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Q2 2019 ION Geophysical Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the ION Geophysical second quarter earnings conference call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Rachel White, Vice President, Corporate Communications. Ms. White, you may begin.

Rachel White ***ION Geophysical Corporation - VP of Corporate Communications***

Thank you, operator. Good morning, and welcome to ION's Second Quarter 2019 Earnings Conference Call. We appreciate you joining us today. As indicated on Slide 2, our hosts today are Chris Usher, President and Chief Executive Officer; and Steve Bate, Executive Vice President and Chief Financial Officer.

Before I turn the call over to them, I have a few items to cover. We'll be using slides to accompany today's call, which are accessible via link on our website, iongeo.com. There, you will also find a replay of today's call.

Before we begin, let me remind you that certain statements made during this call may constitute forward-looking statements. These statements are subject to various risks and uncertainties, including those detailed in our latest 10-K and other SEC filings, which may cause our results or performance to differ materially from those projected in these statements.

Our remarks today may also include non-GAAP financial measures. Additional details regarding these non-GAAP financial measures, including reconciliations to the most directly comparable GAAP financial measures, can be found in our earnings release issued yesterday.

I'll now turn the call over to Chris who will begin on Slide 4.

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

Thank you, Rachel. Good morning, everyone. I'm delighted to join you today. I had the pleasure to meet a number of you at our Investor Day in New York last year when I spoke about our Operations Optimization business and look forward to speaking with more of you going forward.

For my first earnings call in seat as ION CEO, I thought it would be appropriate for me to take a few moments to introduce myself before going over our financial results, market dynamics and operational highlights. I've worked on the geophysical and E&P software industry for the last 30 years so I know the space and players well. During my career, I've held several operational and technology leadership positions at large companies such as Halliburton, PGS and WesternGeco, where I oversaw businesses in excess of $100 million as well as the development and commercialization of new technologies. In the last 20 years, I was involved in global remits, providing engagement with employees and customers worldwide, which is one of my greatest passions.

Since joining ION in 2012, I've run most of the operating businesses here, initially leading the geosciences division, which included our Imaging Services group and Geophysical R&D. Most recently, I've overseen the Software and Devices businesses in Operations Optimization, rebuilding our core while directing our entry into adjacent markets and initiating a digital transformation strategy. I've also had a number of key functions, such as IT and marketing, reporting to me.

Naturally, I have been asked whether there will be continuity in our strategy under my leadership. The answer is yes since I helped craft ION's powering data-driven decision strategy and I believe in it wholeheartedly. However, I do intend to drive a purposeful shift towards improved execution, which I'll speak to in a moment.

The mantra in the E&P sector is all about creating shareholder value. Our offerings are aligned with select growing market segments where we can help our customers make better decisions to improve their profitability. We have been making good progress diversifying our business to harden it against E&P cycle swings, moving closer to the reservoir on the E&P side and moving into adjacent markets such as offshore logistics and defense in Operations Optimization.

My focus in the near term will be on execution and accountability. ION has a wonderful DNA of creativity and innovation, but in a world modulated by a somewhat tentative market recovery and our smaller size, the ambition to handle multiple parallel initiatives can impact one's effectiveness delivering on the promise of the best of those ideas. One of my key goals in the second half of 2019 is to shift our focus to tactical execution. We are going to select a few key initiatives required to drive healthy growth and monitor our performance against the requisite quarterly milestones required to achieve them. We will focus on what's critically important, attack those tasks in sequence and accelerate time to market or fail fast, learning quickly what works best for the business.

Our leadership team is focused on matching our clients' needs with innovative offerings that enable smarter decisions about their investments and operations. These are exciting opportunities to not only build on ION's traditional data library and imaging strengths, but also to commercialize new technology we've been developing over the past few years and to adapt our cutting-edge capabilities to new markets.

Bringing to market new, unique technologies and offerings is key to our strategic execution. ION has always tracked the percentage of R&D dollars that are focused on innovation versus sustaining projects, but we will now measure the share of revenues tied to the commercialization of new technologies. Some parts of the business are already showing good progress there such as the Software group, whose new technology revenues are close to 30% of that business for the first half of the year, and the Software revenue growth we've seen year-on-year has been driven by new technology.

Okay. Let's shift gears to the financials. We had a strong quarter, especially when you consider the continued climate of fiscal discipline among E&P operators. Our revenues were up 69% year-on-year and 13% sequentially. Our adjusted EBITDA this quarter was a positive $7 million, a significant $15 million swing from a negative $8 million in the prior year. Our liquidity remained strong at $68 million. Steve will elaborate on our financial results in a few minutes.

I'll speak first about market dynamics at a high level, and then I'll add additional detail when covering each of our business segments. We still expect the E&P industry to rebound as it becomes increasingly critical to meet production demand in the next decade. We believe the sustained E&P shift to maintain capital discipline and deliver shareholder value has resulted in a much leaner, more profitable environment. E&P management focus is now much more closely aligned with investor interests with emphasis on value metrics such as return on investment and cash generation as opposed to volume metrics such as production or reserves growth.

A positive macro development for our business is that international activity has been picking up while North America has slowed down. Sustainable structural changes have made offshore increasingly cost competitive with shale with improved payback time frames. As a result, we're seeing investments start to flow offshore again, which aligns more favorably with ION's strategy and portfolio.

In addition, exploration returns have rebounded back to healthier levels with frontier areas demonstrating the most attractive returns, which will likely encourage future investment. In contrast, during the downturn, the subdued exploration investment was focused in proven areas near infrastructure. Our data library and new program activity is very well positioned in frontier and emerging basins so these are some positive signals that the offshore industry has turned a corner.

While 2019 E&P spending levels are projected to be up slightly, it continues to be unclear how robust seismic exploration activity and funding will be this year. However, we remain cautiously optimistic given the uptick in backlog since the end of last year and the interest we're seeing in our new multi-client programs.

In our E&P Technology & Services segment, multi-client revenues increased 132% this quarter relative to the second quarter of 2018, primarily due to data library sales in North and South America. As expected, we had very focused engagement from E&P clients on targeted exploration programs in specific geographic areas. We believe that new venture program activity will continue to improve, and as we stated in the fourth quarter call, we plan to increase the number of new sanctioned programs this year. We have sanctioned 6 new multi-client programs so far this year compared to 7 for all of 2018.

The second phase of GrandSPAN, our new 2D multi-client program offshore Canada, commenced this quarter. Due to continued client interest, the project scope more than doubled from last year's expectation to nearly 11,000 kilometers. The program is intended to further improve the understanding of hydrocarbon potential, extend known plays into new areas and de-risk new play types and exploration investments. The industry-supported program combines with 2 other ION BasinSPAN programs to create a contiguous regional seismic data set in excess of 30,000 kilometers offshore Northeast Canada. Acquisition began in June and initial deliverables will be available from early August to be of decision-making value ahead of upcoming lease rounds planned for 2019 and 2020.

We also announced a new 3D multi-client reimaging program offshore Denmark this week, reinforcing our leadership in the 3D reprocessing segment. The initial 2,200 square kilometer phase of the 10,250 square kilometer program is aligned with the Danish energy agency's objective to boost exploration activity by providing a modern, affordable 3D depth-imaged dataset. As a stable and attractive oil and gas investment area with an estimated 3 billion barrels of reserves, a fresh turnover of blocks and new players provides an exciting opportunity for a regional depth-imaged 3D to help drive a new wave of exploration success. The program is ideally suited for upcoming biannual license rounds, the 9th of which is expected to open in 2020. Initial deliverables are expected to be available in September 2019, with final deliverables in January 2020. This class of program looks great from a return on capital employed perspective. We plan to announce additional details about our 6th program offshore Africa soon.

Our backlog is $30 million, up $1 million sequentially and up $8 million from the end of last year. Imaging Services' backlog is the highest it's been since 2015 primarily due to continued awards of higher-value, technology-driven ocean bottom nodal projects. Imaging Services was just awarded a large 2-year ocean bottom nodal data processing and imaging contract in the Middle East, and we are thrilled to continue building our emerging relationship with this E&P operator. Higher-value, technology-driven projects like these enable us to sharpen our toolkit, enhance our abilities with third-party clients and then deploy these technologies and capabilities internally on multi-client programs. We continue to believe this is the right balance for ION where a significant portion of Imaging Services' resources are allocated to higher potential return multi-client programs, and the balance is allocated to proprietary market channels that clearly demonstrate the value of our technology to our customer base.

In our Operations Optimization segment, there's a tale of 2 markets. While there has been some increasing tender activity and pricing improvement in the towed streamer space, we believe that market will remain oversupplied and cost competitive for some time. One of our clients stated recently that they expect activity levels to improve 10% to 15% this year, with vessel pricing potentially increasing 35%, which would be very welcome, but there's still a ways to go for a true recovery. For reference, 3D day rates and activity levels are still down approximately 40% and 50%, respectively, from 2014. In contrast, we believe the seabed nodal industry segment will continue growing rapidly in double digits due to its value in appraising and optimizing production.

Our Software group's revenue was up significantly due to record offshore optimization services revenues for the second quarter in a row with the second quarter beating the prior record by 21%. This was driven by a rebound in seasonal 4D activity and by Marlin being a key component of our offshore offering. 23% of our Software revenue was attributable to Marlin this quarter, and deployments continue to grow across both service providers and E&P customers with sustainable growth now arising from long-term customer commitments. Our second quarter deployments had a global footprint with Marlin systems in North and South America, Europe, Africa and the Middle East and Eastern Asia. We continue to enhance our offering by leveraging new Amazon Web Services components that offer cloud-based customer engagement benefits, ranging from AI to mobility.

As we introduced on our earnings call last quarter, the Marlin SmartPort pilot in the U.K. is progressing nicely. Marlin is designed to be the operations optimization platform supporting a number of offshore applications. Ports and harbors was identified last year as one of the most attractive markets for our technology.

I traveled with our team recently to visit a North Sea port authority that has been operating for over 500 years and has likely undertaken a few technology turns over that time frame. We met the port leadership to discuss the status of our collaboration to develop and deliver our Marlin SmartPort offering and to understand the early adoption benefits. This is a major digital transformation effort which will take the client from paper, radio and physical whiteboard operations management to a holistic digital capability that will give them a competitive edge over other ports. The opportunity for ION with thousands of ports worldwide is quite exciting. We'll discuss this more in later calls.

We have also been working closely with the U.S. Department of Defense or DoD to better understand the potential defense applications of our technology stack. We were invited by the DoD to take part in their Advanced Naval Technology Exercise, or ANTX for short, which demonstrates the potential that emerging maritime technologies can have for the Navy in the near future. In August, we will showcase a range of ION devices and partner capabilities illuminated through the lens of Marlin.

In the Devices group of our Operations Optimization segment, revenues were up 58% year-on-year driven by an increase in towed streamer equipment replacement and repairs. We also leased new rechargeable battery technology for our industry-leading positioning system for the first time this quarter.

Following additional successful field tests in the quarter, we have now deployed our first commercial SailWing system under our preferred recurring revenue model. The first sale of radically new technology can often be the most difficult, but we believe this will be a launch pad to demonstrate the transformational benefits of this technology for the source vessel side of the data collection equation.

SailWing is an innovative foil-based alternative to conventionally bulky marine diverters and has the potential to be $3 million to $5 million a year of high-margin recurring lease revenue as we gain traction improving source vessel performance in the growing ocean bottom marketplace.

I saved discussion of the seabed market segment for last because we now have a truly integrated offering spanning both of our business segments in one of the few strong growth segments in our industry. The ocean bottom market is projected to continue with double-digit growth near term due to its value in optimizing production, along with improving data collection economics. There continue to be new data collection entrants, and we estimate the OBS market to be $1.2 billion to $1.4 billion this year.

We also see new seabed nodal technology advances, such as our new 4Sea operational architecture, that support further efficiencies and enable broader use of superior seabed data. So I'm very pleased that we signed an MOU with iSEISMIC earlier this week to collaborate on seabed acquisition advancement. This partnership represents a unique opportunity for both companies to leverage significant synergies and gain a unique position in the maturing OBS market. iSEISMIC plans to utilize the full suite of ION's next-generation 4Sea ocean bottom acquisition and imaging technology to deliver a step change in the safety, efficiency, quality and turnaround time of seabed surveys.

This collaboration validates our component approach and provides an exciting opportunity to further participate in the growing high-value seabed market and extract recurring revenue from the value our technology delivers without compromising our asset-light strategy. It enables us to commercialize our new 4Sea technology and provides an opportunity to realize the benefits of our technology to acquire ocean bottom multi-client programs more quickly and cost effectively with an experienced service provider. We are looking forward to working together to successfully deploy 4Sea and significantly expand the use of superior seabed data to enhance clients' reservoir decision-making.

With that, I'll turn it over to Steve to walk us through the financials, and then I will wrap up before taking questions.

Steven A. Bate ***ION Geophysical Corporation - Executive VP & CFO***

Thanks, Chris. Good morning, everyone.

Our total second quarter revenues were up 69% compared to the second quarter of 2018. Revenues in our E&P Technology & Services segment were up 88%, and our Operations Optimization segment revenues were up 39%.

Within our E&P Technology & Services segment, our multi-client revenues were $23 million, an increase of over 130%, primarily due to program sales in North and South America. Our Imaging Services revenues were $6 million, an increase of 7%. While our Imaging Services revenues increased modestly, a significant number of new projects closed during the quarter, further increasing our Imaging Services backlog to the highest level since 2015. This increase in backlog, along with an increase in the amount of tender activity we're seeing, often serves as a bellwether for the market picking up and should lead to an increase in Imaging Services revenues during the remainder of 2019.

In our Operations Optimization segment, our Optimization Software and Services revenues were $6 million, a 19% increase from the second quarter of 2018. This was primarily due to an increase in deployments and associated engineering services of our Marlin offshore operations optimization software. Our Devices revenues were $8 million, a 58% increase over the second quarter of 2018, driven by an uptick in equipment replacement and repairs.

Overall, we reported a net loss for the second quarter of $9 million or $0.61 per share compared to a net loss of $26 million or $1.86 per share in the second quarter of 2018. Excluding special items in both periods, our adjusted net loss was $8 million or $0.59 per share compared to an adjusted net loss of $23 million or $1.68 per share in the second quarter of 2018. A detailed reconciliation of the special items in our financial results can be found in the tables of our press release issued yesterday.

Our adjusted EBITDA for the second quarter was a positive $7 million compared to a negative $8 million 1 year ago. This improvement in our adjusted EBITDA is a result of the significant increase in our revenues.

Beginning this quarter, we are presenting adjusted EBITDA using a 2-step method. The first step excludes nonrecurring items. The second step further adjusts our EBITDA to exclude the impact of our stock appreciation right awards at their fair value, removing the counterintuitive effect of SARs accounting given our stock price volatility. It's this second step that we are referring to as our adjusted EBITDA for all periods reported.

Finally, our cash balance was $30 million at June 30. Our total liquidity, defined as the combination of our cash balance and the available borrowing capacity under our revolving credit facility, remained strong at $68 million. There are no outstanding amounts under our credit facility at the end of the quarter.

With that, I'll turn it back to Chris.

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

Thanks, Steve. I'd like to wrap up with our outlook for the second half of the year. We still believe 2019 will be an improvement on 2018, subject to E&P budget levels increasing as expected. The primary drivers of an improvement include an increase in new multi-client programs, rise in Imaging Services backlog, growth in our Software business and the commercialization of several technology offerings we developed over the last few years. The momentum in new venture activity and increase in backlog from the end of the year suggests things are moving in the right direction.

I'm also pleased with our management transition. We are well aligned and committed to accelerate progress executing a strategy that can deliver year-on-year improvement and position the company for the future. We've sanctioned 6 new multi-client programs so far this year across a range of geographies and product types. We also made significant headway on the commercialization of our 4Sea next-generation ocean bottom technology by signing the MOU with iSEISMIC to deploy a complete system.

In addition, we leased our first SailWing system and new rechargeable battery technology under recurring revenue business models. We are also continuing to expand and enhance our Marlin offshore operations optimization software for both E&P and adjacent markets. I'm excited about the runway in front of us as we start to reap the efforts of our technology development over the last few years, benefit from the market recovery and apply our technology to new markets.

With that, we'll turn it back to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Colin Rusch with Oppenheimer & Co.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

Just in terms of these initiatives that you're going to focus on, I think we're very supportive of you getting a more narrow focus. How should we think about how you're looking at priorities and your decision-making? What are the puts and takes? And how should we think about timing?

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

Yes. Colin, thanks for that question. Yes, this is an area pretty close to my heart, which is basically focusing on tactics that will basically support the execution of the strategy longer term, but looking at things quarter-to-quarter that help us deliver and actually help us measure whether we're moving the ball forward or not. So it's something we were doing over the last few quarters in the Operations Optimization group, and it's -- I think it's starting to turn into improved revenue and margin in those businesses. So we're trying to broaden that across the whole company.

So specifically, what we've done is I would actually have the team go off and meet on a few sessions really just to revalidate our strategy, which we've done. The landscape changes all the time so I wanted to check that part first. But we've then gone in and looked at what do we do over the next -- the remaining quarters of 2019 and the quarters in 2020 that are needed to deliver the revenue wedges we have over the longer term in the growth areas that are going to deliver higher returns for the company.

So we've mapped out what those specific objectives are for each of the verticals or each of the businesses for each of the quarters. And we will be tracking that every time we have our internal quarterly business reviews to make sure that the teams are, A, accountable for that and actually moving the ball forward and making sure we don't have too many of those initiatives and milestones on a quarterly basis that we're very focused. So that's what we've put in place and are starting to roll out.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

Okay. I have some follow-ups, but I can take them offline. Just as you think about that process that you've gone through, is the organization optimized for the opportunities that you're seeing right now? Or do you feel like you need to make some adjustments?

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

That's a good question. I think initially -- I've been working in the company for almost 7 years, and we've gone through a whole bunch of organizational changes through the -- even before the downturn, but once -- we got pretty lean through the downturn and we haven't really scaled up anything particularly since then. So we're pretty lean in the operating groups. We think we're focused right for the businesses we're attacking.

The one area we may change as we move forward and get more material take-up in the adjacent markets is perhaps create a separate focus for those particular markets with leadership for that. But I think we're not at that stage yet, so we're just going to focus on having the right people attached to those initiatives, start generating the revenues, start getting recurring revenues in those places and then look at what we need to do next. But otherwise, we're sticking to the organization of the businesses we've got right now.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

Okay. And then just one final one, just a clarification. On the Marlin revenue, you mentioned 23% of software revenue. Is that related to the $5.7 million highlighted in the financial discussion? Or is it a different number related specifically to software revenue?

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

No, it's specifically related to the software revenue. It just is increasingly dominant in the mix, and it's nice to see that because it's not only a new technology that we're introducing amidst our longstanding portfolio of command and control software. So it's got a growth wedge there associated with it, but it's also something we're selling much more to oil and gas companies rather than to the contractor market only.

Colin William Rusch ***Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst***

Okay. And how many customers do you have for Marlin at this point?

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

Well, we have -- in terms of recurring customers that have signed up for the long-term recurring revenue model, multi-year contracts, we've got 3 in that category, and those are oil companies. And then the contractors are using it on a project basis. Actually, the thing that's happening nicely now is that the oil companies are basically telling the contractors that when they show up for one of their projects, they have to have Marlin deployed on their vessels.

So most of the seismic contractors had Marlin already, whether that's seabed or towed streamer over the last year, on a project basis, and we're working towards getting some of those companies signed up long term as well. If they're going to use it on 3 projects through the year, they may as well have it long term. So we've got overall -- we've had probably 15 companies or so using Marlin on a regular basis.

Operator

(Operator Instructions) There are no further questions in the queue. I'd like to hand the call back over to Chris for closing remarks.

Christopher T. Usher ***ION Geophysical Corporation - CEO, President & Director***

Okay. Well, thank you, everyone, for taking the time to attend the conference call this -- in Q2 here, and we look forward to speaking to you on our third quarter call and talk about the progress on our initiatives and our performance. Thank you very much.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.