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CGG.PA - Half Year 2018 CGG SA Earnings Call

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PRESENTATION

Operator

Good day and welcome to the CGG Second Quarter 2018 Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Catherine Leveau. Please go ahead, ma'am.

Catherine Leveau - *CGG - SVP of IR*

Good morning and welcome to this presentation of CGG's second quarter 2018 results. My name is Catherine Leveau, Head of Investor Relation. The quarterly financial information, including the press release, the presentation and the streaming audio webcast of this call are available on our website at www.cgg.com. Some of the information contains forward-looking statements, including, without limitations, statements about CGG plans, strategy and prospects. These forward-looking statements are subject to risk and uncertainties that may change at any time, and therefore the actual results may differ materially from those that were expected.

The call today is being hosted from Paris, where Sophie Zurquiyah our CEO; and Yves Goulard, Acting CFO, will provide an overview of the second quarter as well as provide comments on our outlook. Following the overview of the quarter, we will be pleased to take your questions.

And now I turn the call over to Sophie.

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Good morning, ladies and gentlemen. On the call today, I will give a brief overview of our second quarter results and will highlight some of our key operational achievements. Yves Goulard will review our financial results. I would then make some concluding comments before opening the call to Q&A. I take this opportunity to thank (inaudible) in his acting CFO position. As recently announced, Yuri Baidoukov will join CGG on September 3 as goods CFO. Yuri has an extensive background in corporate finance, management and strategy, and his deep knowledge of the industry will greatly contribute to the success of CGG. We welcome Yuri to the team.

First as a general comment on the market, we continue to see positive momentum across our businesses, and while pricing pressure remains, there are increasing and clear signs of a gradual recovery. Now let's review the Q2 results. I will be commenting on our segment reporting figures, which are the figures used for the company's management purposes. Yves will comment on the IFRS numbers later in the call. As a reminder, the differences in the 2 sets of figures relate to the new IFRS treatment of our prefunding sales.

I will start with the summary of our Q2 segment results. Overall, we delivered a stable year-over-year segment revenue at $338 million with solid segment EBITDAs in line with our expectation. Regarding GGR performance, Subsurface Imaging & Reservoir activity was robust, and Multi-Client was driven by high after-sales partly offsetting lower prefunding. Equipment was back to breakeven as volumes continue to increase strongly. But contractual data acquisition activities remained impacted by continuing competitive market environment.

Segment EBITDAs was at $110 million, down 9% year-on-year at 33% margin. Segment operating income was positive at $40 million due to the Multi-Client sales mix which included many surveys with no remaining book value and strong equipment sales. With rigorous management of working capital, our cash consumption was limited this quarter.

I will now go into more detail to our business segment. Slide 5. GGR segment revenue was down 8% year-on-year at $203 million. Our solid SIR performance was offset by a decrease in Multi-Client prefunding. Multi-Client was down 17% year-on-year at $111 million. Prefunding was low this quarter at $24 million, primarily as a result of government administration delays. This resulted in a low Q2 cash prefunding ratio of 44%, but still yielding an H1 prefunding rate of 63%. We expect to catch up on prefunding in the second half of the year to reach our target of 70%.

After-sales were up 85% at $87 million with significant contributions from the North Sea, Brazil and U.S. onshore. In general, we expect signatures and ratifications by governmental bodies in Africa and Brazil over the coming months. And with this, I remain confident in the outlook for the year. Fleet allocation to Multi-Client programs is expected to be around 60% in Q3 and 55% in Q4.

Subsurface Imaging & Reservoir revenue was up 5% year-on-year at $93 million. SIR performed well across all businesses. And activity was driven by reservoir and production imaging and services.

GGR reached a segment EBITDAs of a $117 million and segment operating income of $64 million leading to a 32% operating margin. The strong margin increase year-over-year came from a higher sales mix of fully depreciated Multi-Client service this quarter. The Multi-Client depreciation rate went down from 67% in 2017 to 36% in Q2 2018. We expect that rate to return closer to normal with recognition of more prefunding revenues down the road.

Slide 6. Let me share some operational highlights of the quarter. In Subsurface Imaging & Reservoir, geographically we're seeing improved demand coming from the U.S. Gulf of Mexico and Asia, with strong contribution from imaging for field development, reservoir delineation and production optimization. Clients value our technology to solve their complex subsurface issues and we see an increasing number of exploration projects around existing infrastructure.

All companies have announced this year 15 FIDs and more expected to come in next June. Those typically drive reprocessing projects or new processing projects on the back of a new acquisition. More and more often, nodes are used to create the seismic baseline for the reservoir which requires complex precise processing techniques which SIR can provide. Down the road, this leads into 4D reservoir activity and production management, a growing segment where we have a leading market share.

In Multi-Client, we've been very active strengthening our unique coverage in Brazil. We have provided the final delivery of our Santos VII survey, which is an exceptional 3D broadband program that covers the Saturno block in the pre-salt area. It was delivered ahead of the fifth production sharing bidding round. Brazil continues to attract large interest from clients across the globe, as it presents a unique long-term offshore growth opportunity that is competitive with unconventionals.

In no way we have begun a large southern extension to our very successful North Viking Graben surveys Horda and Tampen. And we will very soon be starting acquisition of a wide-azimuth survey in the North Sea in the west of Shetland's basin. Of course, unconventional land is and has been a hot topic in our sector for quite a few years now. We've been active in the unconventionals since the beginning with big investments in the most active basins and more recently in the Permian and the (inaudible).

Geophysics in the unconventional resource plays helps operators achieve a better understanding of multiple reservoir properties that can influence productivity and recovery rates. A full geoscience analysis can lead to better decisions about where to drill and how to optimize completion designs to maximize investments. So we're tailoring on Multi-Client surveys allowing our client to take full advantage of the seismic data, including seismic attributes used in reservoir characterization.

For example, we have completed an acquisition in the Wolfcamp Shale play of the Permian basin with good prefunding. In the Wolfcamp study, our acquisition was designed to provide the wide-azimuth data necessary to populate image and characterize the highly factored reservoir represented in the new play in the area. In Australia, using publicly available data, we launched a reprocessing project in the Gippsland basin, a mature offshore area in the southern part of the country. The quality of the images and the neat insights they provided has generated a renewed strong interest from clients in this basin, and we're now proposing a new acquisition in the area.

Reprocessing of all the data is a significant business of ours. Our imaging technology advances very quickly and can realistically be applied to improve surveys even of recent vintage. We've had great success improving our older surveys, combining older surveys with an acquisition and obtaining publicly available data and reprocessing it as we're doing in the Gippsland and in recently to great success in the Perdido basin offshore Mexico.

Moving onto Equipment. The Equipment business shows strong signs of recovery and is back to breakeven. Equipment segment revenue reached $83 million this quarter, up 56% year-on-year. The split is a bit unusual this quarter with 49% of sales in land and 51% in marine. One-off delivery of Sentinel section boosted marine sales. Land sales showed a strong increase year-on-year across the board. Thanks to improving volumes. Segment operating income was positive this quarter at $1 million. High volumes are and will remain a key driver of profitability.

We see Middle East activity picking up. Recent large was the land contract acquisition in Abu Dhabi with Shuweihat and (inaudible). More recently, ADNOC awarded a big project to BGP onshore and offshore covering up to 53,000 square kilometers into 2024. Saudi Arabia and Oman are launching tenders for several new land contractual acquisition surveys. As a result of such increased land activity, we expect increased revenue for land equipment as early as the end of 2018.

This quarter, we delivered channels in Asia and North Africa, mainly in Algeria which is an active market with a strong focus on exploration. In addition, our Equipment business includes a well-established product line at well gauges that services the unconventional market in North America. Demand has been increasing significantly in 2018.

The marine equipment market is still constrained by the challenging marine acquisition market, and therefore the key growth driver for increasing equipment sales will come from the land business. In technology, at the EAG in June, we launched a transition zone version of our state-of-the-art 508 X-Tech seismic acquisition system. This system has the ability to deploy the 508 X-Tech solution in marched zone and water depth of up to 25 meters.

Moving on to Slide 9. Contractual data acquisition continues to suffer from persistent overcapacity and a price competitive market environment, both in land and marine. Segment contractual data acquisition revenue was down 18% to $67 million as activity declined and pricing remain low. In marine, Q2 benefited from a 61% allocation to marine contractual activity. It was 52% in Q2, 2017.

Despite strong operational performance with a 95% production rate this quarter, marine revenue was $40 million, down 35%. The year-on-year revenue decreases explained by the different contract mix this year. Last year at the same time, we were shooting a large contract with a high-end multi-source vessel setup for a national oil company. Looking forward, our fleet coverage is currently at 100% for Q3 and 70% for Q4.

Land & Multi-Physics revenue rose to $27 million, up 30% year-on-year. Segment operating income contribution from contractual data acquisition was negative at minus $7 million including a provision reversal of $14 million. In marine, 2 vessels were active in West Africa for a major oil company and one in the North Sea with excellent feedback from clients in our service quality. As planned, the Endeavour has been returned to her owner end of July after completing the Multi-Client survey in Mozambique. Also we sold the X-Tech Geowave Voyager to SeaBird along with certain seismic equipment for $17 million in cash, which we will receive with a transfer of ownership of the vessel, which is expected in October.

Activity increased in land in North Africa with 3 cruise in operation. Multi-Physics continued to see some improved activity from mining. Our new Falcon Airborne Gravity Gradiometer system which provides high sensitivity and high spatial resolution data has been deployed in Australia on a large project for a mining company with a very good production record.

That completes the business segment review. I will now handover to Yves to comment in more detail on our financial figures.

Yves Goulard

Thanks, Sophie. I'm on Slide 12. I will first start with an update on IFRS 15 application. The discussion between CGG auditors and delegators in relation with revenue recognition for Multi-Client prefunding are still ongoing. Our goal is to have a definitive approach agreed with auditors and the regulators ideally pay off the deliveries of our Q3, 2018 financial statements that last before the release of the full year 2018 results.

Based on this, in this release, we have included a specific segment reporting which are used in our management reporting and are based on the percentage of project completion. This is in line with of course, earlier financial report. The IFRS numbers show pre-commitment revenue recognized in full only upon delivery of the final data.

So now looking at the income statement. Overall, the second quarter based on the segment reporting, the group revenue amounted to $338 million, down 3% compared to 2017 with a business mix quite similar to last quarter as GGR accounts for 60% of revenue, Equipment was 21% and contractual data acquisition for 19%.

For Q2 2018, the Multi-Client revenue to defer amounted to $24 million leading to IFRS quarterly revenue of $314 million and IFRS positive operating income including $3 million of non-recurring charge at $26 million. The difference between IFRS and segment level is solely linked to timing. It depends upon when the final data is delivered on prefunded Multi-Client projects. The IFRS approach increased the revenue variance quarter-to-quarter.

Now at the segment operating income level, the group performance this quarter was positive at $40 million corresponding to a significant year-on-year improvement, which can be explained by the Multi-Client seismics and by the fully depreciated after-sales and a good land equipment sales level, leading to a positive contribution after-sales. Below the EBIT, the cost of debt amounted to $33 million affecting the P&L cost, cash and non-cash attached to the process structuring debt structure while the other financial income amounted globally to a positive $65 million.

Two items can explain this $65 million. First, $75 million one-offs are mainly associated with a positive foreign exchange effect. The foreign exchange effect is resulting from U.S. dollar balance sheet exposure resulting from the financial restructuring and the $13 million for financing. The whole U.S. dollar balance sheet exposure has been drastically reduced by end of June. And the second item is related to a $10 million firstly in refinancing cost. On a pro rata basis, we also had the similar impact in Q1. All in all, the net income amounted to this quarter to $49 million.

Now I'm going on Slide 13, looking at the cash flow. Moving to the cash indicator at $110 million of Q2 segment EBITDA was in line with our expectation. Total CapEx was at $80 million, which was 3% up year-on-year with a Multi-Client cash CapEx at $54 million, down 10% year-on-year and 44% prefunded. In this field CapEx at $18 million, an increase from an extremely low point last year. R&D, research and development CapEx was stable at $8 million.

The combination of the segment free operating cash flow, the global CapEx in $18 million of interests paid led to a segment free cash flow of minus $9 million. All in all, taking into account a $10 million non-cash -- sorry, cash nonrecurring charge made in industrial transformation plan and financial restructuring cost, the IFRS free cash flow stands at minus $19 million of the quarter. We saw this quarter limited cash consumption thanks to rigorous management of working capital, and we will continue to adhere to a strict cash discipline as we evaluate our capital expenditure project.

Moving now to Slide 14. Our financial situation is sound after the completion of this financial restructuring in Q1. We are now benefiting from 2 debt instruments with long-term maturity. First technically 2023 for the first lien component and 2024 for the second lien component. None of those debt has maintenance covenant. Regarding the first in debt, we took advantage of good credit market condition to optimize the debt structure through the accelerated for financing of this instrument in April. This transaction allows us to switch to a fixed rate and to reduce significantly interest rate at 8.4% in average. It breaks down into 2 tranch, a $300 million tranche and a EUR 280 million tranch.

The second lien has a variable rate based on the Libor with a 1% floor, 4% cash and 8.5% PIK. The PIK payment in [cash] component is increasing the debt by cumulative effect every quarter. In Q2, the 2 tranches stand respectively at $366 million and EUR 83 million. We ended June with a liquidity of $447 million and ended debt of $760 million corresponding to a 1.9x financial leverage and a 29% gearing ratio.

I now hand the floor back to Sophie for her concluding remark.

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Thank you, Yves . To conclude, looking at our H1 performance, revenue growth was 6%, and we delivered an improvement in our EBITDAs margin which has now reached 26%. These results continued the gradual upward trend initiated in 2017 based on the strengthening of the oil price. In this first semester of 2018, we delivered a stable GGR sales and saw a strong increase in equipment. Improved volumes in GGR and equipment will be the keys to our success.

The restructuring of CGG was successfully completed at the end of February, and our financial position was significantly strengthened with solid liquidity and a sound financial situation. Our priority remains on cash generation and a rigorous management of working capital. We continue to see positive momentum in a context of a tightening oil market. While many clients are remaining cautiously in their approach to spending, we believe the encouraging fundamentals will lead to a more positive environment where customers will more actively move ahead with their investments and exploration decisions.

In this context, we remain on track to meet our targets for 2018. As I stated in May, we plan to host a Capital Markets Day on November 7 where we will layout our strategy and refresh our plan forward.

Thank you very much and we are now ready to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now take our first question from James Evans of Exane.

James Evans

A couple, if I may. First, I just wanted to dig a little bit deeper into the outlook for the land part of Sercel. So you found it quite positive for Q4 and particularly on the Middle East. I just wondered if you give us a bit more either a quantitative or help us understand sort of the channel uptick that we're seeing the return of MegaCrew tenders for example there. And secondly, just more strategically. I mean, you've been in place for a little bit longer now, Sophie. I just wondered if you could give us any hints on how you are thinking about the perimeter of the business. I mean, obviously we saw a smaller vessel sale completed yesterday. So -- so any more detail on how you're thinking about? A more strategic direction would be appreciated at this stage.

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Good. Well, thank you for your question. So on the outlook for land equipment, I explained what the drivers were for that, for those equipment was essentially those contractual land beds that are ongoing in the Middle East. So now it needs time to translate into equipment in order for equipment. I can't give you the exact timing, but everything makes a thing that it requires the time for those contracts to be awarded and then for the companies to -- to place the orders, so we were kind of thinking we'll start to see the effect of that into the latter part of the year, and probably most likely in 2019. So I can't really give you more because I don't control the whole sequence of events, but indications are that the client wants to go quickly and that the contractor also wants to try and start as quickly as possible. On the second question, I'm afraid you're going to have to wait until November 9.

James Evans

Fair enough. Understood. 7th, right?

Unidentified Company Representative

7, not 9.

Yves Goulard

7.

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Sorry, 7, I'm being corrected, yes.

Operator

(Operator Instructions) We will now move to our next question from Lillian Starke of Morgan Stanley.

Lillian Starke - *Morgan Stanley, Research Division - Research Associate*

I have actually 2. The first one is with regards to the acquisition market, if you can provide a bit of color on what you are seeing for booking into third quarter and fourth quarter? And as well, if you could share some detail around the day rates that you're seeing for acquisition? And then my second question relates to the provision that you had in the same segment. Should we expect something similar going forward or was this more of a one-off item, the $14 million provision reversal that you mentioned?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Yes. So on the acquisition market, I'm sure you've heard me say that I'm cautious on that market. Actually, I see rates in general on average sort of flattish. Now obviously here and there based on specifics, you could see -- we've seen some increased in rates over the summer period. But I don't have really clear -- any sort of indication that that rate is going up. I mentioned the coverage in Q3 for us was 100% and 70% in Q4. And in general, I just like to remind the fact that we are having 5 vessels in operation, so we don't have a huge exposure to that marine proprietary acquisition market. Now the $14 million is a one-off and there's no reason to expect any further down the road.

Operator

We'll now take our next question from Christopher MÃ¸llerlÃ¸kken of Carnegie.

Christopher Møllerløkken - *Sparebank 1 Markets AS, Research Division - Former Research Analyst*

Could you also direct us to what do you expect of working capital development going forward?

Yves Goulard

Yes. I will take this one. As we said earlier, Christopher, we will try to manage very tightly our working capital needs. Obviously, as the market credit will gradually improve, there will be a trend for revenue to increase and the working capital will follow the trend of revenue. Obviously, the way we will manage and we have already started this, this is a bit of a very strong watch on the working capital. I cannot give more color at this stage. It will really depends on the path of volume recovery.

Christopher Møllerløkken - *Sparebank 1 Markets AS, Research Division - Former Research Analyst*

For Sercel, you also mentioned earlier that you had an unusual mix with marine equipment being a fairly large amount of sales. Could you give a bit more color on what drove those Sentinel sales please?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

I mean we'd -- thank you your question. The -- it's just -- I would say it's just a sale that we made of a one-off sale and that's why we qualified it as a one-off because it is -- we don't necessarily see that recurring through the year. So it was a need from a client and we just made a specific sale at that point in time. But we don't necessarily -- it doesn't mean that there is a trend happening on the marine side.

Christopher Møllerløkken - *Sparebank 1 Markets AS, Research Division - Former Research Analyst*

And final question. You also mentioned that ADNOC awarding this large contract to BGP in Abu Dhabi. Is it possible to give any quantification or color regarding what this could potentially mean for Sercel in terms of equipment orders?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

I think at this time -- at this point in time, it's too early to qualify that. As I mentioned earlier, it requires different steps before we see the order and it requires a conversation with the client as well.

Christopher Møllerløkken - *Sparebank 1 Markets AS, Research Division - Former Research Analyst*

And I know I said final, but I have a final-final question. In terms of the orders or the tendering activity you mentioned in Oman and Saudi Arabia, could you say anything regarding how large channel counts we are talking about for these 2 tenders?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

I don't have the specific number. But what I can say is that there is similar scale of what's been going on. So pretty much it's -- we're seeing a companies that are willing to reincrease if you want. We went through the opposite trend previously where you had a certain number of crews with certain number of channel counts and that those number of crews were decreased overtime. And that -- what is happening now is the opposite trend, where we are seeing the number of crews increasing. So it's still the high channel count crews, but pretty much similar in size of the ones that are currently in operation.

Operator

(Operator Instructions). We'll move to our next question from Jean-Francois Granjon of ODDO BHF.

Jean-Francois Granjon - *ODDO BHF Corporate & Markets, Research Division - Analyst*

Two question, please. First one concerned the pricing for data acquisition. So you mentioned some pressure -- over some pressure on the pricing. So could you give us some more color on revenue, the trend, also the pricing? Also some decrease or stabilization? And what do you expect? You mentioned previously that with the decision from (inaudible), could you see some probability to see some increase of pricing in the short term? And the second question, just wondering about your guidance, our target for the full year. So taking into accounts the EBITDA margin reached at 26% for the H1, so we expect between 35% to 40% for the full year. So this means that you should expect a very strong, strong H2, so could you confirm that? And why do you expect so stronger improvement during the H2 compared to H1?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

So thank you for your questions. So on the first one, on the data acquisition, it's a market which is basically where the price is dictated by demand and offer. Right now, there is still overcapacity in general. Now sporadically on a case-by-case basis, you might see price increases just because there is no capacity or little capacity in that for that particular job, in that particular time frame. But I don't think that change is the general view that there is overcapacity. So I don't see the fundamentals for a price increase moving forward certainly in the, say, next year or so. Now on the H2, yes, your calculation is correct. We're at 26% and we need to get to a higher number, and it does need better EBITDA in the second half of the year which we're planning to achieve.

Operator

We will now take the follow up question from Lillian Starke of Morgan Stanley.

Lillian Starke - *Morgan Stanley, Research Division - Research Associate*

I was just wondering if you could share a bit of color if you've heard anything around the possibility of financing equipment on the marine site to some of the -- some of your clients which in the past you've mentioned there a bit more capital constrained. How sort of those conversations or that possibility moving along?

Sophie Zurquiyah-Rousset - *CGG - CEO & Director*

Actually there hasn't been really movement on those conversations. I think the situation is similar to the last quarter. And in on a case-by-case basis, as required, we will we will see what solutions we can offer to address that. It is actually nothing new. This has happened already in past cycles. So we know and we think we can have solutions to address that. But it is not -â€" there's been no movement, let's say, in this quarter.

Operator

There are no further questions over the audio at this time.

Catherine Leveau - *CGG - SVP of IR*

Well, thank you very much for attending. And for those who're going on holidays, I wish you a happy holiday season.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.