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Oceaneering International, Inc. (OII)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: My name is Leandra, and I will be your conference facilitator. At this time, I would like to welcome everyone to Oceaneering Second Quarter 2018 Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period.

With that, I will now turn the call over to Suzanne Spera, Oceaneering's Director of Investor Relations.

Suzanne M. Spera

Director-Investor Relations, Oceaneering International, Inc.

Good morning, and thank you, Leandra. Welcome to the Oceaneering second quarter 2018 results conference call. Today's call is being webcast and a replay will be available on Oceaneering's website. Joining us on the call are Rod Larson, President and Chief Executive Officer, who will be providing our prepared remarks; Alan Curtis, Chief Financial Officer; and Marvin Migura, Senior Vice President.

Before we begin, I would just like to remind participants that statements we make during the course of this call regarding our future financial performance, business strategy, plans for future operations and industry conditions are forward-looking statements made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995.

Our comments today also include non-GAAP financial measures. Additional details and reconciliations to the most directly comparable GAAP financial measures can be found in our second quarter press release. We welcome your questions after the prepared statements.

Rod, I would now like to turn the call over to you.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning. Today in our call, I will review details of our second quarter 2018 results and provide guidance commentary for the third quarter and second half of the year. I will then make some closing remarks before opening the call for Q&A.

For the second quarter 2018, we were encouraged to see activity levels increase leading to the sequential improvement in our adjusted consolidated operating results and earnings before interest, taxes, depreciation and amortization, or EBITDA.

Sequentially, adjusted operating results improved by \$15.2 million on improved profit contributions from each of our operating segments except Subsea Projects. And each of our operating segments maintained positive adjusted EBITDA as our adjusted consolidated EBITDA of \$39 million was better than consensus published estimates.

Our reported loss per share of \$0.34 included the pre-tax impacts of \$7.7 million of write-offs of certain equipment and intangibles associated with exiting the land survey business and equipment obsolescence, as well as \$3.4 million of foreign currency exchange losses. Excluding these items, adjusted net loss per share was \$0.23.

Overall adjusted results from operations and EBITDA were about what we expected for the second quarter. We continue to focus on maintaining liquidity and a strong balance sheet. At quarter-end, our cash and cash equivalents increased slightly to \$340 million. We also have available a \$500 million unsecured, undrawn revolving credit facility, and our nearest loan maturity is not until late-2024.

Oceaneering's ample liquidity and our conservative financial approach focused on maintaining capital discipline and improving returns provides optionality to broaden our service and product offerings or deploy capital in our existing businesses.

Now, let's look at our business operations by segment on an adjusted basis for the second quarter compared to the first quarter and our prior guidance. ROV operating income improved as expected and was up \$7.6 million. This improvement resulted from higher seasonal activity for vessel-based services and an increase in the number of working floating rigs for which we provide drill support services. Our fleet mix during the quarter was 62% drill support and 38% for vessel-based activity, compared to 70% and 30%, respectively, for the prior quarter.

Sequentially, revenue grew 26% on a 24% increase in ROV days on hire as our fleet utilization improved to 54% from 44%, mostly attributable to increased international activity. For our ROV segment, much depends upon the number of floating rigs actually working. While the contracted floating rig count over the past three months is up 5% from 147 rigs to 154 rigs, the number of working floating rigs over the same time period increased 19% from 102 rigs to 121 rigs.

While the improvement in the contracted count is a positive sign, we note that the solid step-up in the working count is a better indicator for activity within our drill support market. Our average ROV revenue per day on hire of approximately \$7,900 was essentially flat compared to the prior quarter. ROV adjusted EBITDA margin of 31% improved slightly from 29% for the first quarter 2018.

During the second quarter, we put two new higher specification systems into service and retired two lower specification systems, leaving our fleet size unchanged at 279 vehicles at the end of June 2018. During the quarter, our drill support market share improved to 60%, with ROVs on 92 of the 154 floating rigs under contract at the end of June. This compares to having 58% drill support market share with ROVs on 85 of the 147 floating rigs contracted at the end of March. We were on 9 rigs of the 13 rigs that received contracts during the quarter; and 5 rigs of the 6 rigs that had contracts expire or terminate early.

Turning to Subsea Products, on an adjusted basis, we realized an operating profit of \$3.8 million during the second quarter on a 4% reduction in revenues compared to the first quarter. Our better-than-expected operating results were due to the timing of awards and execution in our manufactured products businesses, and an increase in demand for our service and rental business offerings.

Our Subsea Products backlog at June 30, 2018, was \$245 million compared to our March 31, 2018, backlog of \$240 million. Our book-to-bill ratio for the second quarter was 1.0 and year-to-date was 0.87.

Sequentially, Subsea Projects' operating results declined more than expected. These results were due to lower-than-anticipated margins on certain projects, timing of projects moving into the second half of the year and a continued competitive price environment for both diving and deepwater vessel services in the U.S. Gulf of Mexico.

In Angola, the Ocean Intervention III will end its current work scope for BP on July 31, 2018, following the completion of our customer's commitment to exercise two, one-month optional extension periods provided for under the Field Support Vessel Services contract. At that time, the vessel will be returned to the owner. Pursuant

to our field support services contract, we will continue to supply project management and engineering services to BP through January 2019.

For Asset Integrity, operating income improved during the second quarter as projected, on higher revenue, due to the traditional seasonal increase in the demand for inspection services.

For our non-energy segment, Advanced Technologies, second quarter operating income improved, as expected, compared to the first quarter, predominantly due to the increased government-related work and modestly improved results in the commercial businesses. Unallocated expenses were essentially flat between the first and second quarter 2018.

Now, let me address our outlook. For the third quarter of 2018, we are expecting an improvement in our consolidated operating results compared to our adjusted second quarter, primarily on Subsea Projects' return to profitability. We expect each of our other operating segments to be flat or slightly down.

Relative to the first half of the year on an adjusted basis, for the second half, we expect to improve our consolidated operating results on increased revenue. We anticipate improvements to be led by Subsea Projects and Advanced Technologies, with high results from ROV and similar results from Subsea Products and Asset Integrity.

We are updating our full-year 2018 adjusted EBITDA estimate to be in the range of \$140 million to \$160 million, with positive EBITDA contributions from each of our operating segments. This change in our full-year guidance reflects us narrowing our estimated range for pre-tax loss by \$10 million, from \$85 million at the high-end to \$105 million at the low-end of the range; estimating depreciation expense at \$215 million, which was the midpoint of our prior guidance, and lowering net interest expense to \$30 million from \$40 million.

We are raising the lower end of our pre-tax guidance range as the level of subsea activity is progressing as we expected. We are also lowering the upper end of the prior range as the higher margin service call-out work necessary for us to achieve that higher end has not materialized. This change also includes the impact of the 2018 delivery of Ocean Evolution being later in the year. As indicated last quarter, we are no longer providing guidance as to our 2018 annual effective tax rate as current conditions do not allow for meaningful guidance in this regard.

I will now talk about the two segments that are expected to generate the most improved operating results during the second half of 2018. For Subsea Projects, profit during the second half is expected to increase due to contributions from our recent Ecosse acquisition and on higher levels of deepwater activity at improved margins.

With respect to the Ocean Evolution, we continue to work with the builder to complete the remaining punch list items and still expect the vessel to be delivered late-2018. In our non-oil field segment, Advanced Technologies, operating income should improve due to increased activity driven from backlog in our commercial theme park business and improved results within our automated guided vehicles business.

Turning to our other segments. For ROV, we continue to project increased days on hire in both drill support and vessel-based activities. This should lead to our second half overall ROV fleet utilization being in the low to mid-50% range with EBITDA margins relatively unchanged at approximately 30%. Our second half ROV fleet mix is projected to be similar to the first half.

For the remainder of the year, we are expecting to maintain our ROV drill support market share at approximately 60%. At the end of June, there were approximately 50 floating drilling rigs that have contract terms expiring during the balance of this year. And we have 35 ROVs on 29 of them, or 58%. Of the 50 floaters, 14 are rolling to new contracts.

There are 20 additional floating rigs set to begin new contracts during the same period. Of the total 34 floaters that have received new contracts, we have 30 ROVs on 26 of them or 76%. In addition, we anticipate there will be some incremental contracting of rigs based on current bid activity.

For Subsea Products and Asset Integrity, we anticipate our results to be similar to the first half of 2018. Specifically for Subsea Products, we expect increased manufacturing activity levels on the execution of lower-margin orders. We are forecasting our operating margins to be in the low-single digit range until we see an increase in Subsea Products backlog and pricing. We still expect an increase in contract awards during the second half of 2018, which should result in a Subsea Products book-to-bill ratio exceeding 1.0 for the full year.

With respect to Asset Integrity, we still expect margins to be in the low to mid-single digit range. For the remainder of the year, we are expecting unallocated expenses to be within our prior guidance of the upper \$20 million range per quarter.

Turning to our CapEx expectations. We are increasing our estimated organic capital expenditure total for the year by \$20 million to a range of \$100 million to \$140 million. This includes approximately \$40 million to \$50 million of maintenance capital expenditures, and \$60 million to \$90 million of growth capital expenditures. This increase in estimated growth CapEx is related to our projected cash expenditures in 2018, associated with a recent contract award expected to commence in late-2019.

In conclusion, for 2018, while the overall offshore markets will continue to be challenging, we are forecasting a second half improvement in activity levels and in our results. We are encouraged by these early signs of improving activity in the offshore energy markets and in our businesses as the industry rebounds.

In the market, Brent oil prices remained above \$70 per barrel for some time now. And the longer-term outlook for oil prices are stabilized as inventory levels have declined. And ongoing process improvements and technology developments continue to lower overall offshore costs, which should result in a continued increase in the number of offshore projects being sanctioned.

In our businesses, we are experiencing an increase in bidding and contract awards. Additionally, existing and near-term opportunities to utilize our assets, invest to meet contractual commitments and develop innovative technologies should increase our available market and contribute to Oceaneering's revenue in the future.

As our customers deploy more capital into exploring and developing offshore energy resources, we believe we will be well-positioned to assist them. We are confident that this momentum will allow us to deliver improved operating results and cash flows in the future. We appreciate everyone's interest in Oceaneering, and we'll be now happy to take any questions you may have.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of Jim Wicklund with Credit Suisse. Your line is open.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good Morning, Jim.

A

Operator: Jim...

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning, Jim.

A

Operator: ...Wicklund, your line is open.

James Wicklund

Analyst, Credit Suisse

I'm sorry. Hey, guys.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Hey, Jim.

A

James Wicklund

Analyst, Credit Suisse

And, Marvin, I'm glad you're still there for a guy who left years ago. It's great to see you're still sitting in the chair.

Q

Marvin J. Migura

Senior Vice President, Oceaneering International, Inc.

Thanks, Jim.

A

James Wicklund

Analyst, Credit Suisse

You bet. So it looks like the first quarter is going to be your revenue bottom company-wide. You're guiding up the second half of the year. And, clearly, we're on a recovery track. The biggest question is the pace of the recovery. I mean you don't have a better crystal ball than most of everybody else I guess, except you talk to your own customers. Can you give us an idea of how you expect the recovery to unfold over the next couple of years? What can we kind of expect? And I know it's being gradual, I know it's improving, but what's going to be the pace of recovery? How long does it take to get back to some period in the past that we can use as a benchmark?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

I would just say, Jim, I mean, you're absolutely right. We're following a lot of what we're hearing from the rig contractors and being a bit of a bellwether. But we see a gradual increase over 2019 and 2020. Trying to understand how that affects a 2014-type number as a peak in our industry offshore. I think of it a little bit like what's happening in the shale world is I think rig efficiency has been better. And so, to say that we're going to have sort of that level of rig – our drill support activity, I think they're going to be better and I think there's going to be more discipline.

So I would expect it to be a nice, gradual increase, notwithstanding any big geopolitical shifts and all the other things that nobody can predict.

James Wicklund

Analyst, Credit Suisse

Q

Exactly.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

But I think we're going to see that return. And I would expect sort of that peak level of drill support activity to be somewhat below what 2014 was.

James Wicklund

Analyst, Credit Suisse

Q

Okay. And then on timing, clearly, the ROV rig business is early cycle. Rigs get contracted first. And then construction and the rest of it happens later. Can you talk about the time lag between the front-end of your recovery in deepwater and your back-end, if you would, recovery to deepwater? What's the timing difference from when you really start to see it in the rig business and then you really start to see it in the vessel support business and the rest of your deepwater exposure?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Vessel support, as you know, probably is more directly tied to the price of oil than it is to the number of rigs because that activity to go out and do some of the production enhancement, we're doing the well intervention, that's going to be driven by just the opportunity to enhance the production and get more barrels to the shore. So I think that to me is almost – it's full cycle. If we can get that work going and the price of oil holds up, that'll stay.

The project business, as you know, tends to be later cycle. We have to start to see that drill success in exploration that leads to the completion work that we participate in, and then the big project work on the orders for our manufactured products business. So that can be in the 18-month range, I think, behind where you really see a good cycle increase that's related to an increase in the first surge in drilling activity.

James Wicklund

Analyst, Credit Suisse

Q

So this sets you up for the next several years of improvement. We just have to figure out the pace then?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Exactly.

A

James Wicklund

Analyst, Credit Suisse

All right, gentlemen. Okay. Thank you very much. Appreciate it. Nice quarter.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Thanks, Jim.

A

James Wicklund

Analyst, Credit Suisse

Good job.

Q

Operator: Your next question comes from the line of Sean Meakim with JPMorgan. Your line is open.

James Wicklund

Analyst, Credit Suisse

James West might not cover them.

A

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Hey. Thanks, guys.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning, Sean.

A

Sean C. Meakim

Analyst, JPMorgan Securities LLC

So just thinking about the revisions to the guidance, as we think about hitting the upper end of the guidance now, say, \$160 million, is that more dependent on activity levels or cost performance? How do you think about the flex points between, say, the bottom end and the upper end of that guidance?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I'll give you the trite answer, yes. But, no, it really is both. I would say more dependent on activity because we do have to see, especially in this third quarter, we want to see strong call-out activity in some of the projects getting done and getting underway. As always, I mean, I don't think we have big cost levers left to pull. We've been running pretty lean.

A

So on the cost side, it really would be the cost that we control now is within the execution of the project. So we've got to execute well. We've got some big projects underway that we're going to have to deliver and, hopefully, beat some of our own expectations on getting those things in under cost. So that's what we'll work on.

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Q

And then would you mind helping us with how you see the progression just seasonally 3Q to 4Q?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

It's interesting. For this season, while we still see the seasonality in the offshore businesses, we actually see a sort of a strong pickup in our manufactured products businesses, both in Ad Tech and the offshore Subsea Products. So it's really levelling off Q3 to Q4 to be almost flat, slightly down in Q4.

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Q

Interesting. Okay. That's very helpful. Just one last one. So with the guide coming down a bit, the newbuild vessel deferral, just curious how you think about the outlook for call-out work compared to maybe some leads for securing fixed-term vessel contracts in the projects business?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

That's a great question. Well, number one, let me kind of touch on the late delivery. While we'd like to have that vessel delivered and it does have some effect on our financials when you think about depreciation versus what we're paying to rent the vessel to replace it. As far as revenue and maintaining the ability to cover the work, we've been able to spot hire a vessel to keep us moving on the work that we had committed to the Evolution. So that top line hasn't been a real effect.

But when you get into that spot market, it's interesting. I would like to see more long-term contracts develop or fixed term contracts for vessels. But I think there's so much capacity available right now that there's not a lot of motivation for people to try to lock up those boats. I think you'd probably see more appetite for that on the vessel owners, which means if we did see it, it would probably be to offer reduced dayrate to be able to lock down work. So, to us, it's not that attractive right now because we've seen a big pickup in the spot market and we've had high activity.

On the other side of that, a lot of the spot work we've seen hasn't been the real, I would say, subsea-intensive stuff that we'd like to see that involves more of our other services, whether that's tooling, or the big subsea work packages that we like to offer. So we want richer subsea work. And in that, we were able to really cover a lot of capacity using our chartering on the spot market. So the market share is up in Gulf of Mexico. Our market share is up because we've been utilizing that spot hire ability. So it's a little bit of a mix, but again I don't see the fixed charters on the near horizon.

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Q

That's very helpful.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

Yeah. I think it's really worked to our benefit as well as not having a lot of vessels ourselves. I think by being able to go into contract on the spot market has really benefited us through this cycle.

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Yeah.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I mean, really using the best boat for each job, being able to do that. So it's been good for us. Thanks, Sean.

Sean C. Meakim

Analyst, JPMorgan Securities LLC

Excellent. Thank you, guys.

Operator: Your next question comes from the line of Scott Gruber with Citigroup. Your line is open.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning, Scott.

Operator: Scott Gruber, your line is open.

Scott A. Gruber

Analyst, Citigroup Global Markets, Inc.

Can you hear me?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Yeah. We got you now, Scott.

Scott A. Gruber

Analyst, Citigroup Global Markets, Inc.

Okay. Okay, sorry about that. Can you walk through your high-level thoughts on the macro in response to Jim's question. Just want to dig in a little bit more as you look out in 2019 and you talk to customers about plans, are you getting more excited about the growth potential in vessel support work, in IMR work? Are you more excited about a potential recovery in drill support work?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I think drill support is slow, but steady. So we like it. We've been successful obviously with the market share and winning more than what our commensurate market rate would suggest. So I think that's good. We like that. But,

on the other hand, this ability to surge and come sooner is going to come from that vessel support and IMR work. That's going to be tied very much closer to the price of oil. So that stuff can pick up. And we have seen increased tendering activity in that space, and we made some – our investments like Blue Ocean and we continue to organically invest in that business, building more capacity there. So I like that market as well.

Scott A. Gruber

Analyst, Citigroup Global Markets, Inc.

Got it. And just turning back to the higher-margin service call-out work that seems to be being pushed to the right a bit here. What geography is that originating from?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I mean, there is some here in the Gulf of Mexico, but there is some abroad as well, and just think about the major basins. It's going to be in those hotspots.

Scott A. Gruber

Analyst, Citigroup Global Markets, Inc.

Got you. But in terms of the disappointment, is it kind of spread across evenly or...

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

No, I would say it's probably more Gulf of Mexico. And when we speak about that, a lot of that is when customers have problems, we're typically one of the companies they do call first. And it's one when you do have the ability to have a little bit more pricing power at that point in time. So that's a type of work. So during the first half of the year, we just didn't see people having as many problems during the first half of the year at least.

Marvin J. Migura

Senior Vice President, Oceaneering International, Inc.

Or willing to correct the problems that they have. And building into that perceived backlog of work that's out there, because the oil prices haven't been worth going out to change a choke. And so, a lot of the concept of deferred maintenance that Helix talks about regarding is well intervention also works about outside the well. A lot of work has been deferred. That is usually high-margin work. Having hydrate remediated to get the flow back to optimal levels is I think part of what we're talking about here in that higher-margin work that hasn't materialized.

Scott A. Gruber

Analyst, Citigroup Global Markets, Inc.

Got you. Appreciate the color. Thank you.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Thanks, Scott.

Operator: Your next question comes from the line of George O'Leary with Tudor, Pickering & Company. Your line is open.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning, George.

A

George O'Leary

Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

It seems like overall just the commentary with regards to the outlook offshore is improving, and I think you guys have already spoken to that. But I'd be curious to hear what pockets, from a geography perspective, where you guys are seeing the most green shoots, whether that be on the ROV kind of side of the equation where tendering activity is improving, and/or the Subsea Products side of the business in terms of the projects that are being bid on that front where you guys are potentially seeing order flow. Any color on where things are better, where things are worse would be super helpful.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I mean, those places that can react most quickly is North Sea and Gulf of Mexico, and I think that's where you get some of the early work. Norway was even a little ahead of the UK sector. Equinor is good to get back to work, so they're going quickly. Africa, while it's big, moves a little bit more slowly. So I think we do see some good things happening, but that's farther out.

A

And then Brazil, Brazil is kind of getting its legs under it, again, now, too, with Petrobras, and we see some good things coming out of Brazil as well. So I think you can kind of gauge by, again, those things that are more of a dynamic market will be the quickest, but there are some good things happening in some of those IOCs as well.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

And we're starting to see more interest in quotation activity around the umbilicals and hardware businesses, so that's an encouraging sign as well.

A

George O'Leary

Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

Okay, great. That's helpful. And that actually feeds into my next question. The Subsea Products guidance is easily digestible, but I just want to make sure I understand the moving pieces correctly. When you talk about the back half, lower-margin backlog flowing through, I guess is that more a factor of the types of products that you expect to sell in the second half of the year? Or is some of that more recent lower-price backlog as we progress through this downturn and in the initial stage of the up-cycle flowing through? So is it more price on products or just lower-margin products flowing through that backlog?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

So, George, it really is – I mean, with all the capacity in that umbilical business, which is the biggest part in that number, there is still very challenged pricing in that. So it's not necessarily the type of products; it really is the price they were won at. We think that's going to continue for a while because there haven't been enough projects to – big projects sanctioned to absorb some of that capacity overall in the market, not just for us. And until we see a little more of that capacity get absorbed and some tightening of the available capacity, I think that we're going to see some pricing even in the new projects being won near term.

A

For us, one of the things that we see when you see it all blended together, upside would come from us putting more of the ST&R, the service and rentals backlog, into that mix. That comes with a higher margin. And, again, we've talked a couple of times already on the call that that is one of the things that we can see an early recovery in. So, if we can put more of that in the backlog, you'll see that number come up.

George O'Leary

Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

Great. Thank you, guys, very much for the color.

Q

Operator: Your next question comes from the line of Ken Sill with SunTrust Robinson. Your line is open.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Good morning, Ken.

A

Ken Sill

Analyst, SunTrust Robinson Humphrey, Inc.

Good morning. I want to kind of step into the Wayback Machine here a little bit. Since deepwater offshore is recovering, oil prices are supportive of what's going on. A business that's been talked about for a couple of cycles, but never really turned into much, is the Subsea Well Intervention and workover business. In prior cycles, we've seen joint ventures formed and new designs and new projects. Is there anything in the works with you guys that could provide maybe a little bit of upside from a pickup in workover activity in the Subsea that we just haven't seen or is that just still a science project?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

No. It definitely is. And give me a chance to share kind of the difference in our strategy versus maybe some of the others. I mean, we're really looking at an asset-light approach to well intervention. The system that we were interested in getting through Blue Ocean is one that can be deployed on a vessel of opportunity, so that we can move it around the world more quickly. We can reduce the cost to the customer by being able to do so by not having a vessel tied up on the days that that system isn't working.

A

So it allows us, I think, to open up a part of the market that just wasn't cost-effective to be addressing with, say, a big – either a dedicated vessel or a drill ship. So by doing so, we're looking to build that market out. We're proving the technology, now. We're adding to the capability because the more things we can do with a system like that, the more valuable it becomes. So by being able to enhance what we can do and getting a better price point for the customer, we think will unlock some market there that just haven't really been there in the past. So, yeah, I do think there are things coming that will change that market.

Ken Sill

Analyst, SunTrust Robinson Humphrey, Inc.

And when could we maybe start seeing something like that? I mean, because obviously everything's more efficient, but there seems to be a big unaddressed need. So is that something that could be a meaningful kind of a new kind of product line?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Absolutely. I think it's going to look like that. And again, what we found is it's like everything that we introduced to the offshore especially when you're introducing equipment into a live well very often, it takes a while for the operators to get comfortable. They spend a lot of time proving out the engineering designs before you even mobilize the equipment. So we've gone through that process with at least a couple of our major customers already. And we're starting to see the work that follows after that develop. So I think it's just a matter of – we're slightly slow to adopt, but I would say that we're kind of on the edge of seeing that equipment go to work.

Ken Sill

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Great. Thank you.

Operator: Your next question comes from the line of Joe Gibney with Capital One. Your line is open.

Joseph D. Gibney

Analyst, Capital One Securities, Inc.

Q

Just had a question on Ecosse. You called it out within projects as helping you get back a little bit into the black here in the third quarter. I know some of that's seasonal lift here in the Gulf of Mexico. But curious is it seasonality also in Ecosse? Are you seeing some sustainable growth maybe beyond third quarter on that front? Might be useful to kind of get a refresh on some thoughts on the survey and trenching side there.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

It's really project-dependent. So we have a backlog that we have that we'll be executing in the second half or third quarter that we expect to complete associated with Ecosse. It really helps in the third quarter. As well as the associated survey work you alluded to that we'll be doing for renewables work here in the U.S. markets as well. So we're seeing the renewables market in general starting to pick up and we're able to pull through not just the Ecosse side of the business, but also ROVs participating in that and survey now.

Joseph D. Gibney

Analyst, Capital One Securities, Inc.

Q

Okay, helpful. And then just a clarification on the Products side, you called out sort of the rental and service component helping the mix a little bit here in 2Q and helping stay profitable. In your sort of low-single digit guide for the back half of the year, what are your thoughts on the rental and the services side of the mix just sort of steady here? Do you anticipate given somewhat of the boost in working rig count that you could see some upward momentum on that component of products margin?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

We'll probably see a little bit of an increase in service and rental in the back half of the year. But I think the bigger component and what kind of pulls the margin down a little bit is we do expect to see a lot more that volume coming through on the umbilicals and hardware that Rod spoke to earlier today, which has been fairly competitive price points that we'd want to map.

Joseph D. Gibney

Analyst, Capital One Securities, Inc.

Sure. Okay. Helpful. I appreciate it. I'll turn it back.

Q

Operator: Your next question comes from the line of Vebs Vaishnav with Cowen & Company. Your line is open.

Vaibhav Vaishnav

Analyst, Cowen & Co. LLC

Hey. Good morning, and thanks for taking my question. I guess first question on ROVs, it sounds like the market is improving based on your market share comment and more activity. Just trying to reconcile those comments that ROV segment flat to down in 3Q?

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Sure, Vebs. I think this is – I mean it's a little bit – there's a lot of moving pieces here. So I'm glad you asked the question because I think more than one person had that one is we do see the improvement in the drill support. We've had a really strong vessel support Q2. Q3, we just haven't seen it happen yet. So remember that some of that vessel support is on call-out work which we have to see materialize. So we risk weight that a little bit when we put it in the forecast. There's weather in the third quarter, especially here in the Gulf of Mexico. So we've got to be a little cautious about what we put in.

A

But on the drill support – the underlying drill support, we do see it going up. I think you'll be able to see sort of the effect of drill support in the fourth quarter. So that will become more apparent. And then we've got a little bit of geographic mix that comes out because of the drill support which softens us a little bit versus some of the strength we've had in the vessel support, not just with the seasonal activity, but also we've had some really good upmanning on that vessel side as well in the second quarter.

So we've got a little bit of that. That's got to balance out in the second half. But overall, I mean, I think that it's not masking some underlying difference. It's just we've got seasonality overlaid with that – how fast that stuff happens in drill support and where it happens.

Vaibhav Vaishnav

Analyst, Cowen & Co. LLC

Okay. That's helpful. Switching to Subsea Projects, can you help us just think about if there's a way we can talk about disappointment in that business and bucket them in those two or three categories? May that be lower margins on the projects, a shift to the third quarter? And also then like what gives the confidence that that business returns to profitability in 3Q?

Q

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

Yeah. I think there are several key elements. We've talked about lower-than-anticipated margins which we obviously did not hit our expected margin profile on a job. That impacted us in Q2. So we don't see that as a recurring in Q3 or the back half the year. We also have some backlog that we'll be executing in the back half the year that we expect has higher margins in it. So that gives us the level of confidence going into the back half of the year as well. And then we talked a bit earlier about the renewable sector and how we're seeing more work and

A

activity in the back half of the year than what we saw in the first half. So I think those are the key elements that we have line of sight to, Vebs, that gives us that confidence.

Vaibhav Vaishnav

Analyst, Cowen & Co. LLC

Q

Okay. And just quickly switching to Subsea Products, it sounds like the revenues are going to be higher in second half based on the comments on the more umbilical flow-through and higher rental business. And with that in context and you guys talking about a one-time book-to-bill for the full year implies that order should be, call it, \$250 million-\$300 million in second half? Just what gives that confidence?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

I think there's certain contracts that we are looking forward to announce in the not too distant future, as well as we have a pretty strong bid activity right now. And we think those will be converting into orders in the back half of the year.

Vaibhav Vaishnav

Analyst, Cowen & Co. LLC

Q

Okay. That's helpful. And one last question, if I may squeeze in. Any segments that are not profitable in 3Q?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

I think we see profitability in each of them at this point in time, Vebs.

Vaibhav Vaishnav

Analyst, Cowen & Co. LLC

Q

Thank you for indulging me. Thank you.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Yes. Thanks, Vebs.

Operator: Your next question comes from the line of Ian Macpherson with Simmons. Your line is open.

Ian Macpherson

Analyst, Simmons & Company International

Q

Hey. Good morning. Thank you.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Good morning, Ian.

Ian Macpherson

Analyst, Simmons & Company International

Q

Hi. You mentioned \$20 million CapEx increase related to a contract opportunity that's ramping, I think you said second half of next year. Could you describe that a little bit more for us?

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Well, we're tap dancing a little bit because we're working on a press release. But, yeah, it's – I won't say more than that, but it is enhanced. So watch this space.

Ian Macpherson

Analyst, Simmons & Company International

Q

No worries. We'll wait for the press release.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Yeah.

Ian Macpherson

Analyst, Simmons & Company International

Q

My other one kind of a boring accounting question and I might have missed this because I got on about five minutes late. But the consolidated guidance for Q3 is for improvement over Q2, and I didn't know if that was for both EBIT and EBITDA or only for EBIT if it matters. And the reason I'm asking is because there seems to be a pretty significant implied decrease in your depreciation expense in the second half. So I just wanted to flesh that out. Thanks.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

Yes to both; improvement in both.

Ian Macpherson

Analyst, Simmons & Company International

Q

Okay. And what's up with the depreciation down about 15% on a run rate in the second half?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

Are you looking at it on an adjusted basis...

Ian Macpherson

Analyst, Simmons & Company International

Q

Well, \$215 million of depreciation for the full year implies, I think, \$100 million in the second half, which is down quite a bit. I didn't see any obvious reasons why. It's not that important. I was just curious.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

Okay. I think the largest component, some of the adjustments are hitting our depreciation line item in the first half of the year.

Ian Macpherson

Analyst, Simmons & Company International

Got it. Okay. Thanks.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Yeah.

A

Operator: Your next question comes from the line of Eduardo Royes with Jefferies. Your line is open.

Eduardo Royes

Analyst, Jefferies LLC

Hey, guys. Good morning. Just to follow-up, I guess, a bit on Vebs' question from earlier. I feel like, historically, we've seen some vessel support weakness in the fourth quarter, and I guess you're talking a little bit about maybe a really strong second quarter and that that's masking a little bit the third quarter. I guess, you touched a little bit on the third quarter in ROVs and I was just curious on the vessel support if we think that then there's another maybe sizable falloff in the fourth quarter, as we've often seen? Thanks.

Q

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

I think what we were guiding to in Projects is...

A

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

The vessel support ROVs? I want to make sure that we're clear here, Eduardo. Are you talking about vessel support of ROVs?

A

Eduardo Royes

Analyst, Jefferies LLC

Yeah.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Or are you talking about vessel activity in Projects? Okay.

A

Eduardo Royes

Analyst, Jefferies LLC

No. Yeah, ROVs. Thanks.

Q

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

I mean, that vessel support activity that hit seasonal has been very normal – like you said, very normal for us for forever. I mean, that's just what we see. But when you say significant falloff, one of the things that we talked about for ROVs is that, while we expect that flattish third quarter improvement in the second half, you can kind of tell that we don't expect as much weakness in the fourth quarter relative to the rest of the year as maybe a traditional

A

year would say. And that's bolstered by what we've been trying to call out is that the underlying drill support business is increasing throughout the year.

Eduardo Royes

Analyst, Jefferies LLC

Q

Got it. Maybe that offset some. And then on Products, could you help us think a little bit about the margin difference between the manufactured products and the service and rental piece? It seems like it's a pretty wide spread, but if there's any perspective you can offer on how we should think about the difference between manufactured products and service and rental? Thank you.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

I think you've kind of nailed it in that, yeah, there is a significant difference, but it's hard for me to call out and tell you what the differential is because sometimes in the service and rental business, we actually do have some specialty manufactured products which look a little more like a product or our other manufactured products. And on the other end, we have backlog that's actually booked for service, which is significantly better than manufactured products. So it will all depend on what the mix of those things are within the service and rentals, and then the relative proportion between service and rentals and manufactured products.

Eduardo Royes

Analyst, Jefferies LLC

Q

Thanks.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

We have not broken it out at sub-segment level...

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

A

Yeah.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

...at this...

Eduardo Royes

Analyst, Jefferies LLC

Q

Got you. And then, I guess, related on the rental side, I think that usually comes out on the Q. I don't know if you guys have it handy or you're willing to share the split on the revenue side?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

A

It will be in our Q.

Eduardo Royes
Analyst, Jefferies LLC

Q

Okay. All right. Thank you.

Operator: [Operator Instructions] And your next question comes from the line of David Smith with Heikkinen Energy Advisors. Your line is open.

Roderick A. Larson
President & Chief Executive Officer, Oceaneering International, Inc.

A

Good morning, David.

Operator: David, your line is open.

David Christopher Smith
Analyst, Heikkinen Energy Advisors LLC

Q

Yeah. Hey, can you hear me okay?

Roderick A. Larson
President & Chief Executive Officer, Oceaneering International, Inc.

A

Yeah. We do, David. We got you now.

David Christopher Smith
Analyst, Heikkinen Energy Advisors LLC

Q

Okay. On the vessel-based ROV activity, I know you give this figure in the appendix of your presentation, the number of ROVs on vessels at the end of the quarter. That stepped up nicely in Q1 to 103 vessels from 89 vessels in Q4. Could you give us any color on what's helping you get ROVs placed on more vessels? Is that mostly displacing competitors? Is it the fruition of prior announcements related to Maersk and Heerema, a step up in renewables activity? And more so, how do you see that figure playing out through the year?

Roderick A. Larson
President & Chief Executive Officer, Oceaneering International, Inc.

A

It's a combination. So you have placement on the number of vessels we have, which you hit it. I mean, we've had a couple extra deployments on Maersk. But the other thing that you're seeing is the number of days worked. So it's not only that we're on – the number of vessels has increased, but the number of days those vessels have worked relative to the number of drill support days we've had is part of that ship. So it's just activity for the vessels we're on is what will drive most of that increase.

David Christopher Smith
Analyst, Heikkinen Energy Advisors LLC

Q

Appreciate it. And I know you gave some color on Projects performance in Q2, but I'm circling on a little bit because I think you had a full quarter with the vessel in Angola, you had a full quarter of Ecosse. Revenues are up nice sequentially, while EBITDA halved. Was there anything specific to Q1 that really helped and wasn't repeated? Or was Ecosse dilutive to margins this quarter? And I know you mentioned backlog with Ecosse and survey work as benefiting Q3. Is that the main difference in your guidance for Q3 improvement?

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

Yeah. When we look at it, we talk about the one project that came in lower than what we anticipated that was impacting our margins. And, yes, the Ecosse, most of the work they have is going to be more in the back half of the year than what it was in Q2. So it was a bit dilutive in Q2, but it will pick up in Q3 as we execute on their backlog.

David Christopher Smith

Analyst, Heikkinen Energy Advisors LLC

Great. Appreciate the color.

Alan R. Curtis

Chief Financial Officer & Senior Vice President, Oceaneering International, Inc.

Yes.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Thanks, David.

Operator: And there are no further questions at this time. I will turn the call back over to CEO, Rod Larson, for closing remarks.

Roderick A. Larson

President & Chief Executive Officer, Oceaneering International, Inc.

Since there are no more questions, I'd like to wrap up as always by thanking everyone for joining the call. This concludes our second quarter 2018 conference call. Have a great day.

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