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## Event Transcript

### IO - Q1 2003 Input/Output Inc. Earnings Conference Call

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IO - Q1 2003 Input/Output Inc. Earnings Conference Call

## CORPORATE PARTICIPANTS

### Bob Peebler

*Input/Output Inc. - Pres, CEO*

### Brad Eastman

*Input/Output Inc. - CAO*

## CONFERENCE CALL PARTICIPANTS

### Thiru Ramakrishnan

*Simmons & Company International - Analyst*

### Patrick Flavin

*Flavin, Blake & Company - Analyst*

### John Morsani

*ING - Analyst*

## PRESENTATION

### Operator

Good morning. Welcome to the Input/Output Incorporated first quarter earnings release. Following today's presentation, there will be a formal question and answer session and instructions will be given at that time. Until then, all lines will remain in a listen-only mode. At the request of the company, today's conference is being recorded for replay purposes. If anyone has any objections, you may disconnect at this time. I would now like to introduce today's conference host, the President and Chief Executive Officer, Mr. Bob Peebler. Sir, you may begin.

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### Bob Peebler - Input/Output Inc. - Pres, CEO

Good morning and welcome to Input/Output's first quarter conference call. Your hosts for today's call are me, Bob Peebler, and Brad Eastman, our Chief Administrative Officer. As we start this call, please refer to the statement regarding forward-looking statements incorporated in our press release issued earlier today and please note that the contents of our conference call this morning are covered by the statement. Also, please note that you can find a reconciliation to reported numbers for non-GAAP measures we will discuss on this call in our press release. Our agenda will be industry perspective, review of our quarterly results, update on other significant events this quarter, and then we will follow that by question and answer period.

While commodity prices have remained strong, we have little indication that the market for our traditional seismic contractors is improving in the short-term, but we are starting to see signs of potential market strengthening in the latter part of the year.

Commodity prices remained strong during the quarter. West Texas index averaged \$33.90 this quarter, up from last quarter's \$28.58. Natural gas prices improved seasonally during the quarter with Nymex spot gas prices averaging \$6.14 MCF compared to 14.14 MCF last quarter. US drilling activity averaged 897 rigs during the first quarter, up 6% from 847 in the fourth quarter and up 10% from last year's first quarter average of 814. International activity has been steady with 744 active rigs last quarter. The international rig count was about even with the fourth quarter and was also about even with the first quarter last year. Canada increased about 75% sequentially with rigs running averaging 494, which also represents a 29% improvement compared to fourth quarter 2002.

We saw mixed levels of seismic activity last quarter. International land seismic crew count softened, averaging 135 for the quarter, down from 187 the same quarter a year ago, but up sequentially. China, in particular remained strong. Russia activity has been hurt by reductions in state incentives for exploratory activity. United States activity also softened, land activity also softened, with active land count crews averaging 29, down from 32 last quarter, and the 37 recorded in last year's first quarter. Canadian land activity averaged 32, crews up 21 crews sequentially and up one crew from the 36 crew average in the first quarter last year.

Marine seismic activity was also mixed. US marine activity declined slightly to 11 active vessels compared to 12 last quarter and 16 a year ago. The international marine fleet averaged approximately 57 active vessels for the quarter, flat with 57 last quarter, but up from 52 active vessels in the first quarter last year. While seismic activity in North America continues to reflect the challenging exploration environment, we are seeing greater stability in the international arena. In particular, Chinese seismic contractors are increasingly active not only in China, but also in other international areas.

Most of our North American centric seismic contractor customers are still in the mode of cutting back and consolidating their businesses. Opposed to this continuing trend, is an increasing awareness of oil companies that there is a growing problem concerning the US inventory of new drilling prospects. For example, we have seen in the recent Gulf of Mexico March bid round, where deep AVO anomalies that are at high risk, hydrocarbon indicators, being bid as they were lower risk, high potential, shallow bright spots. This is a good example of too many oil companies chasing too few of opportunities. In my judgment, these are early indicators of the need for oil companies to get back to the business of finding new reserves vs. the risk

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averse behavior of milking mature fields, which are not producing the opportunities needed to grow.

The difficult short-term question is how long we'll take to this need to trickle down to the seismic sector. I believe it's inevitable that oil companies must embrace new seismic technologies to unravel the geological and reservoir problems to unlock future reserves and IO will be well positioned when that happens. We are seeing several oil companies increasing their planned 2003 drilling budgets and some of this should result in increases in geophysical spending, but likely in the second half of the year at the earliest. In the meantime, we have seen non-traditional seismic contractors such as BGP in China more aggressively expanding, including being the first purchasers of our new VectorSeis systems. Our first quarter sales activity reflects the continued improvement in our sales volume in continued efforts to reduce our cost structure to reach our breakeven revenue target of approximately \$150m. While our first quarter sales meets our projections as discussed in last quarter's conference call, we fell short of our loss per share targeted by approximately \$0.03. Brad will now discuss the quarter in more detail.

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### Brad Eastman - Input/Output Inc. - CAO

Thanks Bob. First quarter sales were \$41.2m, up \$11m or about 36% from last year's first quarter, and up \$4.2m or about 11% from last quarter. The increase is attributable to an increase in land seismic activity with our non-western contractors. Our land sales for the quarter were \$32.6m, an increase of \$15m or about 85% from last year's first quarter and up \$12.2m or 60% from the fourth quarter of last year. Marine sales of \$8.6m declined \$4m or about 32% compared to last year's first quarter and decreased \$8m or about 48% from last quarter. Last quarter's results were skewed by a single large system sale to a Russian contractor. Our gross profit rate this quarter was 21% compared to 23% in last year's first quarter and 16% in the prior quarter. While gross margins are continuing to show sequential improvement, our gross margin fell short of our expectations for the quarter.

This low gross margin percentage is due primarily to three reasons. First, we have continued to transform our business by outsourcing most of our non-core manufacturing. During this transition period, we continue to experience the unabsorbed burden of our fixed and semi-fixed overhead, primarily associated with our Alvin facility. We expect to have completely vacated this facility by the end of this quarter, saving approximately \$2m annually in depreciation and facilities related charges alone. We will also realize substantial cost savings from personnel reductions

after the closure of this facility. Second, in the first quarter of this year we had a decline in our marine sales, which historically contributed a higher gross margin percentage of our overall product mix. Third, in the first quarter of this year we delivered our first VectorSeis System 4 acquisition system to BGP. Our margins on this sale were substantially less than we expect on future VectorSeis sales, including sales we have already contracted for delivery this quarter. This abnormally low margin on this first sale resulted primarily from an introductory price necessary to penetrate the market with our first system. We have already realized a higher cost per station and planned further increases as oil companies start realizing the value of VectorSeis and begin to spec VectorSeis for their seismic surveys.

Also, since production of the BGP system we have identified \$230 per station in additional cost savings and believe that we can continue to wring out costs as we increase volumes and get more practical experience with manufacturing the sensor. Land division gross profit rate was 20% this quarter compared to 7% last quarter and 5% in last year's first quarter. The marine division gross profit rate was 26% this quarter, similar to last quarter and compared to 48% in last year's first quarter. Our target is to have consolidated gross margin at a minimum in the low 30s by the fourth quarter of this year.

SG&A expenses were \$6.9m this quarter, down \$900,000 from last quarter or \$500,000 after excluding fourth quarter severance charges from last quarter. SG&A expenses were down \$300,000 from last year's first quarter. These decreases principally reflect lower compensation expense, due to reduction in personnel, partially offset by an increase in insurance expenses and the inclusion of AXIS Geophysics, which we acquired in July 2002. As a percentage of revenues selling, general, and administrative expenses decreased to about 17% this quarter to 21% last quarter and 24% in the first quarter of last year. We are looking at further cost savings to bring our selling, general, and administrative expenses to approximately 15% of revenues by the end of this year, although second quarter G&A expenses will be negatively affected by planned moving expenses. Research and development expenses were about \$5.3m, an approximate \$1m reduction from last quarter and \$1.7m in the first quarter of last year. These decreases primarily reflect reduced staffing levels and lower prototype expenses. As we complete our development of our new cable-based VectorSeis land system in the second quarter of 2003, our research and development expenses will continue to further decline as we expect to reduce our headcount at the completion of this project. Our target is to reduce our R&D expense to approximately 10% of our revenues by the end of this year.

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Our operating loss this quarter was \$3.8m compared to an operating loss last quarter of \$9.7m and operating loss in the first quarter of 2002 of \$7.5m. EBITDA this quarter was a slight positive of \$100,000. You can find a reconciliation of EBITDA to our reported earnings in our press release issued this morning. Similar to last quarter, depreciation and amortization was \$3m; capital expenditures during the first quarter were about \$1.1m. The company reported an income tax expense of \$600,000 this quarter compared to a benefit of \$3.1m last quarter and a benefit of \$2.7m during last year's first quarter. Our income tax expense for the first quarter primarily relates to our foreign operations. As in the second quarter of 2002, we began to fully reserve our US net deferred tax assets. Our net loss attributable to common shareholders this quarter was \$0.08 per share compared to a loss last quarter of \$0.13 per share and \$0.12 per share for last year's first quarter.

Turning to our balance sheet, our balance sheet remains strong despite an approximate \$20.8m decrease in our cash balances since year-end. Our cash balance at March 31, 2003 was \$56.6m. This decrease in cash is due to increase in our receivables of \$18.2m and a decrease in our accounts payable and accrued expenses of \$7.2m since year-end. This increase in receivables is due to the increase in sales activity, particularly during the month of March. Our accounts and current notes receivable were \$43.0m while inventories declined \$2.3m to \$47.7m at quarter end. At March 31, 2003 our full-time employees totaled 556 compared to 598 at December 31, 2002 and 799 at January 1, 2002. As we complete our move out of our Alvin and Norwich facilities we expect to reduce our full-time headcount by approximately 50 individuals, ending with the full-time headcount of about 500 which is a 37% decrease year-over-year. We accrued the severance charge for these individuals in the fourth quarter of last year but continue to expense their salary until their separation day. In addition, we will likely further reduce headcount in research and development as we wrap up the beta phase of our VectorSeis land acquisition system program. Bob?

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**Bob Peebler** - *Input/Output Inc. - Pres, CEO*

My first four weeks at IO has been mainly occupied by spending time with employees and customers and getting more familiar with the details of our markets and plans. I am encouraged by the early signs of the beginning, early acceptance of our new technology. For example, I am very pleased to report that we have contracted the first sale of a cable-based VectorSeis land acquisition system this month. Contract calls for a 700 station systems to a Geophysics [Inaudible] with delivery expected by

the end of the quarter. As Brad noted, both our pricing and cost of the system showed a marked improvement over the earlier BGP sale and we are going to continue to look for ways to improve our gross margins as our technology gains strength in the market.

In addition, I am pleased to announce that we have hired Jorge Macinish (ph) as our new Executive Vice President and Chief Operating Officer. Jorge has a long and varied history in the geophysical industry, including his early days when even his father was in the seismic contracting business. Jorge has been a party chief on a seismic crew, a country manager with responsibilities for building the seismic business in Latin America and most recently has been the Vice President of Operations for North and Latin America for Landmark Graphics. I believe Jorge will add additional strength to the management team at IO, as he has experience in all aspects of business management including P&L responsibility, data acquisition, operations, data processing, marketing and sales and HR.

Our strategy remains three fold. We seek to one, lower cost and increase flexibility and decrease R&D manufacturing cycle time via outsourcing. Plan to continue to focus on accelerating the adoption rate of VectorSeis technology in markets including exploring new potential business models to capture additional value. And last, to broaden the VectorSeis product and service offering to include all phases of the oil field life cycle including production via permit downhole sensors. Our focus to reduce both the unit cost of our products and our fixed-cost structure as well as rely on outside contractors to speed our R&D cycle for non-core technologies. As Brad noted, we will achieve substantial cost savings once we have completely exited our Alvin, Texas manufacturing facility, which is currently scheduled for the end of this quarter. Additionally, we have now closed our Norwich geophone stringing operations with operations moved to our facility in Jabel Ali and outsourced to various partners. We continue to work with all of our outsourced manufacturing suppliers to reduce the unit cost of our products and have made substantial progress on that front with the providers of our land acquisition system products.

I already mentioned achieving our second VectorSeis system sale, but would like to make a few additional remarks. One of the main attractions for me to join IO as CEO is my belief that we are now in the early adopter stage of the VectorSeis life cycle. I also know that the difficulties of finding and producing oil and gas reserves are increasing and require another round of technology for all companies to be successful. IO has a very unique position with our technology platform to exploit the submerging cycle, but we must find more innovative ways to

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speed up the diffusion of our technology and ways for IO to better capture future value.

In addition to the short-term focus of returning the company to profitability, our main strategic focus will also be expanding our international reach to capture more business for all of IO's products and services and ways to accelerate the market acceptance of VectorSeis. That will be what I will primarily be working on for the balance of 2003.

I am reluctant to give short-term guidance, as the uncertainties are still high, as the market continues to sort out with many of our customers still in very conservative mode. When we look at our current backlog and short-term forecast, I would expect that we will likely see our historical trends. Q2 revenues are slightly weaker than Q1, mainly due to planning cycles of the oil companies that drive capital spending. And our 2003 budget always assumes lower revenues in second quarter. A short-term sales trend seems to be some customers pushing out vs. canceling purchases, particularly in the marine sector. This is likely driven by the same uncertainty as the timing. Even though we have started a bit slower than our 2003 plan, I am encouraged that we have seen topline revenue growth over the last three quarters and year-over-year, and the fact that the company has made great strides in getting the costs more in balance with revenues.

Looking forward, we will need to see how Q2 plays out and how our pipeline of business looks entering into the second half, before providing any guidance for the entire year. In summary, I remain optimistic that our efforts to grow our business while continuing to cut costs and become more efficient will continue to progress throughout the year. We are seeing the beginning of market acceptance for our VectorSeis business line and expect that trend to continue throughout the year. We also plan to expand our international business for all our products by increasing our global presence and sales effectiveness. After my first four weeks on board, I am convinced as ever that my joining IO was a good decision for me. I look forward to continue to work with and build the IO team with a strong eye on the future, while getting ourselves profitable in the short-term.

We are now happy to take questions.

## QUESTIONS AND ANSWERS

### Operator

Thank you sir. We will now begin the formal question and answer session using our Q&A polling feature. If you wish to

ask a question at this time, simply press star one on your telephone touch pad. If you are operating speaker equipment you may need to lift your handset prior to pressing star one or un-mute your telephone. To cancel or withdraw your questions simply press star two. And once again that is star one if you have a question at this time. One moment while the question is registered. And our first question comes from Thiru Ramakrishnan with Simmons & Company. You may ask your question.

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**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

With the new cable based system, that, you delivered in the second quarter, what kind of pricing did you guys get on that?

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**Brad Eastman** - *Input/Output Inc. - CAO*

We are reluctant to discuss the specific pricing on that system for competitive reasons. As we did indicate in the call, we have achieved some better pricing than we did on our first system sale and we are actually looking at, hopefully, some further improvements in the pricing as the sales progress.

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**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

Will there still be a some kind of discount that would impact margins negatively in the second quarter?

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**Bob Peebler** - *Input/Output Inc. - Pres, CEO*

We will see the, at the product level, our product margins are increasing quarter-to-quarter. And we have a medium-term goal of, over the year to continue to see that gross margin increase.

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**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

Okay. And prior management had given kind of a rough '03 guidance for breakeven to maybe slightly profitable and with VectorSeis sales for the year between \$30 to \$35m. Would you like to comment on either one of those?

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**Brad Eastman** - *Input/Output Inc. - CAO*

I think on the VectorSeis sales, we're still targeting \$30 to \$35m in revenue from the VectorSeis sales. As far as the overall profitability of the company for the quarter, I think, as Bob mentioned in his presentation, we are going to wait a short while before providing further guidance.

**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

Alright and last, this question is for Bob. Could you guys give us, this is a more a thematic question, could you give us a feel for your expectations coming into this job verses the reality of what you do on an identity basis?

**Bob Peebler** - *Input/Output Inc. - Pres, CEO*

I am going to repeat to make sure I understood, you said my expectations vs. the reality, is that you --? What I expected vs. what the realities are?

**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

Exactly.

**Bob Peebler** - *Input/Output Inc. - Pres, CEO*

I'm actually -- no big surprises, in fact if anything, the most encouraging thing I have is that the progress we are making with the VectorSeis product line. I think the company has done a good job, assembling the technology. As I talk to customers, I can see a growing awareness of the need for the technology and frankly that was the main driver for me to come here. Now, does that say we don't have a lot of work ahead of us, we have lots of work to do in building out the market, to educate the clients, to look for different ways to capture value, but all that was expected. So, I am quite pleased with being here and no big surprises.

**Thiru Ramakrishnan** - *Simmons & Company International - Analyst*

Great, that's all I have. Thanks a lot guys.

**Operator**

Thank you. And once again that's star one on your telephone touch pad if you have a question at this time. And our next question comes from Patrick Flavin (ph) with Flavin, Blake & Company. (ph) You may ask your question.

**Patrick Flavin** - *Flavin, Blake & Company - Analyst*

Good morning. Could you flesh out for us a little bit the balance sheet items, particularly vis- -vis debt on the books?

**Brad Eastman** - *Input/Output Inc. - CAO*

Yeah, the only debt we have on the books right now is approximately \$31m that we owe to SCF in connection with the redemption of our preferred stock last summer. Additionally, we have about \$19m that we show as debt on our balance sheet that is the sales lease back of our corporate campus here in Stafford. And then we have approximately \$2m in other indebtedness that principally relates to acquisitions we have done in the past couple of years.

**Patrick Flavin** - *Flavin, Blake & Company - Analyst*

Okay. It would be helpful in the future if you could include, you know, at least the principal balance sheet items on your releases.

**Brad Eastman** - *Input/Output Inc. - CAO*

Okay.

**Patrick Flavin** - *Flavin, Blake & Company - Analyst*

Thank you.

**Brad Eastman** - *Input/Output Inc. - CAO*

Sure.

**Operator**

Thank you and once again that's star one if you have a question at this time. And our next question comes from John Morsani (ph) with ING. You may ask your question.



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**John Morsani** - ING - Analyst

Good morning. Can you talk, Bob, I think you mentioned the recent MMS sale and you didn't mention the new incentive to drill for deep gas. Can you just talk about the application of multi-component technology for looking for deep gas down below sort of existing gas-plowed fields?

**Bob Peebler** - Input/Output Inc. - Pres, CEO

Sure. One is, I like to make sure people understand that VectorSeis is what we call full wave technology. Meaning that not only are we bringing in sheer seismic an additional measurement, but because of the fact that it is a digital center, the quality of the P-wave, which is the more traditional compressional wave, we are seeing dramatic improvements in many areas of the quality of that wave. And so, when you combine that then with, for example, bottom hole cables whereas retrievable were actually permit cables. The capability of imaging even on some of these deeper horizons can go up significantly. Currently, sheer seismic has limits on depths. I don't know what those are totally, but I would say, because it totally depends a little bit on the rock type, but I think when you get in to the 14,000-16,000 foot and deeper, you start running out of signal strength and so, there is work to be done there on looking at source strength and moving, obviously for us, to expand the ability to reach deeper on the sheer seismic is important but I would also emphasize that just having a much better quality P-wave also adds a lot of value. So, I think as people, as the deep gas particularly on the shelf becomes more and more interesting to people, they're going to be out there looking for new ways to shoot seismic data. For the ones of you that may not know, if you look at the shelf, there's been about 50,000 wells drilled in the shallow horizons, which would be in the 0-12,000 foot. And there's only, I think this is correct, only 50+ wells have been drilled for the deeper gas wells. So this, in some ways, is almost virgin territory.

**John Morsani** - ING - Analyst

And just, you maybe talk a little bit, there is some discussion that about the libraries that are out there that are, you know, the traditional multi-client libraries and what your technology might be able to do and is there chance that we might see a re-shooting of additional stuff?

**Bob Peebler** - Input/Output Inc. - Pres, CEO

The way I would think about that is if you go back to the early 1980s, there was an abundance of data in 2D libraries. And in fact, the conversations back then is, we have too much data. We are running out of prospects, I mean, there is a whole conversation is very similar to today's conversation. In my belief, as we do move into deeper horizons, as we move into more complex formations, as we move from large structure identification, which is what 3D really started into stratigraphic (ph) traps in place, that is the only way to resolve that and has to have more information. And this industry has been, always will be until we find the last drop of oil & gas, driven by more technology, more information, delivered more cost effective ways. So, the answer to your question is, I believe that we will see re-shoots in the more mature area. I don't think it is going to be these broad based spec shoots, I think it is going to be much more fit for purpose-designed surveys that I think really played to our strength.

**John Morsani** - ING - Analyst

And can you give us a sense just cost efficiency with your cable system? Is there a rough ballpark of what is going to cost somebody if they have got an existing structure to go out and re-shoot that with a multi-component, you know, VectorSeis type arrangement?

**Bob Peebler** - Input/Output Inc. - Pres, CEO

Actually I don't want to comment on that, not because it is not a good question. It is just I would like to answer that when I feel a lot more comfortable with that level of detail. I will say this, I think that when you look at certain types of surveys, for example when Bluebase Retrievable Systems (ph), they can actually be relatively inexpensive for the value they add. But actually trying to, sort of cost out the cost of a permanent installation or retrievable installation vs. a current shoot, I am not really prepared to do that, yet. That is obviously one area we are looking at is how to help people in that business make that a lot more efficient and effective. Today it is more expensive. Clearly we are in the early stages of technology but also remember to remind people that if you go back into the early 80s when 3D was just starting, the cost of surveys were extremely high relative to 2D. This is very natural process where it goes first is what has the greatest impact and then you start building the base of business and costs start coming down and you would expand more and more into the more cost sensitive

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areas. So, I think it is just going to be a natural diffusion rate like we have seen in the past.

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**John Morsani** - *ING - Analyst*

Thank you.

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**Operator**

Thank you. And once again, that's star one if you have a question at this time. One moment, while the questions register. [Gap In Audio] At this time, I am showing no further questions, so I would like to turn the meeting back over to Mr. Peebler. Sir.

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**Bob Peebler** - *Input/Output Inc. - Pres, CEO*

Okay. Thank you very much and thanks for joining the conference call.

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**Operator**

We would like to thank everyone for joining today's conference call and please have a wonderful day.

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