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Q2 2017 NOW Inc Earnings Call

PRESENTATION

Operator: Welcome to the Second Quarter Earnings Conference Call. My name is Sylvia, and I'll be your operator for today's call. (Operator Instructions)

I will now turn the call over to Chief Accounting Officer, David Cherechinsky. Mr. Cherechinsky, you may begin.

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Dave Cherechinsky
Vice President, Corporate Controller & Chief Accounting Officer

Thank you, Sylvia, and welcome, everyone, to the NOW Inc. Second 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 second quarter ended June 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 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 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 Second 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

Thanks, Dave. When the downturn began, no one correctly anticipated how long, choppy and uncertain it would be. In the first half of 2015, the contour of the down-cycle tracked the path of the prior downturn and recovery: WTI oil prices recovered to $60 in June of 2015 and rigs were rebounding almost in lock-step with the 2009 recovery. Then we saw the brutal double-dip phenomenon that turned 2016 into the industry's worst cycle in a generation. Throughout this, our strategy has been to maximize our ability to serve our customers when the market returned, and we are doing just that. Our plan also has been to pull out cost thoughtfully to minimize losses and solidify our position in the market, and we're doing that too.

We recognized that a reduced infrastructure with fewer resources would demand making choices. So we intentionally retained a core of talented people who could weather the cycle. Pursued product lines, customers, transactions and risks where the reward was commensurate with the investment. Collaborated with our suppliers, trained our people and deployed technology to drive real improvement in our margins. Secured many contract wins strengthening our market position and successfully negotiated improvements with low profit accounts. Chose to walk away from some dilutive margin projects and contracts and we did these things and more, and are continuing to look for ways to constantly improve our business, every day.

There is no doubt, the recovery is underway, but its path is uncertain. Notwithstanding, we will continue to focus on the fundamentals, namely: growth, price, expenses, managing the balance sheet and delivering returns to our shareholders. To that end, the second quarter of 2017 represents the fourth consecutive quarter of top line growth and the beginning of our fourth year as a standalone public company.

The second quarter is normally our softest quarter of the year due to Canadian break-up. But, we were able to overcome the Canadian revenue decline with better than expected U.S. Up- and Midstream performance, especially considering the rise in drilled but uncompleted wells, or DUCs, by more than 1,000 to over 6,000 by June, a 20 percent increase since year-end, that occurred as service providers scrambled to staff and refurbish idle frac fleets to meet current drilling and completion activity. Solid gross margin gains and a tightly managed balance sheet and expenses, enabled exceptionally strong flow-through of 35% on sequential revenue growth.

In the quarter, we were on the cusp of break-even EBITDA, even though Canada was experiencing break-up and International contracted due to non-recurring projects. Our U.S. Process Solutions business faced challenges in hiring certified staff in the Rocky Mountain region to process a noted increase in our order book. Timing is everything, and in the second quarter, we saw delays in recognizing revenue on some orders due to customer deferrals and the resource constraints mentioned earlier.

We expect our upstream businesses to continue to experience growth at today’s rig count levels, as we secure resources to work through U.S. Process Solutions projects and as service providers strive to reactivate their idle frac fleets before year-end. For this reason, we expect to reach positive EBITDA and possibly EPS, excluding

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other costs, during the second half of 2017 assuming we don't experience a market contraction, a decline in product margin gains and delays in service companies' ability to successfully deploy equipment to begin working through the backlog of well completions.

Revenue per rig for the quarter, both with and without acquisitions completed in the prior year, remained in-line with quarterly measurements over the last few years. Producing consistent sequential revenue per rig performance indicates a continued strong DNOW market position, considering, DUCs continue to grow, especially in the Permian. Our offshore revenues with operators and drillers have declined over 70%, since 2014, as rigs are scrapped and destocked, and an offshore recovery is not in sight.

In a distribution business, where proprietary products and machinery are largely non-existent, a company's performance is tightly correlated to the quality of its employees and the service they provide their customers. One employee who has absolutely contributed to the performance of DistributionNOW is Paul Matherne, who will celebrate his 44th year with us in just a few months. Paul started with DistributionNOW in 1973 as a Field Representative in Harvey, Louisiana.

During the 1980s, he moved throughout Louisiana and Alabama as a Field Sales Representative. In the late 90's, he became the sales supervisor at our Mobile, Alabama location and shortly thereafter, was promoted to Branch Manager. Paul went on to manage other branches before he eventually accepted the position of Area Process Coordinator for the Greater Gulf Coast.

He eventually moved up through the ranks to become the U.S. Business Process Manager and is currently one of two Lead Process and Risk Specialists for DNOW. Paul, or the "P-Diddy of process" as his team calls him, has coached and mentored dozens of employees during his time at DistributionNOW and I have yet to meet someone who doesn't love him. Whenever he can tear himself away from work and Ducks Unlimited, Paul spends his time fishing and hunting, which is the case with many of our employees along the gulf coast. I'd like to thank Paul, along with our exceptional team of loyal employees, for everything they do to make DistributionNOW the company it is today.

Diving deeper into the quarter, for the second quarter of 2017, we reported a net loss of $17 million, or a net loss excluding other costs of $11 million, which is a sequential improvement on revenue growth of $20 million. The GAAP net loss includes pre-tax charges of $1 million for severance and $6 million for an after-tax charge for a valuation allowance recorded against the Company's deferred tax assets.

GAAP diluted loss per share for the quarter was 16 cents, or a diluted loss per share of 10 cents excluding other costs. Sequential organic revenue improvement of $20 million was driven by growth in the U.S., offset by seasonal weaknesses elsewhere. Incrementals of 35% were much higher than projected, even in the early quarters of a recovery. We continued actively managing expenses by further reducing our branch footprint in contracting areas, helping offset the net employee increase in the growing active shale regions.

On the product margin front, our branch level incentive plan continues to encourage our employees to intentionally push price where appropriate. This, along with the implementation of our pricing software, aided the U.S. in achieving pricing improvements for the second straight quarter, even though price competition remains fierce. Our focus on inventory efficiencies and pricing advanced our Gross Margin position by 90 basis points in the second quarter sequentially, or 260 basis points since the fourth quarter of 2016.

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We could see continued improved Product Margins in the near term as price opportunities expand. We are pushing price increases for products, most notably in high-steel-content categories due to supply, demand factors and rising raw material costs, along with the threat of government actions and antidumping trade suits for pipe. These increases were passed on to the market as line pipe prices continued to move up, albeit at a slower pace in 2Q compared to 1Q for both domestic and foreign pipe.

Lead-times continue to be long on certain products, notably on pipe and engineered valves. This supply bottleneck is due to increased pipeline and well hook-up demand as well as the capacity ramp-up out of the downturn. Manufacturers are adding resources to help trim or stabilize lead-times. We are actively working with our suppliers to maximize product availability for our customers.

OCTG demand remained strong in 2Q due to the rising rig count, and since manufacturers favor this product line, it limited line pipe availability, especially seamless pipe. There are still many trade suits moving through the commerce department. The expected tariffs or quotas that were to be announced at the end of June have still not been revealed, but steel continues to be one of the trade relief targets for the U.S. domestic industry. The threat of these trade sanctions has caused some disruption in the steel and pipe markets.

Regarding activity in the quarter, shale company's access to oilfield services, including rigs, frac equipment and personnel, was impeded, which resulted in a spike in the DUC count. This translated into tank battery construction delays that constrained revenue opportunities in the quarter, but create a tailwind for us in future periods.

Bolstered by robust growth with midstream customers, U.S. Energy Centers saw an 18% sequential revenue improvement, which helped offset the delayed tank battery construction impact with upstream operators. Some of this growth was driven by continued line pipe projects across several regions with midstream, gas utility and offshore Gulf of Mexico customers.

In U.S. Supply Chain Services, we saw 22% growth with our upstream operator customers, mainly driven by the Marathon implementation as well as general activity increases with Devon and Hess. This growth was partially offset by reduced project and turnaround activity with downstream customers and a softening in our industrial manufacturing supply chain businesses.

Large mainline pipeline projects destined for the EagleFord, which boosted 1Q17 revenue levels, did not repeat in U.S. Process Solutions in 2Q17. We are excited, as I mentioned earlier, that U.S. Process Solutions has experienced robust project activity growth destined for most of the U.S. shale plays to be delivered in future periods. As is the case with many companies, attracting and hiring skilled staff to work through increased activity has proven to be difficult, especially for U.S. Process Solutions.

Consistent with most upturns, we are finding that recruiting project managers and ASME fabricator staff with the proper certifications and skills to return to our industry, and the specific cities where we operate, is proving difficult. However, we are addressing these resource needs in several ways including holding local job fairs and recruiting from colleges specializing in our needed skills. We are confident that we will close this gap quickly and work through our current orders.

Our Canadian business performed much better during spring break-up than anticipated. Much of this growth was concentrated in large turnaround projects in the oil sands. Consistent with the U.S., Canada also

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experienced robust growth with midstream customers, including a sizeable actuated valve pipeline project, which muted the freeze-thaw period impact. Some of this growth is related to the early days of a recent long-term commercial win, which is a multi-year pipe, valves and fittings (or PVF) contract with Pembina Pipeline out of Canada. Pembina is proving to be an excellent partner as we progress through this implementation.

We couldn't be more excited about the growth potential within this multimillion dollar opportunity, as well as the strategic leverage we can create within the rest of the midstream sector. This should be a tailwind for Canada as we did not hold this contract previously. Internationally, the Middle East and North Africa continue to be bright spots. Sales in the region for coated pipe, valves, fittings and flanges to multiple countries in the area softened the impact of continued weakness with offshore drillers. Increased sales in Asia Pacific, Africa and Latin America also helped offset the non-recurrence of large projects and continued softness in Europe.

Looking at market activity moving forward, oil prices continue to cause uncertainty as they have averaged in the high $40 range for several months. As I said on the last call, until there are meaningful, consistent storage declines, I believe we will be in choppy waters. Fortunately, even with the inventory report out yesterday, over the past five weeks, high crude, gasoline and distillate inventory declines have been setting new records. If that trend persists, and we experience repercussions related to the 3-year underinvestment in global offshore fields, we could see a re-balancing of supply and demand and solidify the longevity of this up-cycle for our business.

Until then, we will continue right-sizing the business where market activity is soft, investing in active shale plays to service customers' increased needs, growing share and taking advantage of current rig counts and the ultimate completion of DUCs. The culmination of these efforts could be enough to push revenues over the $700 million mark sequentially.

For our U.S. Energy Center business, while I anticipate continued growth, the degree to which revenue improves will be dependent on: Fluctuations in oil price causing operators to moderate their CapEx budgets, service company's ability to not only stem the tide of additional DUC well count growth, but also to address existing well backlog, as they wait for frac spreads to commence completion work, manufacturers ability to get ahead of increased demand for products and stabilize lead times and being able to overcome two consecutive quarters of strong midstream line pipe project work.

However, we have several recently won projects in our U.S. Energy Center business that should help protect against these risks which include: A recent contract win from a midstream customer in the northeast to provide PVF to a fabricator for their pig launcher and receiver packages, A large pipeline project in South Texas, which, in addition to providing PVF, includes onsite employees, material trailers and a DNOW RigPac and the award of a warehouse management agreement with BP in the Rockies.

In U.S. Supply Chain Services, we could experience sequential growth in 3Q, similar to what we produced in 2Q, as increased operator customers help to offset flat revenue downstream and continued softness with industrial manufacturing customers. Additionally, we are in the evaluation phase with several upstream operators interested in our supply chain services solutions, any of which could materialize later in the year or into 2018. Earlier this year, we opened two new valve actuation, repair and modification facilities in U.S. Process Solutions in the Rocky Mountains and in the northeast. Due to the early success of those businesses, we are currently evaluating yet another facility in the Permian.

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Early indications from establishing these regional valve actuation, repair and modification operations outside of our large Houston facility are positive with recent large diameter actuated valve orders to be delivered over future quarters that include: 24 upstream actuated valve packages in the Permian, a large transmission valve actuation and modification project in the Marcellus, 23 upstream actuated valve packages in the DJ Basin and 45 actuation packages destined for multiple shale plays for a large midstream customer.

Based on recent wins and progress to re-staff our shops, we expect U.S. Process Solutions to experience revenue growth in future periods. One example of an exciting win is a recent contract award with ConocoPhillips for their Bakken and EagleFord operations which runs through 2020. We have received the first portion of the release to be delivered through mid-2018 that includes: 20 Separator modules for the EagleFord, 25 Production units for the Bakken and 7 instrument air packages, also for the EagleFord.

In Canada, recovery from spring break-up and kick-off of contracts with Pembina and TransCanada should generate revenue growth. The Montney, Duvernay, Viking and Bakken plays will continue to be the primary revenue generators for Canada. We expect the International areas that grew sequentially in Q2 to continue posting strong results. Additionally, we are anticipating a moderate uplift in revenue from Kazakhstan, Azerbaijan and Mexico, as well as a recent award with BP in Trinidad and Tobago. The combination of performance in these areas should be enough to offset continued offshore market weakness.

Moving to capital allocation. Consistent with 1Q17, we continued to add working capital needed to support growth in 2Q17. Free cash flow used in the second quarter was $53M, compared to $22M used in 1Q17. Capital expenditures were $1 million in the first half of 2017. Sequentially, days sales outstanding and inventory turns decreased slightly to 59 and 4.0 respectively.

Working capital as a percent of revenue, less cash, remained below our stated target and finished the quarter at 22%. We still believe there is room to make improvements to DSOs and inventory turns, and have initiatives in place to produce that outcome over the long-term. During the quarter, we reviewed over 30 deals ranging in size from low single digits to high double digit millions, within and outside the U.S. As you would expect, reaching agreements on valuations in a recovering market is much more challenging than it has been for us during the downturn. We expect this number to rise as some of the Private Equity firms are increasingly comfortable with multiples in the industrial space and may be prepared to start exiting the assets they have been grooming for some time. The question will be whether we are willing to bridge the potential bid-ask spread once they are on the market.

So with that, let me turn it over to Dan.

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Daniel L. Molinaro
Senior Vice President & Chief Financial Officer

Thanks, Robert. We are confident as we approach a return to profitability, and I appreciate the efforts of our dedicated workforce, as I'm 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 and perseverance of the DNOW family. Thanks for all you do.

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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 $17 million, or 16-cents per fully-diluted share on a US GAAP basis for the second quarter of 2017 on $651 million in revenue. This compares with a net loss of $23 million, or 21-cents per fully-diluted share, on $631 million of revenue in the first quarter of 2017. When looking at the year-ago quarter, we had a net loss of $44 million, or 40-cents per fully diluted share, on revenue of $501 million for the second quarter of 2016. The second quarter 2017 results included $6 million of after-tax charges for valuation allowances recorded against our deferred tax assets, and $1 million of pre-tax severance charges. After adjusting for these charges, our second quarter loss was $11 million, or 10-cents per share both non-GAAP measures.

We are encouraged by Gross Margin continuing to rise, improving to 19.0% in Q2, compared with 18.1% in Q1 2017, and compared with 16.6% in the year-ago quarter. The Company generated an Operating Loss of $14 million in the second quarter of this year, versus a $21 million loss in the previous quarter, and an operating loss of $57 million in the year-ago quarter.

Second quarter EBITDA excluding other costs (a non-GAAP measure) was a loss of $2 million sequentially improving by $7 million, reflecting strong flow-thru of 35%. Looking at operating results for our three reportable geographic segments, revenue in the United States was $481 million in the quarter ended June 30, 2017, up 10% sequentially, and up 43% over the year-ago quarter. Year-over-year improvement in the U.S. rig count, coupled with incremental revenue gains from acquisitions, contributed to these revenue improvements. Revenue Channels in the US for Q2 were 57% US Energy, 30% US Supply Chain, and 13% US Process Solutions.

Second quarter Operating Loss in the US was $16 million, compared with a $26 million loss in the first quarter of 2017, and a $44 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, second quarter revenue declined 18% sequentially, to $79 million, reflecting the impact of break-up…and was up 44% over Q2 2016, due essentially to increased Canadian rig activity. For the three months ended June 30, 2017, Canada's Operating Profit was $2 million down only $1 million sequentially and improved $10 million over the year-ago quarter, reflecting the increased rig activity and lower inventory charges.

International operations generated second quarter revenue of $91 million, which was down 5% from the first quarter of 2017 and down 17% from the year-ago quarter. Softening in the overall international market, coupled with the completion of large projects in the first half of 2016, contributed to this year-over-year decline. International's Operating Profit was break-even for the second quarter 2017, representing a $2 million sequential decline, and a $5 million improvement over the year-ago quarter. Despite the year-over-year revenue decline, operating profit improved primarily due to reduced bad debt charges, paired with realized cost savings.

Continuing on our Income Statement, Warehousing, selling and administrative expenses was $138 million in Q2 up $3 million sequentially, and down $2 million from Q2 '16. The decline from the year-ago quarter reflects our continuing cost-cutting initiatives, and a reduction in Accounts Receivable charges, partially offset by additional operating expenses associated with acquisitions. These costs include branch, distribution center and regional expenses, as well as corporate costs.

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Our effective tax rate for the second quarter of 2017 was a negative (0.1) %, and for the six months ending June 30, 2017 was 1.0%. 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 return to profitability, we will be able to begin releasing the valuation allowance, thus reducing our reported GAAP income tax expense in future periods. Without the $6 million after-tax valuation allowance, (which is in accordance with GAAP), our Q2 effective tax rate would have been 35.3%.

Turning to the Balance Sheet, NOW Inc. had $582 million of Working Capital (excluding cash) at June 30, 2017, which was 22% of annualized sales compared with 21% posted in Q1 2017 and remained below our 25% target. The Q2 Working Capital increase was the result of rising revenue. Accounts Receivable increased $6 million sequentially, to $418 million, reflecting our increasing revenue. The pace of bankruptcies in our energy space is easing, but there are still some remaining concerns. Some companies needed to file for bankruptcy in 2016 due to their debt load, but held off until oil prices increased, as it gives them more restructuring options. Banks have begun to loosen purse strings, once again increasing their exposure to the energy industry, but looming debt maturities could be a concern so we must continue to be diligent as we extend credit.

Our current Days Sales Outstanding (DSO) improved to 59 days. While I'm pleased with our progress over the past year or so, there is more that we can do. Inventory was $529 million at the end of the second quarter of this year up $38 million over Q1, as we respond to increased activity. With signs of an improving market, with lead times extending for certain items, we expect inventory levels to continue to rise. Inventory turns were 4.0 times in Q2. Days Payable Outstanding were 49 days.

Our cash totaled $97 million at June 30, 2017, with $77 million located outside the US about one-third of that being in Canada. Having this cash overseas could facilitate financing of an international acquisition. We ended the quarter with $128 million borrowed under our credit facility, and were in a net debt position of $31 million when considering total company cash. Our debt-to-cap was under 10% at quarter's end, and we had $437 million in availability.

Our borrowing cost on the debt approximates 3.5%, as the Fed pushes short-term rates incrementally higher, raising rates for the third time since last December. Our credit facility matures in April 2019. Capital Expenditures for the first half of this year was approximately $1 million. Showing the effects of improving business conditions, and the need to support the organic revenue growth, Free Cash Flow used for the second quarter was $53 million.

Our worldwide market continues to be challenging. We will continue to focus on serving our customers, as we manage costs, concentrate on integration gains from our acquisitions, and seek 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, solid financial resources, and will continue to respond to the needs of our customers.