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Q3 NOW Inc. Earnings Call
Wednesday, November 1, 2017
8:00am CT

Operator: Welcome to the Third Quarter 2017 Earnings Conference Call. My name is Paulette and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session.

I will now turn the call over to Chief Accounting Officer, Dave Cherechinsky. You may begin.

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Dave Cherechinsky
Vice President, Corporate Controller & Chief Accounting Officer

Thank you, Paulette, and welcome, everyone, to the NOW Inc. Third Quarter 2017 Earnings Conference Call. We appreciate you joining us this morning, and thank you for your interest in NOW Inc. With me today are Robert Workman, President and Chief Executive Officer of NOW Inc., and Dan Molinaro, Senior Vice President and Chief Financial Officer. NOW Inc. operates primarily under the DistributionNOW and Wilson Export brands, and you'll hear us refer to DistributionNOW, and DNOW, (which is our New York Stock Exchange ticker symbol), during our conversations this morning.

Before we begin this discussion on NOW Inc.'s financial results for the third quarter ended September 30 2017, please note that some of the statements we make during this call may contain forecasts, projections and estimates, including, but not limited to, comments about our outlook for the Company's business. These are forward-looking statements within the meaning of the U.S. Federal Securities law, based on limited information as of today which is subject to change. They are subject to risks and uncertainties, and actual results may differ materially.

No one should assume that these forward-looking statements remain valid later in the quarter or later in the year. I refer you to the latest Forms 10-K and 10-Q that NOW Inc. has on file with the U.S. Securities and Exchange Commission, for a more detailed discussion of the major risk factors affecting our business.

Further information, as well as supplemental financial and operating information, may be found within our press release, on our investor relations website at ir-dot-distributionnow-dot-com, or in our filings with the SEC.

In an effort to provide investors with additional information relative to our results as determined by U.S. GAAP, you'll note that we also disclose various non-GAAP financial measures, including: EBITDA excluding other costs, net loss excluding other costs, and diluted loss per share excluding other costs. Each excludes the impact of certain other costs, and therefore has not been calculated in accordance with GAAP.

A reconciliation of each of these non-GAAP financial measures to its most comparable GAAP financial measure is included in our press release. As of this morning, the Investor Relations section of our website contains a presentation covering our results and key takeaways for the quarter. A replay of today's call will be available on the site for the next 30 days. We plan to file our Third Quarter 2017 Form 10-Q today, and it will also be available on our website.

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Later on this call, Dan will discuss our financial performance, and we will then answer your questions. But first, let me turn the call over to Robert.

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Robert R. Workman
President & Chief Executive Officer

Before we get started today, I'd like to take a moment to thank our long-time leader, mentor and more importantly, our friend, for the 21 years of guidance he has provided to DistributionNOW. Pete Miller made an immeasurable positive impact, not only on our company, but more significantly on the lives and careers of the entire DistributionNOW family.

It is hard for me to envision the halls of our offices without Pete, especially since I have worked directly for him for the last 16 years. One thing is for sure, I don't think Pete realizes that he has retired because I met up with him one afternoon recently, and had you been a patron in the restaurant that day, you'd realize there hasn't been any change to our mentoring relationship.

While he is no longer our Executive Chairman, I look forward to continuing our long-standing relationship, and seeking his counsel. We all love and miss you already Pete and hope you enjoy your well-earned and deserved time in Telluride with Peggy.

Before I get back to the DNOW results, I'd like to extend our thoughts and prayers to all who were impacted by the recent natural disasters, including hurricanes & California fires. It is in our DNOW DNA to help each other in times of need and I want to thank DNOW's resilient employees who responded to our customers, employees and community needs in a time of crisis.

Despite being based in Houston with nearly two dozen facilities in the areas affected by Hurricane Harvey, our facilities sustained minimal damage. Regrettably, many members of the DNOW family were impacted and are still displaced from their damaged homes. The countless acts of heroism and selflessness, such as using personal boats used for rescue, were very inspirational.

Moving back to DNOW, for the third quarter of 2017, we improved our bottom line results, from a net loss excluding other costs of $36 million a year ago and $11 million in 2Q, to a net loss excluding other costs of $3 million. This was on an expected sequential revenue increase of $46 million, or 7 percent, in-line with a 7 percent increase in rigs.

The third quarter GAAP net loss of $9 million includes pre-tax charges of less than $1 million for severance and $5 million for an after-tax charge for a valuation allowance recorded against the Company's deferred tax assets. GAAP loss per share for the quarter was 8 cents, or a loss per share of 3 cents excluding other costs.

Gross margin percent improved nicely, and along with improvements in warehousing, selling and administrative costs, which were down as a percent of revenue, drove strong sequential EBITDA incrementals of 15 percent, which have now averaged a very strong 24 percent since the 2Q 2016 bottom.

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3Q 2017 marked our first positive EBITDA excluding other costs quarter since the downturn began. U.S. revenues were up 5 percent sequentially while rig counts grew 6 percent. Lower sequential revenue in the US from industrial manufacturers, reduced downstream activity and delayed line pipe projects due to Harvey, drove a $10 million revenue decline, muting the U.S. revenue expansion. Sequential operating profit incrementals in the US of 24 percent were generated as operating losses narrowed $6M on $25M in revenue gains.

Now let me give you some background on our key business drivers, and how they may impact our near- and long-term growth potential. Revenue per rig for the quarter remained in-line with quarterly measurements over the last few years. While rig counts are up 126 percent from the May 2016 trough, rig counts are still down 53 percent from the 2014 peak.

Fortunately for DNOW, we believe the U.S. Drilled but Un-Completed wells, or DUCs backlog, provides a growth driver for us in future quarters as DUC inventories are completed. Even though service companies have been deploying idled horsepower, and plan to continue doing so into 2018, there still isn't sufficient equipment and experienced crews available to keep up with the current rig count as evidenced by the accumulation of DUCs.

Given requirements for planning and scheduling completion jobs, there will always be DUCs. DUCs have surged in recent years, causing the ratio of DUCs to completions to increase. In 2014, the average was 2.6:1 and in 2015 it was 5.5:1. It ballooned to 8.9:1 in 2016 and has moderated, in our favor – but still at historically high levels, to 7.3:1 in 2017.

So while DUC levels continue to grow, presenting a growing future opportunities for DNOW, completions, or the process of making a well ready for production, are now trending up as well – providing an immediate opportunity for increased DNOW U.S. sales as tank batteries get constructed weeks or months after the completion.

Current EIA estimates show U.S. DUC counts at the end of September totaling 7,270, up 9 percent sequentially for the quarter. EIA estimates show U.S. completions in September were 1,029, up 12 percent sequentially for the quarter. U.S. rigs according to Baker Hughes, while dropping most of the quarter, were up 6 percent sequentially from 2Q. Rig counts are a good proxy for DNOW revenues over time. And newly available EIA completions data may serve as a supplementary barometer of customer activity in the U.S.

Looking at the key takeaways presentation on the IR Portion of our website, you'll see a chart showing volatility with the DUCs to completions ratio, which should provide opportunity for DNOW in future quarters as the ratio comes back into balance.

Diving Deeper into the quarter, let me walk you through our business and segment performance in various markets. Fluctuating oil prices and confidence in sustainability of the commodity price continues to hamper larger projects, in our US Energy Center business.

The market continues to be very conservative with a tremendous amount of ongoing bidding. Growth in the Permian remains bottlenecked by the difficulty of bringing on additional experienced talent. We were able to produce strong growth in our midstream projects group, even with a lack of experienced completion crews, which continue to slow well completions and facility builds.

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In the wake of Hurricane Harvey, pipe mills and coaters had to either shut down or delay production and shipments due to flooding, which also pushed back future deliveries. In US Supply Chain Services, upstream revenue grew as the implementation of three Marathon sites in North Dakota, South Texas and Oklahoma, as well as 2 large Oxy sites were finalized.

In US Process Solutions, we substantially overcame the human capital bottlenecks we experienced in 2Q and received several new orders, including an order for more than 50 crude oil pump packages for Western Refining.

For the last two years, our largest Permian customers for US Process Solutions have been purchasing multiplex pumps for each disposal well they drill and for the Big Spring Gateway Pipeline System. In the quarter, revenue with these customers was down due to project timing, however revenue grew in 3Q 2017 in US Process Solutions, driven by diversification beyond our anchor customers.

Canada revenues again were strong, growing $17 million or by 22 percent, aided by a strengthening Canadian dollar and emergence from seasonal break-up. Canadian sequential OP grew from $2 million to $4 million on strong revenue gains. Aiding our growth in Canada was increased upstream activity in the Montney and Viking plays and a new Oilsands MRO agreement. Our composite pipe division in Canada more than doubled in volume as the impact of break-up subsided and roadways were opened for transporting joints of fiberglass pipe and spools of Fiberspar.

Contract rollout activities with Pembina Pipeline, an important new customer, are near completion, which should enhance our future position. We opened a new Total Valve Solutions branch in Saskatchewan with particular focus on Cameron engineered valves that may contribute to our Canadian performance going forward.

International revenues recovered by $4 million as projects resumed, deliveries increased into Kazakhstan's Future Growth Project and overall activity in the Middle East and Europe improved. Even though sequential revenues grew Internationally, operating margins were flat as project sales at better-than-average product margins declined in 3Q. Significant year-over-year 3Q operating profit gains resulted from a 17 percent increase in international sales, while rig counts grew by just 1 percent, generating 36 percent operating profit flow-throughs during that period. Global revenues overall were up 34 percent year-over-year, near the 37 percent growth in rigs.

Looking at the impact on our suppliers, outside of the pipe mills and logistics carriers, Hurricane Harvey had little effect and our logistics carriers were back to normal within a week to 10 days after the storm.

Lead-times for midstream valves remain long as distributor inventories and manufacturers have not yet caught up with demand. We continue to place forward valve orders and our inventory for midstream valves is improving. Line pipe spot prices continued to rise for the 11th straight month as reported by Pipe Logix. Dumping suits continue as two new suits were filed on stainless flanges and forged steel fittings recently.

Conclusions were finalized on carbon flanges which resulted in prices going back to where they were before the downturn started in 2014. We have primary and alternate manufacturers which enables us to make proper adjustments so our supply chain is not interrupted due to these suits, but these suits can cause prices to rise.

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Looking at market activity moving forward. Our fourth quarter is seasonally slower than 3Q due to customer vacations, holidays, and fewer business days, as well as the exhaustion of customer CapEx budgets. Both of these tend to be headwinds against sequential fourth quarter expansion. As well, many customers are commenting that they are experiencing delays currently across the industry for surface equipment.

We believe a few factors this quarter may help to soften those sequential challenges for DNOW, but the vast majority of the time, seasonality prevails. These include increased tank battery construction, modest growth internationally and in US Process Solutions and continued implementation with Marathon's Delaware operation in US Supply Chain Services.

Yesterday we announced that we cemented an agreement with Forum Energy Technologies regarding their Global Tubing coiled line pipe products. We have been working hand-in-hand with Forum for many quarters, jointly communicating the benefits of this product to customers, as compared to traditional joint pipe, and training our sales and operational staff on how to add this arrow to their quiver.
Based on the success of our combined efforts to-date, DNOW and Forum solidified our relationship in a formal agreement and will continue jointly penetrating the market with coiled line pipe. This is another great example of DNOW partnering with a tier 1 brand and product line to ensure that our customers have access to the best and most innovative products and solutions across the energy value chain.

Like we said from the beginning of the downturn, we want to be where our customers need us when the market comes back. Given that this recovery has been an uneven one, where feast or famine themes predominate across the U.S., we are facing a challenge where resources in one area are scarce and in other areas, too plentiful.

As such, we've introduced a beta business model concept for one of our US Energy Center regions to allow for maximum customer reach, at the least possible cost to service from warehousing, selling and administrative and capital employed perspectives. Depending on results of this pilot, this could enable growth and maximum share and better bottom line results. We will continue to focus on generating growth in our pipe and valve product lines and creating an increase in our e-Commerce customer integrations.

US Energy Centers are still experiencing strong bidding in the marketplace, putting a strain on existing resources. Completions are expected to increase and we could see strong infrastructure build and pipeline work out of the Permian and in South Texas. We have a plan in place to attract additional talent to the Permian, but the holiday season this year will probably produce light activity.

The newly implemented sites in US Supply Chain Services will continue to produce sustained revenue and additional opportunity, such as the new site we are implementing with Marathon in Carlsbad, New Mexico. Additional growth will come from orders taken in 2Q and 3Q for larger capital projects, which US Supply Chain Services will begin billing in 4Q.

We provided bids to two long-term customers for 38 multi-purpose oil, water and gas combination LACT units and 55 oil LACT units for which US Process Solutions should receive purchase orders in 4Q 2017 for delivery in future quarters. Also in U.S. Process Solutions during 4Q, our Total Valve Solutions facility in the Rocky Mountains secured two projects for two separate customers, one in the DJ Basin and one in the Bakken. One

project scope included 37 fully automated valve packages with pneumatic actuation and the other encompassed 35 actuators and controls packages that will ship in either late 4Q or early 1Q.

While the Canada market tends to expand seasonally in the fourth quarter, early fourth-quarter rig downturns suggest the usual seasonal lift might be subdued. Gains in the midstream arena could make for better-than-expected results, given this headwind. We are anticipating continued growth in our composite pipe division in Canada as we have recently quoted a half dozen projects in high quantities and unusually large diameters, that if secured, would generate additional revenues in future quarters.

We have also recently submitted proposals to two large Canadian operators from whom we are receiving very positive feedback, and if secured, would have a very favorable impact on our future performance.

Our project bid pipeline from operators and EPC's continues to increase throughout the international segment as customers revalidate pricing of budgetary quotes provided earlier this year to firm up budgets for 2018. We have also seen drillers, such as Borr Drilling, getting more bullish about a recovery in the jack-up market with their acquisitions of several drilling assets to expand their fleet. When activity with offshore customers eventually improves, we will be prepared to support them thus intentionally retaining our bases in Singapore, Australia, the North Sea, Gulf of Mexico and Brazil during this down cycle.

Moving to capital allocation, working capital as a percent of revenue was with and without cash, 26 percent and 23 percent respectively. This was driven by increased inventory, in anticipation of further growth and for long lead-time items which have begun to arrive and increased receivables as sales have expanded. Inventory turns are near target levels, buoyed by improvements in Canada and International, with a decline in the U.S. as the noted long lead-time items began to arrive.

In terms of deal activity, we looked at fewer but larger deals in the third quarter than in 2Q. Some of these have been deals that we have been waiting to come out of the gate for several years and finally had the opportunity to review. But, upon digging further into them, it further solidified our already agreed upon strategy to focus on providing higher value add products and solutions to our customers and not diversifying outside of our core.

Additionally, we had good conversations with some private equity firms about certain assets that would be attractive to our portfolio should the prospect become available and we believe that in some cases that could be in the next year or so. As always, for us, being fiscally conservative in allocating capital, the question will be whether or not we want to bridge the bid-ask spread. But, we have a solid balance sheet to avail when needed. Our strategy continues to be growing organically in our Energy Center business and growing through acquisitions in our US Supply Chain Services and US Process Solutions businesses, leveraging our scale and the higher value add product lines across our segments.

As noted, while our 4Q tends to be weaker, we see some positive signs and are working on internal initiatives we believe could soften those seasonal factors. And as mentioned earlier, as DUC levels continue to grow, this presents a growing future opportunity for DNOW.
Before I turn it over to Dan to run us through the detailed financials, I'd like to take a moment to recognize someone else on the DNOW team, Doug Pennington, who works in our Materials Management Group in Houston as a Material Recovery Manager and has been with the company 44 years.

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Doug started with J&L Supply in Wichita Falls in 1973 as a "Beginner Storeman" and that is where he and Sandra, his wife of 41 years, met and married on April Fool's day. If someone wanted to do a case study on the impact of mergers and acquisitions on employees, I'd highly recommend they contact Doug.

Doug's M&A experience started when LTV merged J&L supply with Continental Emsco, which was then purchased by SCF Partners, who then sold the supply division to Wilson Supply, which was acquired by Smith International before they were acquired by Schlumberger, who subsequently sold Wilson Supply to National Oilwell Varco and then was spun-off into a publicly traded company called DistributionNOW.
When Doug isn't spending time with his wife and his three sons, all of whom have served or currently serve in the military, he is usually in his garage working on computers or out shooting sporting clays. I'd like to thank Doug for his many years of loyal service and ask that he gets inventory turns up by a full point before our next earnings call.

And now I'll turn it over to Dan.

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Daniel L. Molinaro
Senior Vice President & Chief Financial Officer

Thanks, Robert. We are approaching a return to profitability, and it wouldn't be possible without our dedicated workforce and I remain convinced we have the top people in the industry. I am proud to be a part of this wonderful team, and am grateful for the hard work, integrity and perseverance of the DNOW family. Thanks for all you do! We will continue to concentrate on the needs of our customers, while focusing on producing long-term value for our stakeholders.

Robert discussed our business, and I'll say more about our financials. NOW Inc. reported a net loss of $9 million, or 8-cents per fully-diluted share on a US GAAP basis for the third quarter of 2017 on $697 million in revenue. This compares with a net loss of $17 million, or 16-cents per fully-diluted share, on $651 million of revenue in the second quarter of 2017.

When looking at the year-ago quarter, we had a net loss of $56 million, or 53-cents per fully diluted share, on revenue of $520 million for the third quarter of 2016.

The third quarter 2017 results included $5 million of after-tax charges for valuation allowances recorded against our deferred tax assets, and less than $1 million of pre-tax severance charges. After adjusting for these other costs, our third quarter loss was $3 million, or 3-cents per share both non-GAAP measures.

We are encouraged by Gross Margin rising to 19.4**%** in 3Q, compared with 19.0% in 2Q 2017 and compared with 16.7% in the year-ago quarter. The Company generated an Operating Loss of $6 million in the third quarter of this year, versus a $14 million loss in the previous quarter, and an operating loss of $53 million in the year-ago quarter.

Third quarter EBITDA excluding other costs (a non-GAAP measure) was $5 million sequentially improving by $7 million and our first positive EBITDA since the first quarter of 2015. EBITDA sequential flow-thru was 15% in the third quarter 2017.

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Looking at operating results for our three reportable geographic segments, revenue in the United States was $506 million in the quarter ended September 30, 2017, up 5% sequentially, and up 36% over the year-ago quarter.

Year-over-year improvement in the U.S. rig count contributed to these revenue improvements. Revenue Channels in the US for 3Q were 55% US Energy, 30% US Supply Chain Services, and 15% US Process Solutions. Third quarter Operating Loss in the US was $10 million, compared with a $16 million loss in the second quarter of 2017, and a $46 million operating loss in the year-ago quarter. The narrowing of the US operating loss was primarily driven by increased volume and improved product margins.

In Canada, third quarter revenue rose 22% sequentially, to $96 million, and was up 43% over 3Q 2016, due essentially to increased Canadian rig activity. For the three months ended September 30, 2017, Canada's Operating Profit was $4 million up $2 million sequentially and improved $6 million over the year-ago quarter, reflecting the increased rig activity and lower inventory charges.

International operations generated third quarter revenue of $95 million, which was up 4% from the second quarter of 2017 and up 17% from the year-ago quarter. A resumption in electrical projects in Europe and increased customer penetration throughout the Middle East contributed to these revenue improvements. International's Operating Profit was break-even for the third quarter 2017 the same as the prior quarter, and a $5 million improvement over the year-ago quarter. Operating profit improved over the year-ago quarter, due to increased volume.

Continuing on our Income Statement, Warehousing, selling and administrative expenses was $141 million in the third quarter up $3 million sequentially, and up $1 million over 3Q '16, as we grow our Supply Chain Services and Process Solutions businesses. These costs include branch, distribution center and regional expenses, as well as corporate costs.

Our effective tax rate for the third quarter of 2017 was a negative (1.6)%, and for the nine months ending September 30, 2017 was 0.6%. Compared to the U.S. statutory rate of 35%, the rate continues to be impacted by recurring items, including lower tax rates on income earned in foreign jurisdictions that is permanently reinvested, offset by certain non-deductible expenses, state income taxes AND the change in a valuation allowance recorded against our deferred tax assets in the US, Canada & other foreign jurisdictions.

The change in valuation allowance is the most significant factor, and brings our effective tax rate to the low single digits approaching zero. You'll recall that we must record a valuation allowance against our deferred tax assets when for GAAP purposes it is more likely than not that some portion, or all of our deferred tax assets will not be realized. As we continue to return to profitability, we can adjust the valuation allowance, thus reducing GAAP income tax expenses in future periods.

Excluding the impact of our valuation allowance, as well as a favorable return-to-provision adjustment impacting our valuation allowance, our third quarter effective tax rate would have approximated 35%. We expect our fourth quarter GAAP effective tax rate to remain in the low single digits.

Turning to the Balance Sheet, NOW Inc. had $628 million of Working Capital (excluding cash) at September 30, 2017, which was 23% of annualized sales essentially the same as the previous quarter and remained below our

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25% target. Accounts Receivable increased $48 million sequentially, to $466 million, reflecting our increasing revenue.

The pace of bankruptcies in our energy space is easing, and companies have emerged from bankruptcy, but there are still some remaining concerns. Some companies were able to keep their heads above water in 2016, but now that commodity prices have not completely recovered, may still need to do something, whether it's in-court or out-of-court restructuring. Banks are looking more favorably on the energy industry, but upcoming debt maturities could be a concern so we must continue to be diligent as we extend credit.

Our current Days Sales Outstanding (DSO) was 61 days. We've made progress, but there is still more to do. Inventory was $562 million at the end of the third quarter of this year up $33 million over 2Q, as we respond to increased activity.

With signs of an improving market, and continued replacement orders for long lead-time items, including pipe and valves, inventory levels may rise, but we will carefully manage the process. Inventory turns remained at our targeted 4.0 times in 3Q. Days Payable Outstanding were 50 days. Cash totaled $99 million at September 30, 2017, with $83 million located outside the US more than one-third of that being in Canada.

Having this cash overseas could facilitate financing of an international acquisition, if the opportunity develops.

We ended the quarter with $163 million borrowed under our revolving credit facility, and were in a net debt position of $64 million when considering total company cash. Our debt-to-cap was approximately 12% at quarter's end, and we had $441 million in availability. Our borrowing cost on the debt approximates 4%, as the Fed pushed short-term rates incrementally higher. Our credit facility matures in April 2019.

Capital Expenditures were $2 million in the third quarter of this year, and only $3 million for this year, so far. Showing the effects of improving business conditions, and the need to support the organic revenue growth, Free Cash Flow used for the third quarter was $35 million.

Our worldwide market continues to be challenging, as we remain tied to global rig count, and drilling & completion expenditures. We will continue to focus on serving our customers, as we rationalize expenses, concentrate on integration gains from our acquisitions, and seek to maximize new opportunities.

We have confidence in our strategy, in our employees, and in our future, as we position NOW Inc. to serve the energy and industrial markets with quality products & solutions. We are an organization with exceptional leaders, outstanding employees, solid financial resources, and will continue to respond to the needs of our customers.