ION GEOPHYSICAL CORP
Form 10-Q
November 07, 2008

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

COMMISSION FILE NUMBER: 1-12691

ION GEOPHYSICAL CORPORATION

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	22-2286646
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2105 CityWest Blvd. Suite 400 Houston, Texas	77042-2839
(Address of principal executive offices)	(Zip Code)

REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE: (281) 933-3339

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes: þ No: o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes: o No: þ

At October 31, 2008, there were 99,432,147 shares of common stock, par value $0.01 per share, outstanding.

ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
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FOR THE QUARTER ENDED SEPTEMBER 30, 2008

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PART I. FINANCIAL INFORMATION
Item 1. ***Unaudited Financial Statements***
ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2008	December 31, 2007
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32,189	$ 36,409
Restricted cash	5,344	7,052
Accounts receivable, net	180,026	188,029
Notes receivable, net	25,473	5,454
Unbilled receivables	65,578	22,388
Inventories	254,803	128,961
Prepaid expenses and other current assets	25,523	12,717
Total current assets	588,936	401,010
Notes receivable	6,753	
Non-current deferred income tax asset	3,351	2,872
Property, plant and equipment, net	63,961	36,951
Multi-client data library, net	83,004	59,689
Investments at cost	4,954	4,954
Goodwill	306,041	153,145
Intangible and other assets, net	170,749	50,528
Total assets	$ 1,227,749	$ 709,149
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term debt	$ 190,534	$ 14,871
Accounts payable	86,599	44,674
Accrued expenses	74,629	66,911
Accrued multi-client data library royalties	30,586	29,962
Deferred revenue	12,037	21,278
Deferred income tax liability	5,165	2,792
Total current liabilities	399,550	180,488
Long-term debt, net of current maturities	124,316	9,842
Non-current deferred income tax liability	37,505	3,384
Other long-term liabilities	4,115	4,195
Fair value of preferred stock redemption features	2,188	
Total liabilities	567,674	197,909

Cumulative convertible preferred stock	68,785	35,000
Stockholders equity:		
Common stock, $0.01 par value; authorized 200,000,000 shares; outstanding 99,432,147 and 93,847,608 shares at September 30, 2008 and December 31, 2007, respectively, net of treasury stock	994	948
Additional paid-in capital	624,924	559,255
Accumulated deficit	(34,833)	(82,839)
Accumulated other comprehensive income	6,766	5,460
Treasury stock, at cost, 848,422 and 853,402 shares at September 30, 2008 and December 31, 2007, respectively	(6,561)	(6,584)
Total stockholders equity	591,290	476,240
Total liabilities and stockholders equity	$ 1,227,749	$ 709,149

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
	(In thousands, except per share amounts)			
Product revenues	$ 140,332	$ 126,246	$ 337,726	$ 385,587
Service revenues	78,197	47,306	201,627	118,166
Total net revenues	218,529	173,552	539,353	503,753
Cost of products	92,347	89,407	224,601	278,924
Cost of services	53,561	31,498	135,716	86,810
Gross profit	72,621	52,647	179,036	138,019
Operating expenses:				
Research, development and engineering	13,498	12,449	37,507	37,530
Marketing and sales	12,062	10,906	35,440	31,151
General and administrative	15,487	12,428	44,484	35,024
Total operating expenses	41,047	35,783	117,431	103,705
Income from operations	31,574	16,864	61,605	34,314
Interest expense	(1,592)	(1,764)	(2,731)	(5,017)
Interest income	40	273	1,117	1,412
Other income (expense)	743	(823)	1,075	(1,470)
Fair value adjustment of preferred stock redemption features	(1,147)		(974)	
Income before income taxes	29,618	14,550	60,092	29,239
Income tax expense	3,760	1,322	9,343	4,671
Net income	25,858	13,228	50,749	24,568
Preferred stock dividends and accretion	925	589	2,743	1,780
Net income applicable to common shares	$ 24,933	$ 12,639	$ 48,006	$ 22,788
Earnings per share:				
Basic net income per share	$ 0.26	$ 0.16	$ 0.51	$ 0.28
Diluted net income per share	$ 0.25	$ 0.14	$ 0.49	$ 0.26

Weighted average number of common shares outstanding:				
Basic	95,823	81,047	94,676	80,607
Diluted	102,653	97,780	102,127	97,426

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months Ended September 30, 2008	2007
	(In thousands)	
Cash flows from operating activities:		
Net income	$ 50,749	$ 24,568
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization (other than multi-client library)	20,897	19,876
Amortization of multi-client library	64,526	24,959
Stock-based compensation expense related to stock options, nonvested stock and employee stock purchases	6,138	4,586
Fair value adjustment of preferred stock redemption features	974	
Deferred income tax	585	(688)
Excess tax benefit from exercise of stock options	(1,657)	
Gain on sale of fixed assets	(158)	(195)
Change in operating assets and liabilities:		
Accounts and notes receivable	2,409	53,966
Unbilled receivables	(43,190)	(20,315)
Inventories	(69,686)	(24,258)
Accounts payable, accrued expenses and accrued royalties	41,644	7,006
Deferred revenue	(12,943)	(19,377)
Other assets and liabilities	(7,787)	(5,409)
Net cash provided by operating activities	52,501	64,719
Cash flows from investing activities:		
Purchase of property, plant and equipment	(11,201)	(7,167)
Investment in multi-client data library	(87,841)	(45,240)
Business acquisition	(241,589)	
Cash of acquired business	10,677	
Proceeds from the sale of fixed assets	110	268
Increase in cost method investment		(182)
Net cash used in investing activities	(329,844)	(52,321)
Cash flows from financing activities:		
Borrowings under revolving line of credit	175,000	142,000
Repayments under revolving line of credit	(97,000)	(142,000)
Net proceeds from issuance of debt	165,072	
Payments on notes payable and long-term debt	(6,894)	(6,512)
Issuance of preferred stock	35,000	
Payment of preferred dividends	(2,743)	(1,767)
Proceeds from employee stock purchases and exercise of stock options	6,249	5,934

Restricted stock cancelled for employee minimum income taxes	(1,315)	(1,231)
Excess tax benefit from exercise of stock options	1,657	
Purchases of treasury stock	(39)	(117)
Net cash provided by (used in) financing activities	274,987	(3,693)
Effect of change in foreign currency exchange rates on cash and cash equivalents	(1,864)	274
Net decrease in cash and cash equivalents	(4,220)	8,979
Cash and cash equivalents at beginning of period	36,409	17,056
Cash and cash equivalents at end of period	$ 32,189	$ 26,035

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The consolidated balance sheet of ION Geophysical Corporation and its subsidiaries (collectively referred to in this Part I **-** Item 1 as the Company or ION, unless the context otherwise requires) at December 31, 2007 has been derived from the Company s audited consolidated financial statements at that date. The consolidated balance sheet at September 30, 2008, the consolidated statements of operations for the three and nine months ended September 30, 2008 and 2007, and the consolidated statements of cash flows for the nine months ended September 30, 2008 and 2007 are unaudited. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the operating results for a full year or of future operations.

These consolidated financial statements have been prepared using accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States have been omitted. The accompanying consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

Effective September 18, 2008, the Company completed the acquisition of ARAM Systems Ltd. and Canadian Seismic Rentals Inc. (sometimes collectively referred to herein as ARAM). The results of operations and financial condition of the Company as of and for the three and nine months ended September 30, 2008 have been affected by this acquisition, which may affect the comparability of certain of the financial information contained in this Quarterly Report on Form 10-Q. This acquisition is described in more detail in Note 3 *Acquisition.*

During the first quarter of 2008, the Company determined that its engineering expenses relating to product enhancements are more appropriately reflected as combined with the engineering expenses associated with its research and development activities. These engineering expenses related to product enhancements had been previously classified within cost of products. The Company s previously reported cost of products and research, development and engineering expenses for the three and nine months ended September 30, 2007 have been reclassified to conform to the current year s presentation. This reclassification (a total of $0.9 million and $2.8 million, respectively, for the three and nine months ended September 30, 2007) had no impact on income from operations or net income.

(2) Summary of Significant Accounting Policies and Estimates

Refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2007, for a complete discussion of the Company s significant accounting policies and estimates.

(3) Acquisition

In July 2008, the Company announced that it had signed a definitive share purchase agreement to acquire all of the outstanding shares of ARAM from their shareholders. Founded in 1971, ARAM designs, manufactures, sells and leases land seismic data acquisition systems, specializing in analog cabled systems. On September 17, 2008, the Company ARAM and their selling shareholders (the Sellers) entered into an Amended and Restated Share Purchase Agreement (the Amended Purchase Agreement), which amended the terms of the July 2008 original share purchase agreement. On September 18, 2008, the Company, through its acquisition subsidiary, ION Sub (ION Sub), completed the acquisition of the outstanding shares of ARAM in accordance with the terms of the Amended Purchase Agreement.

In exchange for the shares of ARAM, ION Sub (i) paid the Sellers aggregate cash consideration of $236 million (which amount was net of certain purchase price adjustments made at the closing), (ii) transferred to one of the Sellers 3,629,211 shares of ION s common stock and (iii) issued to one of the Sellers an unsecured senior promissory note in the original principal amount of $35.0 million (the Senior Seller Note) and an unsecured subordinated promissory note in the original principal amount of $10.0 million (the Subordinated Seller Note). The aggregate purchase price is also subject to certain post-closing purchase price adjustments under the Amended Purchase Agreement.

The Company agreed under the Amended Purchase Agreement to deposit, as promptly as reasonably possible following the date on which certain audited and unaudited combined financial statements of ARAM satisfying the obligations under SEC Regulation S-X had been completed and delivered to ION (the Financials Delivery Date), an amount equal to $35.0 million plus a portion of the amount of interest accrued on the Senior Seller Note into an escrow account for the purpose of funding post-closing purchase price adjustments and the parties indemnification obligations (the Escrow Account). The deposit of this amount into the Escrow Account (along with the payment in full to the holder of the Senior Seller Note of the remaining amount of interest accrued and unpaid on the Senior Seller Note) will serve to repay in full the indebtedness under the Senior Seller Note. The escrow period will terminate on September 18, 2009, the one-year anniversary of the closing date of the acquisition. The required Regulation S-X-compliant financial statements of ARAM were delivered to ION on November 3, 2008, which, for purposes of the Amended Purchase Agreement, is the Financials Delivery Date. For further discussion regarding the Senior Seller Note and the Subordinated Seller Note, see Note 7 *Notes Payable, Long-Term Debt and Lease Obligations* below.

The Company financed the cash portion of the purchase price for ARAM with (i) $72.0 million of revolving line of credit borrowings and $125 million in five-year term loan indebtedness borrowed under its amended and restated credit facility (the Amended Credit Facility) and (ii) $40.0 million in gross proceeds under a short-term bridge loan that the Company borrowed from Jefferies Finance CP Funding LLC at the completion of the ARAM acquisition (the Short-Term Bridge Loan). ION has entered into a commitment letter dated September 18, 2008 with Jefferies Finance LLC (the Commitment Letter), pursuant to which Jefferies Finance LLC has agreed, subject to the terms and upon satisfaction of the conditions contained in the Commitment Letter, to act in the capacities of sole advisor, sole administrative agent, sole collateral agent (if applicable), sole book-runner, sole lead arranger and sole syndication agent in connection with a $150.0 million senior bridge loan facility. For further discussion regarding the Amended Credit Facility, the Short-Term Bridge Loan and the Commitment Letter, see Note 7 *Notes Payable, Long-term Debt and Lease Obligations* below.

The Company acquired ARAM for the purpose of advancing the Company s strategy and market penetration in the land seismic recording system business. The operations of ARAM are combined with those of the Company as of September 19, 2008. The acquisition was accounted for by the purchase method, with the purchase price being allocated to the fair value of assets purchased and liabilities assumed. As of September 30, 2008, the allocation of the purchase price of ARAM was based upon preliminary fair value studies due to the short period between the date of the acquisition and the end of the quarter. Estimates and assumptions are subject to change upon the receipt and management s review of the final valuations. In addition, the preliminary allocation of the purchase price includes a $6.0 million write-up in inventory to fair market value. The Company expects that the majority of this write-up will flow out to cost of products during the nine-month period following the closing date of the acquisition as the inventory is sold. The preliminary allocations of the purchase price, including related direct costs, for the acquisition of ARAM are as follows (in thousands):

Fair values of assets and liabilities:	
Net current assets	$ 76,046
Property, plant and equipment	24,646
Net other long-term assets	2,678
Intangible assets	116,000
Goodwill	155,620
Deferred tax liability	(35,990)
Capital lease obligations	(3,453)
Total allocated purchase price	335,547
Less non-cash consideration issuance of common stock	(48,958)
Less issuance of seller notes	(45,000)
Less cash of acquired business	(10,677)

Cash paid for acquisition, net of cash acquired	$ 230,912

The intangible assets of ARAM relate to customer relationships, proprietary technology, trade names and non-competition agreements, which are being amortized over their estimated useful lives ranging from five to ten years.

The following summarized unaudited pro forma consolidated income statement information for the three and nine months ended September 30, 2008 and 2007, assumes that the ARAM acquisition had occurred as of the beginning of the periods presented. The Company has prepared these unaudited pro forma financial results for comparative purposes only. These unaudited pro forma financial results may not be indicative of the results that would have occurred if ION had completed the acquisition as of the beginning of the periods presented or the results that may be attained in the future. Amounts presented below are in thousands, except for the per share amounts:

	Pro forma Three Months Ended September 30,		Pro forma Nine Months Ended September 30,	
	2008	2007	2008	2007
Pro forma net revenues	$238,289	$190,123	$604,369	$574,041
Pro forma income from operations	$ 35,118	$ 15,924	$ 73,745	$ 50,777
Pro forma net income	$ 22,839	$ 7,986	$ 42,732	$ 20,232
Pro forma basic net income per common share	$ 0.24	$ 0.09	$ 0.45	$ 0.24
Pro forma diluted net income per common share	$ 0.23	$ 0.09	$ 0.43	$ 0.23

(4) Segment and Product Information

In order to allow for increased visibility and accountability of costs and more focused customer service and product development, the Company evaluates and reviews results based on four segments: three of these segments Land Imaging Systems, Marine Imaging Systems and Data Management Solutions make up the ION Systems Division, and the fourth segment is the ION Solutions Division. The Company s land sensors business unit, which specializes in the design and manufacture of geophones, and its land imaging systems business unit have been aggregated to form the Land Imaging Systems segment. Additionally, with the acquisition of ARAM, the Company will integrate and has included ARAM s business operations with those of ION s land imaging systems business unit. The Company measures segment operating results based on income from operations.

A summary of segment information for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues:				
Land Imaging Systems	$ 81,562	$ 79,055	$ 177,270	$ 242,804
Marine Imaging Systems	49,016	37,099	133,872	116,925
Data Management Solutions	10,408	10,917	29,170	28,097
Total ION Systems	140,986	127,071	340,312	387,826
ION Solutions	77,543	46,481	199,041	115,927
Total	$ 218,529	$ 173,552	$ 539,353	$ 503,753
Income (loss) from operations:				
Land Imaging Systems	$ 11,216	$ 5,663	$ 15,831	$ 16,681
Marine Imaging Systems	14,063	9,912	35,245	32,077
Data Management Solutions	6,820	5,948	17,496	12,686
Total ION Systems	32,099	21,523	68,572	61,444
ION Solutions	14,019	7,443	36,316	7,432
Corporate	(14,544)	(12,102)	(43,283)	(34,562)
Total	$ 31,574	$ 16,864	$ 61,605	$ 34,314

(5) Inventories

A summary of inventories is as follows (in thousands):

	September 30, 2008	December 31, 2007
Raw materials and subassemblies	$ 108,212	$ 70,870
Work-in-process	20,476	13,681
Finished goods	138,523	55,945
Reserve for excess and obsolete inventories	(12,408)	(11,535)
Inventories, net	$ 254,803	$ 128,961

(6) Net Income per Common Share

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Basic net income per common share is computed by dividing net income applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted net income per common share is determined based on the assumption that dilutive restricted stock and restricted stock unit awards have vested and outstanding dilutive stock options have been exercised and the aggregate proceeds were used to reacquire common stock using the average price of such common stock for the period. The total number of shares issued or committed for issuance under outstanding stock options at September 30, 2008 and 2007 was 6,476,325 and 5,983,142, respectively, and the total number of shares of restricted stock and restricted stock units outstanding at September 30, 2008 and 2007 was 759,527 and 787,969, respectively. The number of shares issued under stock option exercises during the nine months ended September 30, 2008 and 2007 was 656,166 and 724,368 shares, respectively.

As of September 30, 2008, the Company had outstanding $3.2 million of convertible senior notes, under which 750,000 shares of common stock could be acquired upon full conversion. In addition, there are 30,000, 5,000 and 35,000 outstanding shares, respectively, of Series D-1, Series D-2, and Series D-3 Cumulative Convertible Preferred Stock (collectively referred to as the Series D Preferred Stock), which may currently be converted, at the holder s election, into up to 3,812,428 shares, 311,664 shares and 2,365,168 shares, respectively, of common stock. As shown in the table below, the convertible senior notes were dilutive for all periods shown. The outstanding shares of Series D-1 Preferred Stock were dilutive for the three and nine months ended September 30, 2008, while the shares of Series D-2 Preferred Stock and Series D-3 Preferred Stock were anti-dilutive for all periods shown.

The following table summarizes the computation of basic and diluted net income per common share (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net income applicable to common shares	$ 24,933	$ 12,639	$ 48,006	$ 22,788
Impact of assumed convertible debt conversion, net of tax	48	1,007	250	3,020
Impact of assumed Series D Preferred Stock conversions:				
Series D-1 Preferred Stock dividends	396		1,325	
Net income after impact of assumed convertible debt and preferred stock conversions	$ 25,377	$ 13,646	$ 49,581	$ 25,808
Weighted average number of common shares outstanding	95,823	81,047	94,676	80,607
Effect of dilutive stock awards	2,036			