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Q1 NOW Inc. Earnings Call
Wednesday, May 2, 2018
8:00am CT

Operator: Welcome to the First Quarter Earnings Conference Call. My name is Sylvia, 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 Senior Vice President and Chief Financial Officer, Dave Cherechinsky. Mr. Cherechinsky, you may begin.

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Dave Cherechinsky
Senior Vice President & Chief Financial Officer

Thank you, Sylvia, and welcome, everyone, to the NOW Inc. First Quarter 2018 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, Executive Vice President.

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 first quarter of 2018, 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 laws, 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 earnings 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 income or loss excluding other costs, and diluted earnings or 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 earnings 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 first quarter 2018 Form 10-Q today, and it will also be available on our website. But first, let me turn the call over to Robert.

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Robert R. Workman
President & Chief Executive Officer

Thank you, Dave, and good morning everyone. I want to thank each of you for taking the time to join us today. This morning, I will review our key financial metrics and go over our strategic progression and business segment highlights. Then I'll turn over the call back to our CFO, Dave Cherechinsky, for a more detailed review of the financial results before he returns it to me for my closing comments.

In speaking with customers, suppliers, other oil and gas market participants and experts, most note the worst of this cycle is behind us, finally. We generally agree, as we saw increased revenues across all reporting segments with notable growth in our U.S. operations both sequentially and year over year. We finished the first quarter of 2018 with revenue of $764 million, up $133 million, or 21%, from the first quarter of 2017, exceeding expectations.

Our revenue growth outpaced global average rig count growth, which was up 12% year over year. Geographically, year-over-year, the U.S. topline increased 28%, followed by a Canadian increase of 6%, and then International at 4%. In the U.S., Energy Centers made up 53% of U.S. revenue, followed by Supply Chain Services at 33% and Process Solutions at 14%.

Gross margin percentage was up 30 basis points as margin gains in the U.S. were offset by product margin declines in Canada, coming off their 4Q highs. Warehousing, selling and administrative expense was $141 million for the quarter, as expected, and up $3 million sequentially, excluding the $10 million gain in 4Q 2017 related to the sale of a property in California that we mentioned on the 4Q call.

Expense control, during the period, in light of elevated revenue growth reflects our focus on cost rationalization and value optimization, including the closure of eight locations this quarter, and 30 in the last year in slower areas, as well as hiring in areas of increased activity.

EBITDA, excluding other costs, was $16 Million, up year-over-year by $25 million. As a result of our strong top-line growth and excellent operational execution, net income excluding other costs was $1 million or earnings per share, excluding other costs, of $.01 cent. Our results show we've started the year strong, and we have an optimistic outlook for the remainder of 2018 as U.S. fundamentals continue to improve.

Our 1Q financial performance gives us greater confidence in the upper end of the guidance we gave on the 4Q call of low double digit to mid-teen growth for the full year of 2018 and could even stretch to high teens if current conditions persist. We do, however, remain cautious due to the unknown downstream effects of trade policy changes, impacts of potential consolidation in the shale plays, market and product pricing pressures, the ongoing offshore drought and general unease and noted softening in Canada.

Our robust first-quarter performance was the result of our employees' hard work as they executed against our four-pillar strategy. These pillars include maximizing our core operations, driving margin expansion, leveraging our acquisitions and approaching capital allocation with discipline. With the ongoing successful execution of these strategic pillars, we can deliver the gains our shareholders expect. And, we made excellent progress on all four pillars in the first quarter.

In the area of maximizing operations, we continue to evaluate our footprint and adjust as the market requires. We closed eight locations and opened one in line with market activity. Another example of our continued focus in this area is our agreement to partner with key manufacturers allowing us to meet increasing demand across Texas, the Rockies, North Dakota and Oklahoma, where recent lead times has been up to three months.

Additionally, there are several human capital efforts underway in the Permian basin to strengthen our position and gain market share there, that includes heightened training and recruiting, as well as relocating key managers. We're also making progress on margin expansion. In addition to capitalizing on the strong market environment, we are enhancing operating margins by leveraging an improved quoting process that enables us to process a higher volume of quotations across markets.

Our continued commitment to stock a comprehensive breadth of inventory enables us to not only get better manufacturer pricing, but allows us to integrate certain products, like an air compressor or multiplex pump product, into modular orders on one skid. This vertical integration gives us advantages over competitors that must buy items from other regional distributors.

Pricing adjustments, related to Section 232 activity, are integrated into our pricing and quoting processes as applicable. We're also driving internal collaboration to leverage total package solutions and utilizing our own expertise instead of outsourcing. In addition, we are continuing to push technology usage in the field, allowing customers have the ability to acquire thousands of products from any of our approximately 275 locations, including our regional distribution centers, or online.

In terms of leveraging our recent acquisitions. We continue to see cross-selling of products from our acquisitions. For example, Odessa Pumps is selling instrument air compressor units and Power Service is selling reciprocating water injection pump packages. The strong collaboration between Energy Centers and Process Solutions is resulting in pull through sales, new customer introductions and increased market opportunities.

As evidence of this, we recently received a sizeable modular component order from a new customer, one of the largest operators in the Permian. This Process Solutions win, which will take several quarters to fabricate and deliver, has opened the door for our Energy Centers to provide all of the pipe, valves and fittings, or PVF, required for the installation and operation of our modular solutions….an order that our U.S. Energy Centers likely wouldn't have received without our ability to bundle with our Process Solutions offerings. As well, expanded valve modifications now offered by our Total Valve Solutions group improved our cost position on recent midstream high value valve and valve actuation projects.

Our fourth pillar is approaching capital allocation with discipline. To that end; we improved inventory turns to 4 times in 1Q while DSO's marginally increased by one day to 59 and DPO's remained flat. Working capital, excluding cash, as a percent of revenue dropped to 22.3%, as expected. We are confident that the execution of our strategy will drive long-term shareholder value, and as outlined, we are making progress on each of the four pillars.

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Turning to look at the market indicators for DNOW, let's start with WTI and rig count. WTI hit $66/barrel in the quarter and led to a U.S. rig count average of 965 for 1Q18, up 31% from 739 a year ago. In Canada, average rig count moved from 299 in 1Q 2017 down to 273 in 1Q 2018. When comparing the 2018 break-up period on a week by week basis to the one in 2017, this particular freeze-thaw cycle is more severe. International rig count is up from the prior year average by 3%, to 970 in 1Q 2018 from 939 a year ago quarter.

WTI pricing remaining in the current range is a positive trend for our Global Energy Centers and other U.S. operations. Our second indicator is Drilled but uncompleted wells, or DUCs. According to the EIA, March ended with a DUC count of 7,692 wells. Keep in mind that the declining DUC growth trend is favorable as it represents wells being completed and the opportunities for our businesses to participate in that activity.

The third indicator that we evaluate is Completions. Completions continued to grow in 1Q, even though there were 331 more wells drilled than completed in the quarter. Like the DUCs, we continue to believe that this trend is favorable for our business. Based on all three indicators, we believe DNOW is positioned well to take advantage of the improving market.

Turning to our reporting segments. Let's start with our largest segment, the U.S. Revenues were $562 Million, up $123 million year over year, or 28%. Incremental operating profit flow-through was 24% year over year. Sequentially, revenues were up $74 million, or 15%, outpacing rig count growth in that same period. Sequentially, 1Q operating profit incremental flow-through was strong at 19%, excluding the $10 million benefit of the property sale in 4Q 2017. An improvement in rig count and our focus on tightly managing expenses produced these strong flow-throughs. Strength in the Permian and with large Supply Chain customers in particular, drove more than half the U.S. growth and helped drive gains in excess of rig expansion growth.

Looking at the specific operations within the U.S. the U.S. Energy Centers business reported significant gains from several large customer orders. The Permian had the largest revenue increase, with slight increases in the Rockies, South Texas, Bakken and San Juan Basin. We gained market share in this area by adding three new customer accounts. We also saw the greatest increases from midstream projects in the Mid-continent area. Midstream pipe customer activity was strong in the quarter, though it was offset both by revenue disruptions from the nor'easters that made it difficult for some customers to accept shipments, as well as the lack of visibility around the potential impact of the new trade policies.

Product availability will be more difficult for many distributors, especially those that were more reliant on import sources and did not have good domestic sources, as we do. We have both import and domestic sources and have been shifting as required to maintain our service to our customers. Due to increased volume, many domestic manufacturers are not taking on new distributors but continue to supply their existing partners.

Moving forward, assuming that rig count and commodity price trends continue, and there are no major supply disruptions, unforeseen events or major inclement weather, we see a continued positive trend for our U.S. Energy Centers business revenue. The Permian will likely lead activity gains. One potential disruptor is the tariffs and the downstream impact from those.

US Supply Chain was up 37% year over year, and 19% sequentially. The sequential growth was primarily from increased activity with our SCS integrated supply energy customers, as well as from our Downstream & Industrial business, which added a new ExxonMobil pipe, fitting and flanges, or PFF, contract and saw the completion of several turnarounds. Machine Tool Supply also added a new manufacturing customer in the quarter.

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U.S. Supply Chain energy customers grew as a result of large construction projects in the Delaware Basin, with continued partnership with Oxy and Marathon, capital projects from Hess and Devon, and a steady flow of orders for fabrication work in Texas. U.S. Supply Chain Services may be down slightly in future quarters due to sizeable 1Q project-related swings in activity, a decrease in turnaround activity and branch restructurings.

For U.S. Process Solutions, we saw 14% year over year revenue growth, and 4% sequentially. The Power Service business order activity is promising, adding customer orders for LACT units, saltwater disposal packages and ASME vessels in the quarter. Odessa Pumps also added new midstream customers in the quarter.

The Permian remained the most active region for U.S. Process Solutions, with the Bakken, DJ, Powder River and Eagle Ford seeing increased activity. As oil prices remain at current levels or rise, this should lead to an increase in well completions, which bodes well for the Process Solutions business. There are several projects set to be awarded or to begin in 2Q. These include produced water disposal pumps, large LACT units, actuated valves and vessels for new and existing midstream and upstream customers.

Turning to our Canadian operations, Canadian revenue was up 6% year over year at $102 Million. 1Q is usually our busiest Canadian quarter as January through March is our coldest part of the year and the frozen ground allows for better site access. Sequentially, revenue was up 20%, stemming from the seasonal increases including market share growth from two new customers in the quarter as well as the favorable impact of foreign exchange rate fluctuations.

Moving into the 2nd quarter, Canada will experience breakup as the freeze-thaw cycle has historically reduced our Canadian revenues as much as 35% sequentially. Our optimism from market share gains and growing midstream customers is dampened by export pipeline constraints, the current regulatory environment and Statistics Canada's prediction of decreased capital spending in Canada for 2018. As a result, we are cautious about our Canadian operations for the next few quarters.

Finally, the International segment reported revenues of $100 Million. This segment is up 4% both year over year and sequentially. Gains in the quarter are due largely to favorable foreign exchange rates year-over-year and customer contracts in the Middle East, Europe and Australia. We are starting to see several green shoots internationally from Asia Pacific, the Middle East and North Africa for some new builds, a recent tender out of Europe and new electrical and cable frame agreements. However, that is all tempered by the unknown implications from Section 232 for import materials shipping from the U.S.

As I said earlier, assuming that business drivers and commodity prices maintain their upward trends, and that there are no major supply disruptions or unforeseen events, we are optimistic about DistributionNOW's near-term prospects.

With that, I'll turn the call over to Dave to review the financials.

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Dave Cherechinsky

Senior Vice President & Chief Financial Officer

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Thanks, Robert.

For the first quarter of 2018, the company generated $764 million in revenue, an increase of $95 million or 14% sequentially, and growth of $133 million or 21%, from the same period in 2017. This marks the strongest sequential-quarter revenue gain on an absolute dollar basis since 3Q14. Gross margins grew to 19.4% in the first quarter, up from 18.1% in the same period of 2017, the highest levels for gross margins since the fourth quarter of 2014.

Warehousing, selling and administrative expenses or WSA, was $141 million in line with our "$140 range" guidance. This was just $1 million more WSA than the second quarter of 2016, which since then on a run rate basis, we added $1 Billion dollars in revenue to our business. In other words, the same level of expense for a business, now $1 billion larger. In 1Q18, WSA was up $3 million sequentially, after excluding a $10 million gain on sale of property from 4Q 2017. We expect WSA to be in the low- to mid-$140s range per quarter for the remainder of 2018.

Operating profit was $7 million or 0.9% of revenue compared to an operating loss of $21 million or negative 3.3% of revenue in 1Q17. Net Income for the first quarter was $2 million or $0.02 cents per diluted share, an improvement of $25 million when compared to the corresponding period of 2017. Our effective tax rate for the three months ended March 31, 2018 as calculated for U.S. GAAP purposes was 24.1%. As our profitability increases, and when we are no longer subject to a valuation allowance in the U.S., we expect our effective tax rate to be in the mid to upper 20% range.

On a Non-GAAP basis, EBITDA excluding other costs was $16 million or 2.1% of revenue for the first quarter of 2018. Net income excluding other costs was $1 million or 1 cent per diluted share. Other costs after tax for the quarter included a $1 million benefit from changes in the valuation allowance recorded against the Company's deferred tax assets, we excluded this gain to arrive at Net income excluding other costs.

In 1Q 2018, we continued to evaluate the provisions of the Tax Cuts and Jobs Act as well as all interpretive guidance issued to date. We have not completed accounting for all the effects of this new law, but have recorded provisional amounts which we believe represent a reasonable estimate of the accounting implications of the Tax Act.

In April, guidance was issued by the IRS and Treasury Department which clarified that we could elect out of using our 2017 net operating losses when computing the one-time transition tax. Therefore, we recorded adjustments to provisional amounts originally recorded at December 31, 2017. We excluded this impact in computing net income excluding other costs for the three months ended March 31, 2018.

Moving to our segments, every reporting segment experienced growth year over year and sequentially. U.S. revenues grew to $562 million, a 28% improvement from the first quarter of last year driven by an improvement in U.S. rig and completions activity. Canadian revenues were $102 million, up 6% year-over-year, despite a decline in Canadian rig count, the growth due primarily to a favorable foreign exchange rate. And internationally, revenues were $100 million in the first quarter of 2018, up $4 million from a year ago, also as a result of foreign exchange.

Moving on to operating profit, U.S. generated operating profit of $3 million or 0.5% of revenue, an improvement of $29 million when compared to the corresponding period of 2017, improving primarily due to significant

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revenue increases coupled with flat operating expenses. Canada operating profit was $4 million or 3.9% of revenue, an increase of $1 million when compared to the corresponding period of 2017, the gains attributable to improved product margins in the period.

International operating profit was zero, a decline of $2 million when compared to 1Q17. Despite the increase in revenue discussed above, operating profit declined primarily due to increased bad debt charges in the first quarter of 2018.

Turning to the balance sheet. Cash totaled $80 million at March 31, 2018, with $68 million located outside the U.S. half of that being in Canada and the UK. We ended the quarter with $175 million borrowed under our revolving credit facility, and a net debt position of $95 million when considering total company cash. Our debt-to-cap was 12.8% at March 31, and we had $452 million in availability.

Our borrowing cost on the debt approximates 4%, and we expect the Fed to continue to push short-term rates incrementally higher, as they attempt to fend-off inflation. Working Capital, excluding cash, as a percent of revenue was approximately 22%, under our target of 25%.

Accounts receivables were $496 million at the end of the first quarter, up $73 million, as our DSO's moved to 59 days. First quarter inventory levels were $609 million. Turn rates were 4.0 in 1Q and in our guided range of 4 turns or greater. Accounts Payables were $331 million at the end of the first quarter with DPOs flat from year end at 49 days.

Cash flows used in operations was $30 million for the first quarter with capital expenditures of approximately $1 million, in line with our previous guidance. Resulting in Free cash flow used in the quarter of $31 million. Finally, we are pleased that on April 30, we successfully closed on a new five year $750 million global senior secured credit facility, with potential to increase it to $1 billion under certain conditions.

This new facility replaces the senior secured $750 million revolving credit facility expiring in April of 2019. The new facility has no financial maintenance covenants. In addition, our new credit facility has better pricing, when compared to our previous facility, allowing us to execute on our growth priorities, while lowering costs. Our new credit facility expires in April 2023.

With that, I will turn the call back to Robert.

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Robert R. Workman
President & Chief Executive Officer

Thanks, Dave. Let's wrap up with the outlook for the remainder of 2018. Our outlook is tied to global rig count and drilling and completion expenditures, particularly in North America. Oil prices and U.S. oil storage levels will continue to be primary catalysts for determining U.S. rig activity. Our approach continues to be to advance our strategic goals and manage DNOW based on market conditions. Before I move on to recognize one of our dedicated employees, I'd like to summarize the progress we made in the execution of our four-pillar strategy.

We maximized our operations by adjusting our footprint in line with customer demand and by optimizing our human capital and supplier relationships. We executed on margin enhancement initiatives by improving our quotation and pricing processes, expanding our breadth of inventory, and driving intra-company collaboration.

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We leveraged acquisitions through enhanced cross selling and collaborations and we approached capital allocation with discipline, improving inventory turns. With the further successful execution of our strategy, we fully expect our continued improvement towards generating shareholder value. With that, let me recognize one of the employees whose daily hard work and dedication enable us to deliver on our promises.

David Dybala's extensive 44-year career with DNOW started as a Warehouse Driver for Wilson Supply in Houston when the Oilers started playing in the Astrodome and Dan Pastorini was still the quarterback. David spent nearly his entire career in South Texas, mainly at our Victoria Texas Branch. He and his wife, Cathy, and two children, enjoy spending time together as a family on their ranch outside of Goliad, Texas.

One of the many feathers' in David's cap, was his leadership over one of our largest branch projects in 2009. It involved a South Texas customer's critical ramp up on its Eagle Ford infrastructure and generated nearly $100 million in revenue. It was a challenge, but David made it happen.

David has been involved in all of the different markets that we serve and has developed many people throughout the organization. His attention to detail and process compliance, extensive product knowledge, markets experience, and understanding of the industry make him an ideal mentor for anyone in our company, new or experienced.

And, when it comes to picking up a tab, many believe they can get a watermelon out of their pocket quicker than David can get a nickel out of his. That conservatism, along with his leadership, and years of dedication, make it not only an honor for all of us to call David a very loyal employee, but more importantly, a friend. Thank you and your family for all that you do for DNOW David.

And with that, let me turn it over to Sylvia to start taking your questions.