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Operator

Good afternoon, ladies and gentlemen, and welcome to the Input/Output conference call. At this time, all participants are in a listen-only mode. Following today's presentation, instructions will be given for the question and answer session. If anyone should need assistance at any time during the conference, please press the star followed by the zero and an operator will assist you. As a reminder, this conference is being recorded today, Thursday the 29th of January, 2004. I would now like to turn the conference over to Mr. Jack Lascar. Please go ahead, Sir.

Jack Lascar - Input/Output - Partner

Thank you, Steve. Good afternoon and welcome to Input/Output's fourth quarter and year end conference call. We appreciate you joining us to review our final results for 2003. Your hosts today are Bob Peebler, President and CEO, Jorge Machnizh, EVP and COO, and Brad Eastman, General Counsel and Secretary. Mike Kirksey, our new EVP and CFO is joining us on the phone from Europe. To avoid potential phone issues, Brad Eastman will cover the financial results. However, Mike will be available to answer questions. Before I turn the call over to management, I have a few items to go over.

If you would like to be on our e-mail distribution or fax list to receive future news release, or experienced a technical problem and didn't receive yours this afternoon, please call DRG&E and relay that information. That number is 713-529-6600. If you would like to listen to a replay of today's call, it is available via web cast by going to the Investor Relations section of the company's website at www.i-o.com or via the recorded instant replay until February 5, 2004. To use the replay feature, call area code 303-590-3000 and use the pass code 567421.

Information reported on this call speaks only as of today, January 29, 2004 and therefore you are advised that time sensitive information may no longer be accurate as of the time of any replay. Management is going to discuss today certain topics that will contain forward-looking information that are based on management beliefs as well as assumptions made by and information currently available to management. Forward-looking information includes statements regarding expected revenues, gross margins, EBITDA and earnings per share for the first quarter and full year 2004. Although the company believes that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to have been correct. Furthermore, as we start this call, please refer to the statement regarding forward-looking statements incorporated in our press release issued today and please note that the contents of our conference call this afternoon are covered by this statement.

Risks that the company faces are discussed in greater detail in the company's filings with the Securities and Exchange Commission including the company's report on Form 10K for the year ended December 31, 2002. Please also note that you can find a reconciliation to reported numbers for non-GAAP measures that we will discuss on this call in our press release. I'd like to turn the call over now to Bob Peebler.

Bob Peebler - Input/Output - President and CEO

Good afternoon and thank you for joining us. The agenda this afternoon will include highlights of the past year, a review of the fourth quarter and full year results, a discussion of our new strategic direction, a preliminary look into 2004 followed by a question and answer period. First of all, I'm very pleased to announce that we achieved profitability during the fourth quarter. We achieved our revenue, gross profit margin and earnings objectives right in line with the guidance we gave you during our third quarter conference call.

Revenues were up 19% compared to the fourth quarter of 2002. Adjusted EBITDA was a positive \$3 million and we generated \$633,000 in net income or one cent in earnings per share. Our gross margin reached 26% demonstrating the progress we are making in raising our gross margins to more acceptable levels and operating expenses during the quarter declined 31% compared to last year's fourth quarter. We strengthened our financial condition by issuing 60 million of convertible securities early in December. The offering was very well received by the investment community and was completed very quickly, a testament to the market interest in I/O. We used approximately \$16 million of the net proceeds of the offering to repay existing short term high interest debt and plan to use the remainder of the proceeds for potential acquisitions that support our strategy and for working capital to support our planned growth.

On the cost side of the equation, we made substantial progress in reducing our operating cost structure during 2003. Operating expenses fell approximately 3% last year. Approximately half of this improvement was driven by lower research and development and general G&A expenses. We reduced fulltime headcount from 598 at the end of 2002 to 479 at the end of the year, a 20% reduction. We completed our move out of our Alvin manufacturing facility during the middle of 2003 which resulted in approximately a \$2.5 million per year reduction in depreciation and facilities charges from our fixed cost structure as well as additional savings from headcount reductions. We continue to review the utilization of our existing facilities to find further ways to reduce our fixed cost structure. As part of our continuing effort to reduce our cost structure and increase our manufacturing flexibility, we entered last year into several outsourcing agreements to manufacture seismic equipment both in the U.S. and in Mexico. These agreements are part of our plan to reduce fixed costs and accelerate product delivery to our global customer base. Furthermore, these actions will over time provide significant operational and logistical

benefits to I/O's existing and future customer base.

Effective January 1 of this year, we consolidated the three operating units of our land operations into one integrated division that will result in some further cost savings, but most importantly will improve our ability to provide our land customers with improved products and better after sale service. From a business development standpoint, we successfully commercialized our VectorSeis System Four land acquisition platform in April, which resulted in over 20 million of system sales during 2003. This new technology introduction allowed us to establish a presence in key markets in North America, Russia, Eastern Europe and China. To date we've concluded over 70 land VectorSeis tests in commercial projects around the world.

Our strategic technology alliance with Apache, which we mentioned last quarter, will help I/O to accelerate the adoption of advanced seismic imaging technologies. Educating all companies on the value of VectorSeis Full-WAV digital imaging specific to their E&P portfolio brings value to them and ultimately to seismic contractors by resulting in pull through. As evidence of the commercial strength of this approach, Apache selected Trace Energy Services headquartered in Calgary, from among several interested contractors as a preferred contractor for the VectorSeis seismic acquisition program in Canada and the U.S. Coincident with Apache's selection of Trace, I/O sold a 2,000 station VectorSeis System Four to the company during the quarter. We will be also providing processing services related to the VectorSeis acquisition projects as they unfold.

In almost every situation, we are looking for ways to leverage the seismic processing capabilities provided by our GMG access geophysics group based in Denver. As we move forward, we are confident that our new model will provide I/O with a highly differentiated competitive advantage in the marketplace and we'll continue to look for similar opportunities with other oil companies. In addition to the improvements in our financial performance and structure,

cost reductions, and new product successes, we also strengthened our senior management team and the board of directors. Over the past year we have brought on board Jim Hollis, our VP of Land Imaging Systems Division, Chris Friedemann, our VP of Commercial Development, Mike Kirksey, our new EVP and CFO, and Jorge Machnizh, our EVP and COO. I believe that we now have the nucleus of executive talent to execute our strategic plan over the next several years.

Also during the third quarter, I/O's board of directors was strengthened with the election of Dr. Bruce Appelbaum, former President of Global Exploration for Texaco, and John Seitz, former CEO for Anadarko. They both bring an in-depth understanding of E&P technology and how it is purchased and utilized by oil companies. We're also in the final stages of selecting the members of I/O's new technology advisory board that will be made up of recognized E&P technology executives and experts from academia for the purpose of providing guidance to our strategic R&D programs. This is one more example of our strategy of building better bridges to the oil and gas end user community, which should result in increased demand for our technology.

The market environment is improving and although we are not seeing a robust seismic market, we are starting to see pockets of recovery. E&P companies continue to talk about the importance of seismic to their finding and development efforts and are starting to recognize its importance to better understanding challenged in areas such as the deep shelf in the Gulf of Mexico. For example, this is a case where the wells could be very expensive and today's success ratios reflected in finding costs are too high. Our strategy, which I will talk about in more detail later in this call, is predicated on the fact that oil companies will become increasingly compelled to embrace new seismic technologies that unravel their most pressing geological and reservoir problems.

We intend to work closely with oil companies around the world to better understand these challenges, identify ways that we can work together to deploy

technology in partnership with our seismic contractor customers to unlock future reserves and deliver discernible value to the bottom line. As market conditions improve, which we believe they slowly are I/O will be well positioned as a trusted partner and technology provider to deliver value to both oil companies and seismic contractors.

Now moving to the financial results. As I mentioned at the beginning of the call, we are very pleased with our fourth quarter results. We showed continued improvements with higher revenues and higher gross margins with a lower cost structure. Brad will now discuss the quarter and the year in more detail.

Brad Eastman - Input/Output - CAO

Thanks, Bob. Fourth quarter sales were up 19% to \$44 million compared to \$37 million during the fourth quarter of 2002;. The improvement is entirely attributable to an increase in land seismic activity with our non-Western contractors, particularly an increase in demand for our VectorSeis System Four land acquisition system. We recorded \$10 million in VectorSeis revenue in the fourth quarter. Our land sales for the quarter were \$35.4 million, an increase of \$15 million or about 73% from last year's fourth quarter. Marine sales of \$8.6 million declined \$8 million or about 48% compared to last year's fourth quarter. The weakness in the marine market is a reflection of the overcapacity and continued consolidation by the large players such as PGF, Western JICO and Baratoss.

Our reported gross margin this quarter was approximately 25% compared to 15% in last year's fourth quarter. Land division gross profit rate was 22% this quarter compared to 6% in last year's fourth quarter. The marine division gross profit rate was 39% this quarter compared to 25% in last year's fourth quarter. The improvement in gross margin was driven mainly by volume improvements as well as by higher margin sales of VectorSeis System Four land acquisition platforms. Selling, general and administrative expenses were \$6.7 million this quarter, compared to \$7.7 million in the

fourth quarter of last year. As a percentage of revenues, selling, general and administrative expenses decreased to about 15% this quarter compared to 21% in the fourth quarter of last year. Although we will continue to look for ways to reduce our overall SG&A expenses such as our most recent consolidation of three business units into one land division, we believe that our current organization is properly structured with our expected level of business going forward and that additional improvements will need to come via increased revenues and improved gross profit margins.

Research and development expenses were \$3.8 million, a reduction of approximately 40% or approximately \$2.6 million from the fourth quarter of 2002. These decreases primarily reflect reduced staffing levels from balancing our project portfolio and the fact that the significant System Four development program moved from prototype to commercialization in mid 2003. This level of spending brings us closer to our objective of R&D spending as a percentage of revenue being 8 to 9%. Our earnings from operations this quarter were \$744,000 compared to a loss from operations in the fourth quarter of 2002 of \$9.7 million. Adjusted EBITDA this quarter was a positive \$3 million compared to a negative \$5.8 million for the fourth quarter of last year.

You can find a reconciliation of adjusted EBITDA to our reported earnings in our press release issued this afternoon. Depreciation and amortization this quarter was \$2.4 million down from \$3.8 million during last year's fourth quarter. Capital expenditures during the fourth quarter were about \$1.7 million. The company reported an income tax expense of approximately \$190,000 this quarter compared to a benefit of \$3.1 million during last year's fourth quarter. We continue to maintain a full valuation allowance of our net deferred tax assets and reflect no benefits from current net operating losses. Our net income attributable to common shareholders was \$633,000 or one cent per share compared to a loss of \$6.5 million or a loss of 13 cents per share for last years' fourth quarter.

Moving on to the results for all of last year. 2003 sales increased 27% to \$150 million from \$118.6 million during 2002. Land sales this year reached \$114.3 million, an increase of 75% compared to \$65.2 million in 2002. Marine activity decreased about 33% with sales of \$35.7 million this year compared to \$53.4 million last years. We believe that the primary driver for low marine sales for 2003 was the extreme pressure that marine seismic contractors were under due to overcapacity and related weak pricing.

We have seen PGF go into and emerge from bankruptcy, Western GECO reduce their fleets and little new additions with the exception of some new entrants. We don't expect a quick turnaround in marine, but do expect to experience some pent up demand because the current operating fleets are working with old equipment. This year's gross margin was 19% compared to 15% in 2002. The gross margin for land was 15% in 2003 compared to 6% in 2002. For marine, the gross margin was 30% of revenues in 2003 compared to 37% the year before. This year's selling, general and administrative expenses were \$29.3 million, 20% of revenues compared to \$30.4 million or 26% of revenues in 2002. This year's SG&A expenses include \$1.3 million of severance and moving costs associated with the closing of the Alvin facility. Our year end run rate was approximately \$30 million annualized and we are still carrying expenses related to changes in the executive team and other pre-consolidation costs including forming the land imaging systems division.

Our selling, general and administrative expenses also continued to be burdened by too much office space in Houston that we are working to resolve. 2003 research and development expense decreased about \$10.1 million to \$18.7 million compared to \$28.8 million in 2002. The decline in research and development expenses primarily reflects reduced staffing levels, the cancellation of our marine solid streamer project, and the commercial phase of our VectorSeis System Four land acquisition platform as well as a greater focus on core seismic imaging technology and outsourcing of other elements of research and development.

Our loss from operations for 2003 was \$21.3 million compared to a loss from operations of \$63.6 million in 2002. Included in our loss from operations for 2003 and 2002 were \$1.1 million and \$22.0 million, respectively, of charges related to the impairment of certain long lived assets and goodwill. The company reported an income tax expense of \$348,000 for 2003. We reserve our net deferred tax assets and report income tax expense from foreign operations. Our net loss to common shareholders for 2003 was \$23.2 million or 45 cents per share compared to a net loss to common shareholders of \$120.8 million or \$2.37 per share in 2002 which included a \$60.0 million charge to establish a reserve for our net deferred tax assets.

Our balance sheet finished strong with approximately \$59 million in our cash balances at the end of December. The increase in cash during the quarter was mainly due to the proceeds of our convertible offerings partially offset by an increase in working capital as a result of improved sales and the repayment of \$16 million of short term debt. Accounts and current notes receivable increased by \$7 million to \$48.7 million from the third quarter, brining our working capital, defined as current assets less current liabilities, up \$59.3 million from \$74.1 million at the end of September, 2003 to \$133.5 million at the end of December, 2003. Our debt to total capital ratio increased from 23% to 38% during the same timeframe. I will now turn it back to Bob for discussion on our current strategic thinking and preliminary look at 2004.

Bob Peebler - Input/Output - President and CEO

Thanks, Brad. I'd like to take this opportunity to share with you few key elements of our strategic plan, which we have been developing over a period of several months. First, we believe we are facing a number of promising trends in the seismic industry including One, demand for hydrocarbons is outstripping increase in supply. Two, new hydrocarbon provinces appear on the brink of reopening to U.S.

service and technology companies in Libya, Iraq and around the Caspian Sea suggesting another round of exploration and development activities in very large petroleum bases. Three, oil companies have begun to embrace the power of seismic imaging across the reservoir life cycle, extending the demand for seismic related products and service beyond pure exploration and development to also include product enhancements. Four, oil companies are also realizing the need for more custom designed seismic surveys that are better tailored to the targeted reservoir versus spec surveys. And last, many of the remaining reservoir challenges require specialized technologies and methodologies including full-wave data, broader span coverage, referred to as wide azimuth and higher density spacing to improve resolution and increase information about the reservoir. All of these trends will drive new seismic activity both in land and marine and will drive the need for improved technology in increased number of surveys which will lead to an increasing number of station count, all signaling an improvement in our future business environment. Our vision going forward has four main elements, which directly address the industry trends and needs.

The first element is to reposition ourselves as a seismic imaging solutions company versus a seismic equipment manufacturer. As a solutions provider, I/O is looking to compete and provide value across the reservoir life cycle. This means that we will position ourselves to lead with the broader segment of the seismic industry value chain from survey design and planning to processing technology and services. Oil companies spent in excess of \$5 billion in 2003 on seismic products and services. This broader segment provides us with new opportunities for I/O to participate in growth. Two good examples are our entrance into the high end processing business via our GMC Access Geophysics acquisition and our move towards participating in the 4D Permanent Monitoring business. We do not have plans to move into the seismic crew business as that is not a core focus of I/O and would put us in direct competition with our seismic

acquisition contractor customers. In certain cases such as processing and 4D monitoring, we will be selling directly to oil companies instead of selling to seismic contractors as an OEM manufacturer.

The second element is to lead in the emerging 3D wave of seismic technology called full-wave digital imaging. I/O has spent over \$100 million during the last few years in developing the next generation digital sensor with the objective of being able to accurately record the seismic full-wave field, which includes the pressure, or P, and the shear, which is called S waves, and increase resolution and fidelity for both. This is critical breakthrough technology that will enable finding oil and gas that cannot be found with traditional methods. Related to this, we see an industry gap in interpretation tools to efficiently enable and effectively enable geologists to take full advantage of the shear waves. We plan to participate on our own or through strategic partnerships in filling this gap. In addition, this new era of full wave digital imaging will also drive a new generation of survey design and planning and processing technologies and associated services and we view these as important strategic growth areas for I/O.

The third element of our strategy is to reduce full cycle seismic imaging costs by shortening cycle times and reducing logistics costs with new technologies and services. With increased demand and reduced availability, one of the main systematic problems of the seismic is the logistics cost of collecting the data, both land and marine. The industry needs breakthrough approaches that significantly reduce the operational costs, which we estimate often exceeds 70% of the total image cost including planning, acquisition, processing and interpretation. One example is VectorSeis Ocean, our new retrievable seabed system using VectorSeis sensors that has the promise of reducing the cost of collecting seismic data including shear on seabed by 60-70% eventually making it competitive with towed streamer survey.

The fourth element of our strategy is to form closer relationships with the ultimate end user of the seismic imaging, the oil

companies. We are focusing our efforts on E&P companies in order to better understand their imaging requirements, not only from an image quality standpoint, but also from a cost and cycle time perspective. This helps oil companies understand the value of our solutions and the impact that our technology can have on finding new and production additional reserves. Subsequently, this provides us with opportunities to be more of a solutions provider and significantly improve our value proposition with the E&P companies. Our recent alliance with Apache is a clear example of our new strategy. Although we are in the early stages of implementing these four strategies, we believe that we have strong technology and operational base to build upon and our management team is fully committed to our vision and we look forward to making progress towards our goals in 2004.

Looking at 2004, we expect a challenging and an exciting year in terms of product transitions and new product introductions. In our land imaging division, we expect to introduce our new System Four analog cable, scheduled for late Q2, early Q3. This new product is based on the System Four platform that has been proven by contractors around the world to analog cable delivery and improved field operational efficiencies. System Four A/C takes the functionality to the next level by giving seismic contractors the flexibility to use either traditional analog geophone sensors or digital full wave VectorSeis sensors even on the same survey. System Four A/C will be the first land imaging platform in the market with this hybrid analog/digital capability. With the introduction of System Four A/C, we are transitioning out of the image analog system during the first half of 2004 with plans of ending production before the end of summer. We expect high demand for System Four A/C, as it allows seismic contractors to position for the full wave digital future while reducing the investment risk of market timing related to the diffusion of the new technology.

We also believe we will have a much more competitive analog product compared to the older image system especially when

considering that I/O is the market leader in sensor analog geophones. On the marine side, we believe that seabed imaging, using either retrievable cable systems or permanently deployed sensors, will become an increasingly important part of the total marine seismic imaging business in the next few years. We have early successes with the prototype retrievable seabed system with Conoco Phillips and their working interest partners at the Ecofish field in the North Sea. Based on the successes at Ecofish, we made the decision to extend and commercialize the technologies used there such that later this year we will be introducing our VectorSeis Ocean Retrievable System. We look forward to our first VectorSeis Ocean System planned for late Q2 or early Q3, and expect the demand for this product to increase as we believe experience will show an improved image with our new system. The deep shelf is a good example where new seismic data is needed and seabed is the best bet for the improvement needed.

On the permanent monitoring side, we expect the market to develop a bit more slowly if for no other reasons than oil companies are generally still cautious when contemplating investments that can run into the tens of millions of dollars and be fixed for the next 10 to 15 years. Nevertheless, interest is picking up regarding this technology and we have had several commercial discussions that are underway with the early adopters of this 4D seismic imaging technology. However, we don't believe we will see much in the way of revenue from permanent systems until 2005 at the earliest.

In our towed streamer business, we are introducing our next generation positioning technology, which will improve positioning accuracy by 80%. This new technology will substantially reduce positioning errors that were acceptable in spec 3D surveys that can be made a major source of unacceptable error in 4D time lapse surveys. This new technology allows the geophysicists in the oil companies to identify more subtle changes in the reservoir including movements of fluids. Our GMG access business is expected to continue its rapid

growth in 2004 driven by our ability to hire the right people and build our supporting infrastructure. The lead punch at GMG Access is our leading AZIM processing that can be applied to solve many of the problems that the industry faces and is very synergetic with VectorSeis data. To give you two examples, we helped one client in the Rocky Mountains improve the resolution of their subsurface image such that they could see reservoirs and faults that their competitors could not. And the second, a major operator in Alaska used AZIM methodology to identify fractured patterns in the subsurface that were previously not well understood. As a consequence of our work, they re-planned their horizontal well program and drilled the three most productive wells in a field of 25 year old play and this field is now revitalized. We expect processing to grow faster than our acquisition technology business since they participate in both processing of new data and reprocessing.

Looking ahead, based on our current backlog of business, our improved cost structure and the expected impact of our new product introductions, we expect 2004 revenues to be in the 175 to 195 million range. We expect a slight strengthening of our business from our more traditional customers and continued growth from our international markets, mainly in the CIS and Middle East countries. Most of our expected top line growth should come from our new product offerings including an expected doubling of VectorSeis based systems sales from the \$20 million we generated in 2003. We expect consolidated gross margins to be in the high 20s to the low 30s. Improved margins will be driven by new products, better sales execution, improved manufacturing costs and the impact of our improved cost structure. Based on the expected levels of revenues and gross margin, EBITDA should be in the 20 to 25 million with an earnings per share of 5 to 15 cents.

Because most of the product introductions, including System Four Analog and VectorSeis Ocean, will take place during the middle of the year, we are forecasting our earnings to be skewed towards the second

half. Our first quarter is unfolding fairly close to our original 2004 plan with a slight to moderate loss mainly driven by expected slow land analog sales due to the transition from our Legacy Image platform to the new System Four A/C platform. Furthermore, manufacture ring lead times are pushing several large planned vibrator truck sales out of Q1. As a result we expect first quarter revenue to be in the \$32 to \$40 million range and earnings per share to range between a loss of 2 cents and a loss of 8 cents. We believe that accelerating VectorSeis System Four sales through the balance of the year starting in late Q2 will offset the image system related transition issues.

In conclusion, I'm very pleased with our return to profitability at the end of 2003 and the strategic foundation that we had begun to build last year to support our future growth plans. I expect 2004 to be a much better year financially than 2003 with return to profitability for the entire year. Much of our success in 2004 will depend on our continued rapid growth in VectorSeis System Four and GMG Access processing accompanied with successful product introductions of DigiCourse and VectorSeis Ocean in our marine division and System Four Analog in our land imaging systems division. We will continue to strengthen our international presence and look forward to additional growth in Russia and Eastern Europe and an expanded presence in the Middle East market. We are also expecting to see some marginal improvement in our base business driven by an improved business environment for our contractor customers. Our vision clear, we have the management team in place and new technologies to sell. 2004 should be a good year. We will now open for questions.

QUESTION AND ANSWER

Operator

Thank you, Sir. Ladies and gentlemen, at this time, we will begin the question and answer session. If you have a question, please press the star followed by the one on your pushbutton phone. If you would like to decline from the polling process, press the star followed by the two. You will hear a three tone prompt acknowledging your selection. Please ask one question and one follow up and re-queue for additional questions. If you are using speakerphone equipment, you will need to lift the handset before making your selection. One moment, please for our first question. Our first question comes from Joe Agular with Johnson Rice & Company. Please go ahead.

Joe Agular - Johnson Rice - Analyst

Thank you. Good afternoon. That was really an excellent recap there, Bob, I appreciate it very much. Very thorough. I'm trying to think which question would be best to ask here. I wanted to maybe ask you a little bit about the acquisition strategy of the company given some of the new product introductions and direction that you're taking on the processing side. Your recent financing I guess you did disclose that you were anticipating perhaps making some acquisitions with proceeds. I'm just wondering, not necessarily specific, really specifics there, but just kind of how, what type of strategy you're looking at, where you're looking to deploy some capital in acquisitions and what you need maybe to fill in some of the holes right now.

Bob Peebler - Input/Output - President and CEO

Thanks, Joe. One, in the acquisition, at a very high level, one thing we're not going to do is to basically just acquire to grow. That is not the purpose of the acquisition.

Obviously we intend to grow if we do acquisitions, but we're not just saying we're going to grow by acquisition. Our acquisitions are going to be very much aimed at strengthening the strategy that I've laid out. I think in that conversation, I talked about platforms of growth all the way from planning to processing, as examples of areas that we think are going to be rapid growth areas. We also see some other areas very much related to the technology that we have in growth areas such as permanent monitoring and different areas like that that could be interesting to us. So I think that broadly speaking, I would say look at the areas that we're talking about growing the business in, sort of that value chain and that would be a reflection of some of our thinking. Now obviously again, we're not just looking for add-on products or whatever just from a consolidation point of view that anything we do is going to really have a strategic fit for our company's direction.

Joe Agular - Johnson Rice - Analyst

I guess I just want to clarify one thing. To pursue the growth strategies that you have outlined, you pretty much have the base in place right in that anything that you acquire is just something that would sort of compliment what you have already. Is that a fair statement?

Bob Peebler - Input/Output - President and CEO

I think that's a fair statement. That doesn't say that there's not some (indiscernible) areas that are augments of those platforms, but I think that's basically a fair statement.

Joe Agular - Johnson Rice - Analyst

Okay, as a follow up if I could, I'd like to just ask a question with regard to the fourth quarter results which were very good obviously versus the last several quarters. Given your outline of about \$10 million of VectorSeis sales in the quarter and substantial gross margin improvement, it

kind of implies that you all are getting pretty good pricing on VectorSeis and I just want to see how much of that is the case versus maybe some other efficiencies that you may have gained in some of the moves that you've taken in consolidating or outsourcing some of your manufacturing of your traditional business line.

Bob Peebler - Input/Output - President and CEO

Yeah, Joe, obviously if you have a new technology and a new product, you tend to get better pricing and margins than on old technology and so that's why we're happy to be phasing out of our old land imaging system and phasing into our System Four. Pricing is a function of what your customers value and will pay for and also what it takes to create that. And we've been working on both fronts. On the manufacturing side, it's intuitive and certainly practical to think that a company of our size can't afford to have full manufacturing capabilities in a sort of cyclical and bumpy business or lumpy business. And so to move facilities away from I/O and lever other people's facilities is one great example of giving us flexibility. Now we think we're just at the beginning of getting all the value out, in a sense. We've made some real gains by the first round of outsourcing but we think we can improve in those processes now that we've done that. So we'll be continuing to look at how to have better partnership relationships with our outsource providers, flow of information, things we can to even become more efficient. And the third thing is just continuing to look for ways to design in our products ways to design out costs and we'll be doing that continuously. So I think that our goal and our stated goal to this company going forward is to really look at how to continue to improve our margins. As I said in the call and I think I said last quarter, we're sort of coming to the end of things we can do from just a pure cost cutting consolidation point of view. The game now is just really running the company better and I think going forward this year, our focus is more on improvements in gross margin than things like headcount and those factors. As

the business increases, we'll probably be adding a few folks in various areas.

Joe Agular - Johnson Rice - Analyst

Okay, just to summarize, I guess, is it fair to say though that you're pleased with the kind of margins that you were able to achieve on those VectorSeis sales?

Bob Peebler - Input/Output - President and CEO

Yes, we were.

Joe Agular - Johnson Rice - Analyst

Okay, great. I may come back later with a follow up. Thank you very much.

Operator

Next we have a question from John Morisanti with ING. Please go ahead.

John Morisanti - ING - Analyst

Hi, Bob. Congratulations. It's nice to see the company back in the black.

Bob Peebler - Input/Output - President and CEO

Thanks. I like this side of the line much better.

John Morisanti - ING - Analyst

I bet you do. Just -- Joe sort of asked my first question there and I guess we'll sort of see as you go on with the acquisition front. I just was trying to get a sense of -- in your deal with Apache -- kind of where you were -- you're obviously at the very early stages of what one hopes to be a very long term

relationship there. But have you cycled enough through with them in terms of shooting a prospect, analyzing the data, going back and seeing what your drill results are and whatever, and actually have the full package you could actually take to somebody else who was unfamiliar with what you're doing to say this is what we can do for someone like Apache or this is what we can do for you?

Bob Peebler - Input/Output - President and CEO

John, actually the facts are that the surveys have just started. We consummated the deal with Apache and then had to get the, in this case, Trace, set up to run the surveys and we're just now starting the surveys up in Canada. This is the Canadian shooting season. In fact one of our guys just got back this last, this week actually, and we're feeling very good about the first shoot which was a small one, just sort of getting started. They'll be shooting for several months on the portfolio with Apache and then you move into the processing and the interpretation. So we won't - it will be awhile before we see the full cycle results. But we don't have to wait to the very end to start understanding at least each step of the way the value adds. So first step is that hey, the system is working great, I think Trace has felt good about the performance of System Four. We're starting out in a pretty difficult environment that's - It's cold up there, as you know, so it's stress testing our equipment and things are really working well. So we're feeling really good about how we're coming out of the box with the system and now we're looking forward to sort of that next exciting step is when we'll start getting data into the processing shops and start processing the data.

John Morisanti - ING - Analyst

Okay. All right, thank you. Again, congratulations.

Operator

Ladies and gentlemen, if there are any further questions, please press star one at this time. We have a follow up question from Joe Aguilar. Please go ahead.

Joe Aguilar - Johnson Rice - Analyst

Well, I had a couple more questions if you don't mind, Bob. Regarding the VectorSeis Ocean product that you mentioned in your remarks, the Conico Phillips Ecofish field was testing a prototype of it or was this - could you just clarify exactly what?

Bob Peebler - Input/Output - President and CEO

Sure. Let me give you just a real quick - this is the first time that we have been able to put VectorSeis sensors on a seabed and that's important for a couple of reasons. One is that on the seabed you tend to get better coupling anyway and you get better P waves. But also, you can't get sheer waves through the ocean, you can't get - a sheer wave doesn't travel through water so in addition you get the added advantage of the sheer wave or what's called a converted wave in this case. The other - the Ecofish was where we were using a retrievable cable but their intent in that case was to be more or less sort of testing some concepts around permanent monitoring. Although it isn't permanent yet, we're using retrievable cables. But they also have discovered a lot about the Ecofish field on this one line we've laid out. So it gave us the advantage of having a pilot program where we're shaking out the retrievable system and how it works in the marine environment, but also seeing some great data coming back on VectorSeis on the seabed.

Now what we're moving towards now is the commercialization of this system, retrievable cable, which will effectively compete with what's called ocean bottom cable, but we believe that the methods that we're using for, if you want to think of the logistics of getting the cables in and out of the water and the deployment, it should be much more efficient than the standard OBC

approach. For one reason, it eliminates some of the survey boats and so it's called a buoy system. So I don't have time on the call to go into all the nuances of the system, but it is a way of becoming much more efficient at getting seabed measurements which inherently are better quality and you get the added sheer wave compared to towed streamer. One of the reasons people haven't used it more widespread is that the cost has been as much as three to six times greater than towed streamer. And also there's always been a lot of reliability issues, but we think that we've got a system that over time is going to be quite effective. So we're excited about that product and we'll probably be out there hopefully with a contractor sometime in the second half, actually putting it in the water.

Joe Aguilar - Johnson Rice - Analyst

That sounds very appealing. One of the other issues I know that comes up from time to time with OBC is water depth limitations. What is the Conoco - - what water depth is that? And maybe what water depth do you see?

Bob Peebler - Input/Output - President and CEO

We think the limit currently designed is about 2,000 meters.

Joe Aguilar - Johnson Rice - Analyst

That's pretty deep. So that's very interesting. Okay, if I could ask one other question as long as I have you?

Bob Peebler - Input/Output - President and CEO

One more. We've got some other people on the queue.

Joe Aguilar. Okay, well I'll jump in. Thanks.

Operator

Next we have a question from Ik Ping Li with Tutman Roble. Please go ahead.

Ik Ping Li - Tutman Roble - Analyst

Hi, I have a couple of questions. One, can you talk about why your working capital increased in the fourth quarter?

Brad Eastman - Input/Output - CAO

Sure. A lot of our sales this quarter happened to be fairly back end loaded. We shipped them in the fourth quarter and so they have not had a chance to collect the cash yet. That's the primary reason. Working capital was, the increase in working capital was really caused by an \$8 million increase in the receivables and a \$3.3 million decrease in accounts payable.

Ik Ping Li - Tutman Roble - Analyst

How about inventories?

Brad Eastman - Input/Output - CAO

Inventory went up about \$1.1 million. If you participated on our last quarterly conference call, you'll remember we had purchased \$3 million of inventory, excess marine inventory, from a bankrupt customer to prevent it from going out on the gray market and we believe that's the primary reason that our inventories went up this quarter.

Ik Ping Li - Tutman Roble - Analyst

Okay, that's helpful. Can you give me an estimate of your capital expenditure in 2004?

Brad Eastman - Input/Output - CAO

I think we're going to expect capital expenditure levels to be about the same as they were this year. About \$5 million.

Ik Ping Li - Tutman Roble - Analyst

I do have one follow up question. Can I ask it now?

Bob Peebler - Input/Output - President and CEO

You can ask, go ahead.

Ik Ping Li - Tutman Roble - Analyst

Can you just take the Trace and Apache example and walk me through what additional service type of revenue you are expecting to generate from that process besides selling the equipment to Trace?

Bob Peebler - Input/Output - President and CEO

Yeah, that would be from the GMG Access AZIM. I'm going to give you the short answer. It will be - - over time it will be in the millions, but it really is going to depend on as the program unfolds. It's just very hard for us to predict that. We do know, just looking at the size of the projects and sort of the conversations, I think conservatively it's easy for us to imagine a million or two million dollars coming out of it. But what we believe is going to happen and I think Apache believes is going to happen is that we're sort of in the early stages with their first portfolio and we're going to go down two paths. We're going to do some reprocessing of data to better select some opportunities, but we're also going to be involved in processing the data as we acquire it, and so we're actually still working on the program with them on what that's going to look like, so we'll probably have a better answer as this thing unfolds.

Ik Ping Li - Tutman Roble - Analyst

That will be -- I guess you mentioned that will be over how long a period of time?

Bob Peebler - Input/Output - President and CEO

That's probably several months, maybe a year, and I'm saying that just sort of a one year window. And that's actually on a fairly limited scope. It could expand beyond that

Ik Ping Li - Tutman Roble - Analyst

Okay. Thank you very much.

Operator

Our next question comes from Chip Skinner with Royce Investors. Please go ahead.

Chip Skinner - Royce Investors - Analyst

Great quarter. My question was just answered but I was wondering at what stage would this Apache deal do you think you might be ready to go out and market this to other E&P companies?

Bob Peebler - Input/Output - President and CEO

Well we have a strategy and a goal to work on that this year. What we're looking for - - you have to keep in context for Apache - - Apache is about trying to help build the understanding of our technology and help with the momentum of the technology and part of that is to have some success. And so we're sort of looking at a portfolio of opportunities and we're wanting just to replicate Apache exactly. We may want to find a different kind of technical challenge or different area that we can hook up with another company. We don't want to have overlapping activities at this stage just

because we'll get in trouble just resource wise. In the very short term, we're just focused on making the Apache one successful so we don't want to take our eye off that ball. But We do have a goal this year inside to continue to see how we can - - probably it won't be exactly the same with any of them, but we're trying to find and do plan to have a strategic relationship with certainly more than one this year.

Chip Skinner - Royce Investors - Analyst

Thanks.

Operator

There are no further questions at this time, gentlemen. Please continue.

Bob Peebler - Input/Output - President and CEO

Okay, we would like to thank you for taking the time to attend this conference call and we look forward to speaking to you again next quarter. Thanks.

Operator

Ladies and gentlemen, this concludes the Input/Output conference call. Thank you once again for your participation today. You may now disconnect.

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