137891019101

KLX Energy Services (Q3 2018 Earnings)
December 5, 2018

C: Michael Perlman; KLX Energy Services; Treasurer and Senior Director of Investor Relations
C: Amin Khoury; KLX Energy Services; Chairman, CEO & President

P: Brad Handler; Jefferies LLC; Analyst

+++ presentation
Operator^ Good day, ladies and gentlemen, and welcome to KLX Energy Services' Third Quarter 2018 Earnings Conference Call.

(Operator Instructions) And as a reminder, today's conference is being recorded for replay purposes.

I'd now like to turn the conference over to Michael Perlman, Treasurer and Senior Director of Investor Relations at KLX.

Michael Perlman^ Thank you, James. Good morning, and thank you for joining us. Today, we are here to discuss KLX Energy Services' financial results for the third quarter period ended October 31, 2018.

The company's earnings news release, which was issued earlier this morning, presents our third quarter 2018 results. If you haven't received it, you'll find a copy in our website. For comparison purposes, we presented our financial results on a GAAP basis as well as an adjusted basis to exclude the onetime cost of approximately $23 million associated with the merger of the Aerospace Solutions business with The Boeing Company, the spin-off as a KLX Energy Services business into an independent public company, the amendment of the $100 million asset-based lending facility, the issuance of the $250 million senior secured notes due 2025 and the acquisition of Motley Services, which was completed on November 5, 2018, all of which are collectively referred to as Costs as Defined.

We will begin with remarks from Amin Khoury, Chairman and Chief Executive Officer of KLX Energy Services. Also on the call this morning is Tom McCaffrey, Senior Vice President and Chief Financial Officer.

For today's call, we prepared a few slides to help you follow our discussion. You can find our presentation on the Investor Relations page of the KLX Energy Services website at klxenergy.com. In addition, copies of the slides are posted on our website for you to refer to.

Before we begin, we have some additional information to cover. Any forward-looking statements that we make are subject to risks and uncertainties. And as always, in our prepared remarks and our responses to your questions, we will rely on safe harbor exemptions under the various securities acts and our safe harbor statements and the company's filings with the Securities and Exchange Commission.

We will address questions following our prepared remarks. At that time, the operator will provide Q&A instructions.

Now I will turn the call over to Amin Khoury.

Amin Khoury^ Thank you, Michael, and good morning, everyone. We are very pleased to be speaking with you this morning as we review what has been an extraordinarily productive third quarter.

During the quarter, management completed the merger of the Aerospace Solutions business with The Boeing Company, the spinoff of the Energy Services business into a publicly traded company, the issuance of $250 million of senior secured notes due 2025, the addition of a large diameter coiled tubing product service line through the acquisition of Motley Services, the successful launch of our DHPS service line, including our proprietary line of dissolvable plugs, and the launch of the HydroPull tool used in our thru-tubing operations that complements our large diameter coiled tubing product service line.

During this period, we also completed the establishment of all IT, legal, accounting, tax, treasury, risk management, internal audits and human resource functions to be able to operate as a stand-alone public company with robust financial and operating controls independent from our former parent, KLX Inc.

Additionally, in our efforts to continue to address the trend towards extended-reach laterals and plug-and-perf style completions, we introduced to our customer base several important new proprietary product service lines. First, our line of magnesium-based dissolvable plugs, which we co-developed with an engineering firm. Second, our patented debris-less flotation collar, and finally, a HydroPull tool used in our thru-tubing operations and which complements our large diameter coiled tubing PSL. The HydroPull tool was introduced through a cooperative marketing agreement.

These new proprietary product service lines are already making a solid impact on fourth quarter revenues. As we move forward as an independent public company, we expect to leverage our integrated platform to continue to launch new and differentiated product service lines through internal development, through partnerships and licensing agreements and through acquisition.

We believe KLXE has the unique opportunity to capitalize on our very broad geographical coverage, our strong customer relationships, our diversified portfolio of services and products and our premier reputation in each of our served markets.

We intend to maintain a strong balance sheet and substantial liquidity to effectively navigate the cyclicality of the energy markets while continuing to build long-term value for our shareholders.

On today's call, we will review the current oilfield services market, discuss our third quarter financial performance and provide full year 2018 financial guidance, along with our preliminary outlook for 2019.

Let's now review the oilfield services market. For the most recent period, the industry has reported relatively stable drilling activity in the U.S. onshore market with the overall rig count up about 13% as compared to the prior year, but essentially flat as compared to the prior quarter. On average, drilled but uncompleted wells, or DUCs, have increased almost 10% as compared to the prior quarter and now stand at approximately 8,500 DUCs with approximately 3,900 of those, or 45%, in the Permian alone.

The Permian Basin accounted for a majority of the increase in DUCs, growing approximately 20% quarter-over-quarter. Growth in the Permian DUC count can be primarily attributed to pipeline takeaway capacity issues, and to a lesser extent, the inability of many operators to move equipment due to the Texas floods.

The Permian pipeline takeaway capacity issue has resulted in a significant slowdown in completion activity and a dramatic increase in a number of drilled but uncompleted wells. We believe this trend will reverse as additional pipeline capacity comes online in 2019 and as operators become more efficient with multi-well pads. In fact, we believe the oilfield services industry does not have the capacity to support the expected increase in completion activity in 2019.

We are already experiencing a very substantial increase in RFP activity as E&P operators try to lock up quality service providers. This activity is expected to increase further as E&P customers finalize their 2019 CapEx budgets. In fact, one of our customers has offered up price increases to ensure availability of equipment and personnel.

Although, quarter-over-quarter drilling rig count was flat in the third quarter, the number of drilling permits issued increased substantially with over 4,800 drilling permits issued in the U.S. in October alone. That was up nearly 40% month-over-month and 23% year-over-year. The Rockies, more specifically Wyoming and Colorado, accounted for approximately half of all permits issued and led all regions with an approximate 1,000 or 80% month-over-month increase.

As you well know, U.S. crude oil production exceeded 11 million barrels per day for the first time in August of 2018, and EIA expects U.S. crude production to average about 12 million barrels per day in 2019, rivaling Russia and Saudi Arabia. This growth in production is being driven by surging domestic unconventional shale output, which is replacing declining production from conventional resources.

The rate of growth of global demand output by OPEC members, international non-OPEC members, Iran sanctions and potential additional releases from our strategic petroleum reserve, are all factors which will influence the price of oil in 2019.

However, there is very little excess supply to meet growing global demand. The combination of reduced offshore investment, the rapid decline curves of shale wells and the time pullback in production by international producers in the face of continuous long-term demand growth bodes well for those companies which can create a sustainable model.

Let's now turn to Slide 3 and discuss our third quarter 2018 consolidated results. Third quarter 2018 consolidated revenues of $123 million represented 38% organic revenue growth as compared to the same period in the prior year. Our consolidated results reflect the 34% increase in Rocky Mountains segment revenues, a 66% increase in Northeast/Mid-Con revenues and a 22% increase in Southwest segment revenues.

On a product line basis, completion, production and intervention revenues increased approximately 52%, 43% and 11%, respectively. These strong organic revenue growth numbers speak to the overall growth in our customer base, the breadth of our services which we are supplying to our customers and the increasing share of customer spend, which we are realizing.

Clearly, we are becoming more important to our customers by being able to offer a broad portfolio of specialized services and equipment, including our own proprietary product service lines. This has resulted in an increase in individual customer spend for the services which we provide. In fact, in the third quarter, the number of our customers that generated over $3 million in quarterly revenues increased by a 150%, and the number of our customers that generated over $2 million in quarterly revenues more than doubled as compared to the same period in the prior year. In fact, we served almost 600 customers during the quarter and the top 25 of those customers generated about 65% of Q3 sales.

On a sequential quarterly basis, revenues increased 4.5%, driven by strong growth in our Northeast/Mid-Con geo region, which was partially offset by lower revenues in our Southwest region due to the Texas floods. 17 consecutive days of rain and the attendant floods, road and highway closures and impassable mud negatively impacted third quarter Southwest segment revenues by approximately $6 million or about 13%. While we expect Permian takeaway issues to continue to negatively impact E&P operators in our Southwest region, our recent market introductions of new proprietary PSLs and the positive impact which we are experiencing with the Motley customer base is expected to drive strong fourth quarter growth for KLX, even in the Permian.

Third quarter adjusted operating earnings and adjusted operating margin of $13 million and 10.6%, improved by about $15 million and 1,265 basis points, respectively, as compared to the same period in the prior year.

Adjusted EBITDA and adjusted EBITDA margin were $26.6 million and 21.6%, respectively, representing a 189% and 1,128 basis point increases over the same period in the prior year.

As compared to the second quarter, consolidated revenues increased 4.5%. Adjusted EBITDA was down slightly due to higher expenses related to the initial introduction of several new tools and the weather-related negative impact on Southwest revenues and operations.

Adjusted net earnings and adjusted net earnings per diluted share were $16.6 million and $0.83 per diluted shares, increases of $15.5 million and $0.78 per share, respectively, as compared to the prior year period.

Let's now turn to Slide 4 and review our Rocky Mountains third quarter 2018 results. Third quarter Rocky Mountains segment revenues of $48 million represent a 34% organic revenue growth as compared to the same period in the prior year. The increase in revenues was driven by increases in completion and production activity of approximately 73.8% and 29.9%, respectively.

Rocky Mountains segment gross profit increased $5.2 million or almost 63% to $13.5 million on the 34% increase in revenues. Rocky Mountains segment adjusted operating earnings increased $4.8 million to $6.1 million in the third quarter, reflecting increased operating leverage and solid demand for higher-margin PSLs. Adjusted EBITDA increased by $5.3 million or 95% to $11 million on a 34% increase in revenues. On a sequential quarterly basis, revenues and adjusted EBITDA were essentially flat. Here, again, we expect solid fourth quarter growth in our Rocky Mountains segment due to excellent customer reception for the new proprietary product service lines introduced in the third quarter.

Let's turn to Slide 5 and review our Northeast/Mid-Con segment performance. Third quarter 2018 Northeast/Mid-Con segment revenues of $37 million represented 66% organic revenue growth as compared to the same period in the prior year. The increase in revenues was driven by a 68% increase in intervention activity, 68% increase in production activity and a 64% increase in completion activity. Northeast segment gross profit increased more than 200% on the 66% increase in revenues, while adjusted operating earnings increased $8 million to $6 million, reflecting increased operating leverage and solid demand once again for our higher-margin PSLs. Adjusted EBITDA increased by $9 million or 600% to $10.5 million on the 66% increase in revenues. On a sequential basis, revenues increased about 25%, while adjusted EBITDA increased to $10.5 million, representing a 28.5% adjusted EBITDA margin.

Let's turn to Slide 6 and review the third quarter results for the company's Southwest segment. As mentioned earlier, third quarter 2018 Southwest segment revenues of $38 million were negatively impacted by the Texas floods. The 17 consecutive days of rain, the attendant floods, the road and highway closures, the impassable mud, all basically impacted third quarter revenues by about $6 million. However, in spite of the weather-related issues, revenues were up 22% as compared to the same period in the prior year. The increase in revenues was driven by a 38% increase in production activity, a 26% increase in completion activity and almost an 8% increase in intervention activity.

Southwest segment gross profit increased 75% to $7.2 million on the 22% increase in revenues. The segment's adjusted operating earnings increased $2 million to $1 million in the third quarter, reflecting increased operating leverage and solid demand for our higher-margin product service lines.

As compared to the same period and the prior year, adjusted EBITDA increased by $3 million or about 150% on the 22% increase in revenues. However, on a sequential quarterly basis, revenues and adjusted EBITDA declined $2.4 million and $1.7 million, respectively, due to the weather-related issues as well as the new PSL validation and introduction cost.

Nevertheless, we are expecting strong fourth quarter organic revenue growth in our Southwest region due to our new proprietary PSL additions, including our dissolvable plugs and flotation collars as well as our proprietary fishing and thru-tubing tools.

Let's now take a moment and review our financial position on Slide 7. Prior to the spinoff, we received a $50 million capital contribution from our former parent. In addition, the company completed the sale of $250 million of senior secured notes due 2025, which generated approximately $243 million of net proceeds. $139 million of the net proceeds was used to fund the cash portion of the Motley Services acquisition, which was completed on November 5. As of October 31, 2018, cash on hand was approximately $313 million, or if we adjust for the acquisition of Motley, about $174 million of cash on hand. There were no borrowings outstanding under the company's $100 million credit facility.

Now let's briefly review our full year 2018 guidance. We're updating and increasing our full year 2018 guidance to reflect the addition of the large diameter coiled tubing product service line in November as a result of the completion of the Motley acquisition. Exclusive of the acquisition, we expect solid organic growth in all three of our geographical segments, driven by new proprietary PSLs introduced in the third quarter, including our dissolvable plugs and proprietary fishing and thru-tubing tools as well as solid organic growth in Southwest segment revenues arising from access to Motley's customer base.

So as compared to the prior year and -- our revenues are expected to increase by about 60% to approximately $520 million. Fourth quarter organic revenue growth is expected to reflect high single-digit percentage increases as compared to the third quarter. Adjusted EBITDA is expected to increase approximately 360% to approximately $114 million, representing a 22% adjusted EBITDA margin. Return on invested capital is expected to be approximately 18%. And all of that guidance excludes integration cost, which we will incur associated with the Motley acquisition, and we expect that to happen in the fourth quarter and don't have an estimate of cost as of today.

Let's now turn to Slide 9 and review our fiscal year 2019 preliminary outlook. And obviously, the outlook assumes more or less stable oil and gas prices at more or less current levels. So revenues are expected to increase by about 45% to approximately $750 million. Adjusted EBITDA is expected to increase approximately 65% to approximately $190 million, representing an approximate 25% adjusted EBITDA margin. Adjusted net earnings and adjusted net earnings per diluted share are expected to be approximately $97 million and approximately $4.50 per diluted share, respectively. That's a little less than about a 40% increase. CapEx is expected to be about $100 million. Free cash flow is expected to be approximately $60 million or about 8% of revenues. And return on invested capital is expected to be approximately 22%.

With that, I will turn the call back over to Michael for the Q&A portion of this morning's call.

Michael Perlman^ Thank you, Amin. I will now turn the call over to James for the Q&A portion of today's call. James will provide instructions on how to ask a question. James?

+++q-and-a
Operator^ (Operator Instructions) Our first question will come from the line of Brad Handler with Jefferies.

Brad Handler^ I guess, actually, your clear comments, Amin, not withstanding, I guess, I'd just love to just sort of dig into the fourth quarter because it's such a dynamic, if not in a great way, time in our space. So maybe we can review a little bit of what you're seeing and then kind of parse out. So another, a lot of your peers now were talking about pretty significant activity declines in the fourth quarter sort of double digit. And it's really is -- it's not just a fracking problem, there were some pricing issues in fracking. But it's literally that activity will fall off and fall off very hard in December. I guess, you're obviously speaking to new product introductions and some of the drivers that are helping to offset that, but is that what you see in the market as well? Do you expect that December is just a very quiet month even relative to October, November?

Amin Khoury^ I think that your question speaks to the model. In other words, we have such broad geographical coverage now. We're in Pennsylvania, West Virginia, Ohio, Colorado, Wyoming, Oklahoma, Louisiana, North Dakota, Texas, New Mexico, et cetera, et cetera. We are basically everywhere. And I mentioned earlier that the combination of the breadth of our geographical coverage, the size of our product line, the broad product line that we have, enabled us to service 600 customers during this past quarter. And that was like a 20% increase in the number of customers that we covered as compared to the same quarter last year. And really, importantly, those customers that delivered $3 million or more of quarterly revenues, that was up like a 150% compared to the same period last year. And the customers that delivered $2 million or more in quarterly revenues, but less than $3 million, that was more than double the number last year.

So it is the combination of the very large number of customers that we're serving in a large geographical customer base and the breadth of our product line, together with the new product service lines that we introduced in the third quarter, which are already beginning to generate substantial revenues in Q4, which gives us some confidence about the Q4 outlook that we're providing, which is high single-digit revenue growth.

So there may be less activity among a number of customers, but we are very substantially increasing our share of customer wallet or customer spend for the customers that we're serving and we're very rapidly increasing the number of customers. And then during this fourth quarter, we will get access to the Motley customer base, which will further help Southwest revenue growth, in addition to the new PSLs.

So for us, it's about breadth of product line, the breadth of the customer base and the introduction of new products and some new customers that we had access to this quarter due to Motley that is giving us the optimistic outlook for Q4.

Brad Handler^ Understood, understood. And they're obviously -- it's obviously helpful that there are a number of pieces to that story. So I understand. That's great.

I guess, as a follow-up, I'll bite on this key point about sort of taking more of the wallet, if you will. Can you lay out for us a bit of what you could see near-term potential as either expressed in sort of number of customers running at that $3 million a quarter run rate or you could express it in terms of where the aspirations are to get to, say, $5 million a quarter of run rate or something like that. How much opportunity do you see over the next 12 months to kind of continue to take more of the wallet?

Amin Khoury^ Well, I'll try to express it this way. In this quarter, our top 25 customers generated $80 million of revenues or pretty much two-thirds of our revenues in the quarter. So the share -- the size of spend that we are growing is large with our top 25 customers. They're probably more than that, but we sort of cut it off at the end of 25 and then have the balance of our customers in a list. But all of those customers, all of the top 25, generated more than $1 million in revenues per quarter. And there are probably a number below the top 25, which also did the same. And as you move up, there are customers that generate $2 million, $3 million, $4 million, $5 million per quarterly revenues.

What we expect to do in the fourth quarter or the next year, I'm certainly not going to hazard a guess as to how many customers are going to generate what amount of revenues. But we expect to continue to grow the size of our customer base and we expect to continue to gain share of wallet. It is particularly important that we've introduced the dissolvable plugs and our new thru-tubing assets in the third quarter at the same time we acquired the CT business because of the natural relationship between those service offerings to our customer base.

And interestingly, when we announced the Motley acquisition, we have customers in Oklahoma, Colorado, North Dakota and Wyoming begging for us to be -- to deliver -- to put in the first CT assets -- large diameter CT assets, which those customers don't have today. So the synergy of the services that we have and CT, together with the breadth of our customer base, again, gives us some confidence in our 2019 outlook.

Brad Handler^ Understood. That's very helpful color. And I am as almost as a throwaway given what we've heard around the mixed success around dissolvable plugs, we’re certainly very interested to see how yours fare. I'm pleased to hear your enthusiasm about it and customer interest in it for sure.

Thanks. I will turn it back and maybe get back in queue, but I'll let others have a turn.

Amin Khoury^ Okay, thank you.

Operator^ At this time, I'd like to turn it back over to the executive team and Mr. Perlman for closing remarks.

Amin Khoury^ All right. I think Brad wore everybody out with his customers -- with his questions and asked most of the questions.

With that, I think we will end the call and wish everybody a good day. And we'll note our respect for the passing of George Bush, number 41. Have a great day.

Operator^ Ladies and gentlemen, that does conclude today's conference. Thank you very much for your participation. You may all disconnect. Have a wonderful day.