encouraged by what we expect will be strong sales through our distributor in Japan, with orders beginning early in the 3<sup>rd</sup> Quarter. These initial orders will reflect pent up demand

stemming from long-awaited new government incentives that will go into effect for energy efficiency, water source and geothermal heat pump systems.

Development of our newest distributor relationships will be reinforced in the 2<sup>nd</sup> half of this year with training and joint sales calls. These markets hold good growth potential for us, and will respond well to our efforts in Russia; Denmark; Scandinavia; and the European Union markets.

New Distributors and project leads will be pursued in the 3<sup>rd</sup> quarter in Serbia, Philippines, Mexico and the Ukraine. We're pleased about sales prospects for the Phillipines, where systems are engineered, specified and bid very similar as to how they are done in the U.S. Our distributor in India has placed a significant order which will be manufactured by our China JV.

India and China offer sales opportunities to our JV and International sales force for the sale of Hyper Engineering's IntelliStart and SureStart units. This device, manufactured in our plant in Wollongong - New South Wales, Australia, is a unique software solution for limiting in-rush current, facilitating the start of electric motors at use in markets with unreliable or "dirty" electrical power.

**Where would you like to see the Company two to three years from now?**

These initiatives will drive higher revenue levels and gross margin improvement:

First, as an outcome of our trade alliances with utilities, sales of our residential units will climb at an increasing rate. As an outcome of upcoming cornerstone product innovations, WaterFurnace units and our distributor and OEM brands will win increasing shares of the market. Sales of aligned products will complement our core competencies, increase our top line in the near term, and mitigate any dip in revenue at the conclusion of the Federal tax credits in 2016. Realizing the full potential of domestic sales in China will drive increased earnings for WaterFurnace Renewable Energy, and beneficial synergies from global component sourcing.



**And something that correlates with the previous question. At the shareholder meeting last month, Mr. Huntington spoke about the four cornerstones of the business. Can you explain that to us?**

A big factor in our success over the next two to three years will be enhancements to our product portfolio. Tomorrow's success will be built upon these deliverables - our four cornerstones: Variable capacity geothermal units, Advanced zoning systems, Home energy management and geothermal's contribution to renewable hybrid comfort systems that achieve Net Zero Energy.

1. First, Variable capacity geothermal units. Our 7 Series residential unit, launched in 2012, signifies groundbreaking innovations on multiple fronts. Most notably as the geothermal industry's first variable capacity residential unit and the only unit to surpass the industry's highest benchmarks for efficiency. These ratings greatly surpass the performance of ordinary conditioning systems, and perform at efficiencies up to 30% higher than current two-stage geothermal heat pumps. Our embedded software controls work in unison with variable capacity technology ... A variable-capacity compressor, variable-speed ground loop pump, and variable-speed blower motor can now combine to offer a truly unique level of comfort.
2. Our second cornerstone: Advanced zoning systems. Homeowners tell us that geothermal heating and cooling and WaterFurnace units, in particular, deliver a level of comfort that's like no other conditioning system of any kind. That's because our systems provide the precise distribution of comfortable air all year long, eliminating the hot spots and cold spots that typically occur within a home. For instance, during heating, you'll experience warm air without the hot blasts associated with ordinary gas furnaces, or the cooler air of an air source heat pump. And in the cooling mode, our WaterFurnace systems deliver cool, dehumidified air.

3. Our third cornerstone is Home Energy Management. Before the close of 2013, WaterFurnace will introduce geothermal's first iPhone- or Smartphone based remote control of your home's thermostat, and a wide array of its functions, including not only temperature adjustment, but also zoning controls. To complement this functionality, homeowners will be able to monitor the energy consumption of their system, and receive system notifications in response to their own pre-set parameters. These Home Energy Management features may be retro-fitted to any 7 Series, 5 Series or other WaterFurnace unit with our "Aurora" generation of embedded software controls.
4. And our fourth cornerstone: Renewable hybrid comfort systems – Net Zero Energy. Hybrid Solar Photovoltaic and Wind Energy Systems may be combined with geothermal to accomplish dramatic reductions in energy consumption, and achieve unsurpassed comfort.

**Great, and can you also shed some light on the management team of WaterFurnace and its largest shareholders?**

Tom Huntington's leads WaterFurnace International as our President and CEO. Before joining the Company in May 2009, Tom served as President of York Heating & Air Conditioning's \$1 billion Unitary Products Group. Prior to York, Tom was Senior Vice President of Global Sales and Marketing at Bristol Compressors. From 1992 through 1995, Tom helped grow Evcon / Coleman Industries from \$100 million to \$350 million in sales at which point York International acquired the company.

Fred Andriano is our CFO & Treasurer. Fred has been instrumental in accomplishing the broad scope of work necessary to the formation of WFI China, our joint venture with Shenglong, including not only the regulatory and financial underpinnings of the agreement, but also the initial management infrastructure. Fred was also a key contributor to the acquisition of Hyper Engineering in 2011.

Herb Batrouny joined WaterFurnace last year as our Senior Vice President of Asia – Pacific Operations.

Herb contributes valuable experience from his progressive roles with Johnson Controls in both heating and air-conditioning manufacturing and global supply chain management. Herb's insights on component sourcing have already yielded significant cost savings for us. Our joint venture has benefitted from Herb's leadership, in terms of teamwork and our shared focus on key performance indicators.

Michael Albertson is our Senior Vice President of Sales & Marketing. Upon joining WaterFurnace in 2007, Michael made an immediate contribution, and soon was called upon to lead all of our sales channels along with technical training and marketing. Michael's early accomplishments included the development of both creative talent and leadership talent in our Marketing Department, as well as the conversion of our Western United States sales territories from a Distribution model to Dealer Direct sales.

The largest blocks of WaterFurnace shares are owned by the Shields family. Our founder, Jim Shields, recently retired from service on the Board of Directors as Chairman Emeritus. Jim was recognized for laying the foundation for our success by his son, Tim Shields, our Chairman of the Board, at the May 9<sup>th</sup> Annual Shareholders' Meeting.

Any review of our future potential would be lacking without a mention of the people that support our management team. Human capital at work within the WaterFurnace culture has been the primary driver of our success. A daily emphasis on cost reduction through the elimination of waste pervades every level of our organization. In fact, each calendar quarter, every WaterFurnace employee meets to celebrate cost reduction ideas that have resulted in validated savings. WaterFurnace has grown and assembled the industry's best talent to lead the most innovative, dominant player in geothermal's residential market. In 2009, it was the insight of our current leaders that accomplished the successful "flip" of our sales model from 75% new construction market to 75% replacement. That was a great accomplishment, considering that we were able to efficiently and effectively equip our Direct-to-Dealer network with the sales and marketing tools needed for a whole new approach to selling.

**Before we go, what would you say are the two or three most compelling reasons for a long term investor to consider WaterFurnace today?**

First, our cash generation. Even with cash outlays in 2012 for new product launches, the China joint venture, and a vigorous dividend, our net cash position is solid.

Secondly, our dividend and dividend ratio. Our quarterly dividend was raised from 24 cents to 25 cents per share, in step with our positive outlook for both WaterFurnace's US business and the JV in China. We are confident that our cash flow going forward is more than sufficient to support this dividend level. With recent trading bumping up against 52-week highs, our dividend ratio still exceeds five percent.

Lastly, our lack of reliance on long term debt. Our balance sheet positions WaterFurnace to seize opportunities if we should choose to take on long term debt. Without the need to service long term debt, WaterFurnace is able to pay an attractive return to our shareholders while internally sourcing capital expenditures with a proven track record of above average return on capital, 20% on a fully-taxed, trailing 12-month basis.

In closing, I'll emphasize again that our leaders have been hard at work to build upon our four cornerstones, complement our core competencies with aligned products, partner with utilities to reduce the homeowner's initial investment, re-double our efforts to grow international sales, reduce our material costs through vertical integration, and seize the opportunity to succeed that's afforded by the gradual recovery of the U.S. housing market. With confidence in both our human capital and our financials, we look forward to sustained and profitable growth.

**Fantastic. Rick, it's been a pleasure speaking with you and on behalf of all our listeners, thanks for helping us gain insight on your Company. We'd be happy to have you back for an update in a few months and wish you and WaterFurnace all the best.**

Well thank you. My best regards to you and your investor group as well.

## **Interview Feedback**

We welcome your questions and feedback regarding this interview at:

<http://www.smallcaps.us/profitable-and-high-dividend-paying-waterfurnace-renewable-energy-expands-at-home-and-abroad>

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## **Contact Smallcaps.us**

Twin Squares  
Culliganlaan 1  
1831 Brussels  
Belgium  
Tel. +32 (0)2 808 58 41  
E-mail: [contact page](#)

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