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|                              |                      |                       |
|------------------------------|----------------------|-----------------------|
| <b>New Rec: Seitel, Inc.</b> | <b>(SEI-\$19.50)</b> | <b>March 18, 2001</b> |
|------------------------------|----------------------|-----------------------|

**Position: Sell      Target: \$10      Timing: 2 (1=aggressive; 5=cautious)**

| 000\$            | Q1 01e        | Q2 01e        | Q3 01e        | Q4 01e        | 2000           | 2001e          |
|------------------|---------------|---------------|---------------|---------------|----------------|----------------|
| <b>Revs</b>      | <b>45,165</b> | <b>48,271</b> | <b>49,163</b> | <b>51,743</b> | <b>163,811</b> | <b>194,342</b> |
| <b>EPS\$</b>     | <b>0.27</b>   | <b>0.30</b>   | <b>0.30</b>   | <b>0.30</b>   | <b>1.02</b>    | <b>1.17</b>    |
| <b>Y/Y Grow</b>  | <b>146%</b>   | <b>24%</b>    | <b>0%</b>     | <b>-18%</b>   | <b>70%</b>     | <b>15%</b>     |
| <b>PE</b>        |               |               |               |               | <b>19</b>      | <b>17</b>      |
| <b>PSR</b>       |               |               |               |               | <b>2.9</b>     | <b>2.4</b>     |
| <b>Consensus</b> | <b>0.26</b>   | <b>0.32</b>   | <b>0.34</b>   | <b>0.39</b>   | <b>1.00</b>    | <b>1.31</b>    |

**Shares Out: 24.3M**

**Mkt Cap: \$474M**

**FYE: Dec**

Summary: Seitel provides 2D and 3D seismic data to petroleum exploration and production companies. The company also sells oil and gas. Fiscal year 2000 sales increased by approximately 27% year over year and reported earnings increased by approximately 67%. Seitel tried to spin off the oil and gas portion of the

business in 1999 and during 2000 sold off portions. Seitel may attempt to spin off or sell DDD Energy (aka Vision Energy) in 2001 as it needs cash. We have three main issues with Seitel. First, the amortization rate of its database appears to be too slow, leading to overstated earnings and an overstated balance sheet asset. Second, its revenue recognition policy for many of the types of transactions that the company reportedly makes does not appear to comply with GAAP. Finally, in our view, Seitel is not a cash generator, and is not an economically profitable business for stockholders, though its unusual compensation program makes it quite profitable for management.

The company's 2D/3D data bank is its key asset. On the books at 9/30/2000 for \$341 million, it is, in effect, the company's inventory for sale. Its total value exceeds shareholder's equity by about \$80 million. Because cost of goods sold is determined by matching the period's data sales to an amortization rate based on management's estimate of the future sales of the data sold, reported operating margins are largely influenced by management's discretion.

The data bank, at its current size, and given the current run rate of seismic data sales and amortization, has enough data for nearly five years of business. This would not be the case were the company to employ an amortization rate like many of its peers in the industry. We estimate that, on average, Seitel's amortization rate is between one half to two thirds that of its largest competitors.

Were Seitel to apply an amortization rate similar to the rest of the industry, we estimate that reported earnings would have been only \$0.13 for 2000 versus the earnings of \$1.02 reported. In addition, an amortization rate like that of its competitors would reduce book value by about \$128 million, wiping out about 50% of stockholder equity, and all of retained earnings. We also note that for federal tax filing purposes, Seitel's actual cash taxes paid to the government is far below what is reported for the use of investors.

The value of the data bank is highly suspect. Seitel is engaged in a number of sales practices that may be exacerbating the problem. For instance, we are told that Seitel is bartering its data for customer data. Seitel books the revenue as a sale, and receives the customer's data in exchange. The only problem is that the customer's data often may not be of good resale quality. Some observers also report that Seitel may "sell" as much as 20 miles of its own data in exchange for just 1 mile of a customer's data. If this is the case, as industry observers claim, then Seitel appears to be booking fictional profits on these so called sales.

Another practice engaged in by the company, according to industry observers, is that it sells in advance the right to certain amount of data to a customer. The customer then can look at a great deal of data before actually

deciding which data to license. The revenue is booked at the time that the deposit is made, not when the data is chosen. According to customers of Seitel, their license period does not begin until the data is chosen. This practice cheapens the value of the database. More importantly, however, we think that the company is being too aggressive in its timing of revenue recognition in these instances.

The company's previous auditors, Arthur Andersen, was "replaced" on December 1, shortly before SAB 101 went into effect for Seitel. Is it possible that Arthur Andersen resigned over accounting differences with management?

The new auditor, Ernst and Young, is now claiming SOP 00-2 as a justification for Seitel's aggressive accounting. We think that Ernst and Young is over reaching. As we discuss below, SOP 00-2 is very clearly meant as guidance in a very specific industry, the film entertainment industry, as we explain in detail below, and was not intended for seismic data. We think SAB 101 is the correct accounting guidance, as we discuss below, and that Seitel is not in conformance with SAB 101. Indeed, as we also discuss later, we do not think that Seitel is in conformance even with SOP 00-2, even if it were applicable.

Seitel would like to spin off or sell DDD Energy. The company reportedly would not take \$150M for the energy business and wanted \$200M. We estimate the business is worth at most about \$150M-\$175M. This would provide Seitel with much needed cash. It would also highlight even more clearly the importance of seismic data sales as the key to the company's long-term success.

Seitel is also creating a very large storage area network through its wholly-owned subsidiary Seitel Solutions to hold its seismic data and to allow access and data manipulation via the internet. This project may allow it to keep up with competition in the data storage market. However, it will not solve fundamental data quality problems. This project will also be a cash user.

Consensus estimates for 2001 are \$1.30. We estimate \$1.17 even using Seitel's current accounting methods. We also estimate that, were Seitel to utilize accounting similar to that of its peers, earnings would be closer to \$0.46 per share in 2001. Seitel's current enterprise value of about \$687 M is about 15 times year 2000 reported EBIT, and about 12 times our estimate for 2001 reported EBIT. Given that Seitel, in our opinion, should be reporting less than 50% of the EBIT it reports, the shares are very expensive.

Moreover, our view is that the company does not really make money at all. Cash flow after spending on seismic data acquisition and cash invested in oil and gas properties has been negative in 6 out of the last 8 reported quarters. Operating cash provided by the seismic business has been less than cash spent to acquire

seismic data in 7 of the last 8 quarters. While data acquisition appears below the operating cash flow line, this is really like inventory and could easily be above the line, as it is in at least one competitor's financial statements. In any event, the company is a net user of cash.

Book value of Seitel is reported at \$10.70, but, when adjusted for our estimate of a realistic amortization policy, is about \$5.50. Our initial price target for SEI shares is \$10, and \$6 longer term.

#### Discussion:

1. Seitel mainly provides seismic data to oil companies for use in search of hydrocarbon reserves. Founded in 1982, the company has amassed a library of proprietary seismic data principally covering both onshore and offshore locations in North America. Revenues are generated by selling the acquired data to over 400 customers.

Seitel has grown its data library rapidly over the last couple of years. At 9/30/00 the gross seismic data bank was on the books for \$684 million, compared to just \$346 million at 9/30/97.

Over the past several years Seitel has been a cash user and has managed to sustain its operations through the sale of oil and gas interests and through the addition of debt.

2. The implementation of Staff Accounting Bulletin No. 101 (SAB 101) appears to have been a major problem for Seitel. The deadline for Seitel's implementation was Q4, 2000. Seitel's accountants Arthur Anderson were "replaced" on December 1, and Ernst & Young took the job. If Seitel were to employ SAB101 we think it would have a significant impact on revenue and earnings. SAB 101 examines the substance of the transaction and allows revenue recognition when income has been earned. In our view, Seitel is currently recognizing revenue before the product is delivered, and therefore before the income has been earned.

SAB 101 states four specific points that should be examined to determine if revenue should be recognized: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured. However, in many instances Seitel appears to be recording revenue before the delivery of product to the customer.

Seitel's CFO reports that clients often commit to purchase large sums of data to receive a discount. The customer gives Seitel an up front non-refundable

deposit and over the next year or more the customer can draw down a certain amount of data. When the customer actually selects the data it wants, the customer signs a supplemental agreement with the details of the arrangement, including the licensing period. Seitel currently recognizes all of the income when the contract is signed. We think that because the payment is actually a deposit, or a pre-payment, Seitel should not recognize this revenue at the time the deposit is made.

Another type of transaction is a “review and purchase” type of transaction in which a client will pay up front for the ability to review a certain amount of miles and then is entitled to a license for a fraction of the amount that was reviewed. When the client decides what data it wants a supplemental agreement will be signed stating the details of the contract. Seitel appears to recognize all of the revenue up front when the original agreement is signed. Again, we think this revenue recognition is premature.

In the "frequently asked questions and answers" document relating to SAB 101 issued by the SEC it is stated:

"The discussion in SAB 101 demonstrates the need to consider two related questions in the assessment of when a non refundable up front payment may be recognized as revenue:

What is the earnings process, and when does it culminate?

Is the undelivered or unperformed obligation essential to the functionality of the performance or product for which the up front payment is ostensibly received?

The staff indicated in SAB 101 that a registrant's analysis of these questions should consider the customer's perspective on the transaction."

It seems clear that the undelivered or unperformed obligation is essential in the case of Seitel's data base, and revenue should not be recognized until chosen and received by the client. Customers apparently think their license period begins when data is chosen.

Both Seitel's CFO and the Ernst & Young audit partner take the position that the authoritative guidance that allows revenue recognition up front is the AICPA Statement of Position 00-2 Accounting by Producers or Distributors of Films and specifically referenced paragraph 72.

First, SOP 00-2 was written to replace FAS 53, Financial Reporting by Producers and Distributors of Motion Picture Films. SOP 00-2, which takes effect for fiscal years beginning after December 15, 2000. SOP 00-2 was written to provide specific guidance to the motion picture industry. In the motion picture business the customer commits to a particular film for a particular period of time. SOP 00-2 allows the film distributor to recognize the revenue even though the

particular film may not have been physically delivered. In essence, it is a FOB the film distributor sale.

First SOP 00-2 was written specifically for "feature films, television specials, television series, or similar products (including animated films and television programming) that are sold, licensed, or exhibited, whether produced on film, video tape, digital or other video recording format."

Seitel is not in the film entertainment industry, which is the specific application meant to use SOP 00-2. Seitel sells seismic data.

Second, even if it were applicable, Seitel could not recognize revenue as it does. SOP 00-2 states: "The film is complete...has been delivered or is available for immediate and unconditional delivery."

However, in Seitel's case, as we have seen, the product may have been neither chosen nor delivered. Customers of Seitel have said that the license period, from their perspective, does not begin until the data is selected. Theoretically, then, Seitel would not even know the correct amount to amortize against the revenue, since each piece of data has its own estimated forecasted useful life.

We think that the notion that SOP 00-2 is applicable is clearly just a stretch to find something to justify Seitel's accounting. We think that Seitel's previous auditors, faced with SAB 101, could not continue to go along with Seitel's accounting. Seitel was able to find an accountant that could agree to a creative solution. This accountant is not the accountant for other seismic data companies that we know of. We think that SOP 00-2 is being misapplied in this case and is indeed not even being followed.

We think that the accounting should reflect that in cases where the customer has paid to take a certain amount of data in the future, the customer has actually made a pre-payment. The company should debit cash and should credit deferred revenue until the customer takes delivery of the product, at which time revenue should be recognized and amortization should begin. If the company is booking revenue without the product having been chosen or delivered, how does it know what to amortize, since each piece of data has its own amortization period?

According to competitor Veritas DGC's 10K "Revenues from the licensing of multi-client data surveys are based upon agreed rates set forth in the contract and are recognized upon delivery of such data". This varies from Seitel's revenue recognition policy as Veritas only recognizes revenue when customers actually receive the data they have purchased. Seitel's 12/31/99 10K states "Revenue from seismic data licensing agreements is recognized when each seismic data program

is available for use by the licensees.” Seitel’s position is when a contract is signed the data is available for use by the licensee. However, in the instances described above the fact that the customer has not selected the specific data to be licensed would suggest the data is not actually available for use by the licensee. Indeed, it appears that the licensing period has not actually begun until the data is chosen, and a supplemental agreement is required to establish what has been licensed and when. If this is correct, and we point out we have not seen these agreements, then it seems the case against early revenue recognition would be very solid.

We looked to other companies that sell data to see how they recognize revenue. What we found was that all others that we know of recognize revenue when the data is actually delivered to the client, in accordance with SAB 101. Other companies that sell different types of data such as Acxiom Corp. (ACXM – Nasdaq) use a revenue recognition policy which is more reasonable, “Revenues from sales and licensing of software and data are recognized when the software and data are delivered, the fee for such software and data is fixed or determinable, and collectibility of such fee is probable.”

3. According to industry sources, Seitel engages in practices that seriously further call into question the value of its database. According to customers and industry insiders Seitel sells more data than does its competitors for the same amount of money. Seitel also is in the practice of trading data with clients. This is important to understand.

Industry insiders say that Seitel sells its data at much lower prices than the rest of the industry. That is to say that Seitel will sell more linear or square miles of data per dollar of revenue than its competitors. Industry insiders, including customers of Seitel, say that the company does this because much of its data is of lesser quality than that of its competitors.

The result is that more of Seitel’s data has been viewed per dollar of revenue recognized. This should lower the value of data, and would suggest that Seitel should be amortizing the value of its data more rapidly than its competition. Seitel will also have to continue to purchase proportionally more data to continue to generate higher sales. Seitel president Paul A. Frame has already stated, “. . . we are currently bidding on several seismic databases that would be accretive to earnings.”

In an interesting way, Seitel can afford to pay more for databases than the competitors, since it will be more "profitable" for Seitel. This is not, however, for any economic reason. It is only because under Seitel’s current policy the database will be amortized over a 10 year period, twice as long as most competitors. One industry participant reported that he had been recently out bid by Seitel, probably

for this reason.

Another practice that Seitel engages in is that of trading data with customers and booking the bartered data as revenue. This type of transaction helped Seitel to record sales for the fourth quarter of 2000, according to management. To illustrate how this works, one of Seitel's customers might own 100 square miles of 3D data. Seitel will offer the customer licensing rights to 100 miles of 3D data for the exclusive ownership of some amount of the customer's data. The ratio appears to be usually in the customer's favor. Seitel customers have told us of deals where Seitel traded as much as 20 miles of its own data for just 1 mile of the customer's data. We have a great deal of trouble understanding why Seitel should be able to book a sale for a full 20 miles of its data under these circumstances.

Seitel records revenue on the sale of the data that it gives to the customer and records a receivable. When payment is made, in the form of data, it debits its databank for the amount. Not only is the revenue thus suspect, so is the quality of the data bank.

Indeed, Seitel has received a certain number of miles from a customer that the customer may have deemed useless to it. One customer said, euphemistically, that this data "would not give a competitive advantage" to Seitel customers. Nevertheless, Seitel now has to sell the data that the client gave up to make any "real" money.

Seitel thus records a sale and makes earnings estimates, but renders little economic benefit to shareholders. Revenue is booked, but the asset received may be worthless. Both income and databank assets may be overstated as a result. Although the numerous insiders with whom we spoke said Seitel is not the only company to engage in this type of transaction, they did say that Seitel is the most actively involved in the practice and it is the only public company they mention.

The total impact of these data trades in 2000 will be unknown until the 10K is filed. Seitel did some of these deals only in Q4 00. In 1999 data trades totaled \$6.5 million and represented about \$0.03 per share. One customer reported he was currently involved in finalizing such a transaction.

4. Seitel uses an amortization policy against its seismic data library that does not appear to reflect its useful life. Nor does it appear to accord with the amortization rates used by Seitel's peers. Although reported EBIT (excluding restructuring charges) for the first nine months of 2000 was \$32.9 million, we think that a better estimate would be \$6.0 million.

Moreover, by applying what we think to be a more appropriate amortization

schedule to Seitel's seismic data library over the last five years, we might conclude that Seitel's book value was overstated by \$128.3 million at 9/30/00. Since Seitel's reported retained earnings at 9/30/00 were \$120.7 million, and since no cash dividends have ever been paid, we think that Seitel may have actually destroyed shareholder value over the years.

a. According to Note C of Seitel's Q3 00 10Q:

“Costs incurred in the creation of proprietary seismic data, including the direct and incremental costs of Company personnel engaged in project management and design, are capitalized. Substantially all (greater than 88%) of the costs incurred to develop the Company's data bank have been for programs created by the Company. The Company uses the income forecast method to amortize the costs of seismic data programs it creates. Under the income forecast method, seismic data costs are amortized in the proportion that revenue for a period relates to management's estimate of ultimate revenues. Management estimates that 90% of the costs incurred in the creation of seismic data is amortized within five years of such data becoming available for resale for two-dimensional seismic data and within seven years of such data becoming available for resale for three-dimensional seismic data. If anticipated sales fall below expectations, amortization is accelerated. The Company also purchases existing seismic data programs from other companies. The costs of purchased seismic data programs are generally amortized on a straight-line basis over 10 years; however, the costs of a significant purchase (greater than 5% of the net book value of the data bank), are amortized using the greater of the income forecast method or 10-year straight-line method. As of September 30, 2000, almost all (97%) of the net costs of the Company's data bank are expected to be fully amortized within 10 years from when such data becomes available for resale.”

The vast majority of purchases by Seitel recently have been for 3-D data, meaning that most data library acquisitions are being amortized over 10 years. While, theoretically, most of these costs might be amortized within the first couple of years based upon "management's estimate of ultimate revenues", it appears that Seitel's estimate of "ultimate revenues" does not reflect reality, as we illustrate below.

b. Seitel's policy of amortizing capitalized costs over as much 10 years was viewed skeptically by our contacts at four competitors, all of whom are or were in the financial area of the business. It seems clear after talking to them that Seitel's amortization rate is too slow relative to industry practice. Seitel argues that its data holds value longer because it does not own the equipment for data acquisition, and therefore is not forced to accumulate useless data when times are slow just to keep the equipment occupied. Competitors reply that this is not the case. First, it is more expensive for Seitel to accumulate the same data, since it owns no equipment. Second, Seitel argues that because customers have funded this data it shows that it is more desirable. However, competitors point out that the fact that this data has already been looked at makes it less valuable. We think Seitel's claims about superior quality are specious, and are just excuses for its slow

amortization.

Publicly traded Veritas (symbol: VTS) and TGS Nopec (Oslo Stock Exchange), for instance, amortize their seismic libraries over periods not exceeding five and four years depending on the data. According to its financial filings Veritas aims to have the majority of data amortized within the first two and three years. TGS Nopec, amortizes at least 40% within the first year according to its 1999 annual report.

The North American leader in seismic sales is WesternGeco. A current employee familiar with the amortization policy reports that WesternGeco effectively amortizes 3-D data over 3 to 3 1/2 years and 2-D data over 2 to 2 1/2 years. About 50% of the data acquisition costs for a given data set were typically amortized in the first year, in line with expected revenues. By this person's estimate 50% of the revenues from a set of new data is earned in year one, 30% is earned in year two, and 20% in the out years, with the largest portion of this remaining 20% being earned in year three.

5. Were an amortization policy closer to that of the industry be applied to Seitel's income statement, the result would be that Seitel's EPS for 2000 would have been \$0.13 a share, and not the reported profit of \$1.02 per share. All of the data used in our analysis are available in Seitel's 10-K and 10-Q filings.

Our analysis assumes that all data acquired is 3-D and is amortized 50% in the first eight quarters from acquisition and the remaining 50% on a straight line basis over twelve quarters starting at the end of year two, which still is not as rapid a schedule as is actually employed in the industry.

a. Using these assumptions, we recalculated Seitel's reported operating profits and EPS for the first nine months of 2000 in Table 2. Compare those results with reported results in Table 1.

Table 1. Seitel 2000 results, as reported(\$ mm's)

|                         | <u>3/31/00</u> | <u>6/30/00</u> | <u>9/30/00</u> |
|-------------------------|----------------|----------------|----------------|
| Data bank revenue       | 23,019         | 33,980         | 38,762         |
| Data bank amortization  | 10,288         | 15,461         | 17,560         |
| Data bank cost of sales | 77             | 403            | 45             |
| Data bank gross profit  | 12,654         | 18,116         | 21,157         |
| Total EBIT              | 6,952          | 11,777*        | 14,144         |
| EPS                     | \$0.11         | \$0.24 *       | \$0.30         |

Table 2. Seitel 2000 results, using adjusted amortization schedule(\$ mm's).

|                   | <u>3/31/00</u> | <u>6/30/00</u> | <u>9/30/00</u> |
|-------------------|----------------|----------------|----------------|
| Data Bank revenue | 23,019         | 33,980         | 38,762         |

|                                  |         |         |        |
|----------------------------------|---------|---------|--------|
| Data bank amortization, adjusted | 23,481  | 23,399  | 23,264 |
| Data bank cost of sales          | 77      | 403     | 45     |
| Data bank gross profit, adjusted | -539    | 10,178  | 15,453 |
| Total EBIT, adjusted             | -6,670  | 3,839*  | 8,440  |
| EPS, adjusted                    | -\$0.26 | \$0.01* | \$0.15 |

\*Before restructuring charge of \$4,394

b. Seitel's book value of \$260.2 million at 9/30/00, if its amortization rate is too slow, is also inflated.

We estimate that total gross data bank additions since 6/30/95 have been \$473.5 million. Total amortization against that total, under the assumptions based on industry practice, would amount to \$260.4 million. This suggests that Seitel's book value for its data bank should be \$213.2 million, and not the much higher \$341.5 million reported on its 9/30/00 balance sheet.

In other words, one-half of Seitel's 9/30/00 book value of \$260.2 million may be worthless, and book value should be closer to \$131.9 million. It follows that all of its retained earnings of \$120.7 million at 9/30/00 may also be illusory.

c. The problem with Seitel's amortization policy can be seen in another way. Recall that Seitel's amortization policy reads: "seismic data costs are amortized for each project in the proportion that its revenue for a period relates to management's estimate of ultimate revenue." That is to say, each dollar of net data bank on the balance sheet has been "matched" by Seitel to expected revenue.

The \$341.5 million of unamortized costs represents \$753.8 million in future seismic revenue sales, using Seitel's reported Q3 00 data bank gross margin of 54.7%. This means that Seitel has over five years of future sales "stored up" on its balance sheet, given its Q4 00 data library sales of \$34.0 million. This is the same as having five years of inventory.

d. Yet another way to analyze Seitel's seismic business is to view it on a cash basis. One can think of Seitel as an information broker. It matches buyers of seismic data with providers of seismic data. To be successful, it needs to earn a "spread" between its purchases and its sales.

Indeed, Seitel appears to have had a cash spread to work with in 1995, 1996 and 1997. The spread disappeared in 1998 and in 1999, and opened up in 2000. However, the recent increase in sales and decrease in purchases could be misleading. With energy prices the highest in years, older data which may not have made economic sense to examine previously now may be more useful. There is a marginal price at which oil and gas in a given location may become profitable

to extract. A downward move in prices would dampen interest in locations that are marginal. It seems that this would be especially true of much of Seitel's database, which is old and which has been picked over many times in the past. Seitel also continues to have cash flow problems related to these purchases of data which we discuss further below.

Table 3. Seitel's seismic cash expenditures versus sales.

|      | Gross Data Bank<br><u>Additions</u> | Seismic<br><u>Data Sales</u> |
|------|-------------------------------------|------------------------------|
| 1995 | \$33,417                            | \$55,749                     |
| 1996 | 52,143                              | 67,138                       |
| 1997 | 76,616                              | 85,560                       |
| 1998 | 139,117                             | 125,863                      |
| 1999 | 116,343                             | 109,671                      |
| 2000 | 70,704*                             | 138,761                      |

\*2000 estimates based upon actual nine month results and Off Wall Street Q4 00 estimates

e. Another problem with the amortization policy is that “group shoot” data is not amortized at an accelerated rate. A “group shoot” is when Seitel gathers numerous interested customers for data in one specific area, who cover 75% of the direct costs of data acquisition. Seitel is able to add this data to its library for resale after an agreed upon time. It would seem reasonable to accelerate the rate of amortization on this data, because if Seitel really does “know” its clients as well as it claims then it probably has been able to identify the clients who would be interested in the data, and they probably participated in the shoot and therefore have already seen the data. That would minimize the opportunity for resales, and one would expect the future cash flow to be less than for data which is fresh and done on pure speculation.

6. Actual taxes paid was just \$4.9 million for all of 1999 and the first nine months of 2000. Seitel's reported income taxes on the income statement over this same period, however, was \$14.8 million. The difference may be attributable to timing differences associated with Seitel's oil and gas business. Another explanation may be that Seitel reports to the IRS that seismic data depreciates more quickly than what the company reports to investors.

Table 4. Seitel quarterly tax information (\$mm's).

|   |                 |                |                |                |
|---|-----------------|----------------|----------------|----------------|
|   | <u>12/31/99</u> | <u>3/31/00</u> | <u>6/30/00</u> | <u>9/30/00</u> |
| Taxes per income statement              | 2,561           | 1,349          | 2,374          | 3,874          |
| Cash taxes paid per cash flow statement | 201             | 659            | 61             | 2,383          |
|   | <u>12/31/98</u> | <u>3/31/99</u> | <u>6/30/99</u> | <u>9/30/99</u> |
| Taxes per income statement              | 3,316           | 848            | 2,879          | 850            |
| Cash taxes paid per cash flow statement | 776             | 466            | 1,300          | -213           |

7. Cash flow from operations, net of data bank additions, has been negative, reinforcing the notion that earnings quality is poor. Over the last two years, cash flow after spending on data has been negative by over \$46 million. Data and oil and gas expenditures are, after all, for inventory for a company like Seitel, and not capital spending in the usual sense.

Table 5. Seitel cash flow analysis(\$mm's)

|                                       | <u>12/31/99</u> | <u>3/31/00</u> | <u>6/30/00</u> | <u>9/30/00</u> |
|---------------------------------------|-----------------|----------------|----------------|----------------|
| Operating Cash from Seismic business* | 16,221          | 25,200         | 12,086         | 20,802         |
| Cash invested in Seismic Data         | 16,558          | 20,587         | 17,916         | 22,323         |
| Net                                   | (337)           | 4,613          | (5,830)        | (1,521)        |
|                                       | <u>12/31/98</u> | <u>3/31/99</u> | <u>6/30/99</u> | <u>9/30/99</u> |
| Operating Cash from Seismic business* | 9,914           | 24,669         | 16,775         | 5,603          |
| Cash invested in Seismic Data         | 18,838          | 62,623         | 29,668         | 19,345         |
| Net                                   | (8,924)         | (37,954)       | (12,893)       | (13,742)       |

\*Used average income split from 9/30/00 to 12/31/98 to determine cash from seismic data

While Seitel reports cash invested in seismic data as an "investing activity", it is interesting that publicly traded Veritas reports increases in its seismic data library as a change in "cash flow from operations". This is more appropriate, in our opinion, given the inventory like nature of the data.

The most alarming part of the cash flow problem is that this year, which has seen the most modest purchases of seismic data in years, the company still has negative cash flow. Over the last three quarters when we look at total cash from operations less cash invested in seismic data and in oil and gas properties we see a negative cash flow of almost \$6.0 million. The company will say special charges of \$4.4 million were included in that period, but in fact only \$1.7 million was paid out in cash during the period.

8. Given its negative cash flow, Seitel's balance sheet has become more levered. Seitel total enterprise value now stands at \$687 million. Debt to equity has increased to 83%. There is a decrease from 12/31/99 to 9/30/2000 mainly due to the sale of oil interests which has allowed Seitel to pay down some of the debt, but the cash has not come from operations.

Table 6. Seitel total debt balances

| (\$000's)    | <u>12/31/94</u> | <u>12/31/95</u> | <u>12/31/96</u> | <u>12/31/97</u> | <u>9/30/98</u> |
|--------------|-----------------|-----------------|-----------------|-----------------|----------------|
| Total Debt   | 11,839          | 57,560          | 84,025          | 89,773          | 135,215        |
| Total Equity | 101,329         | 120,378         | 155,641         | 207,273         | 226,298        |
| Debt/Equity  | 12%             | 48%             | 54%             | 43%             | 60%            |
| (\$000's)    | <u>12/31/96</u> | <u>12/31/97</u> | <u>12/31/98</u> | <u>12/31/99</u> | <u>9/30/00</u> |
| Total Debt   | 84,025          | 89,773          | 150,672         | 225,200         | 215,397        |

|              |         |         |         |         |         |
|--------------|---------|---------|---------|---------|---------|
| Total Equity | 155,641 | 207,273 | 237,587 | 243,024 | 260,194 |
| Debt/Equity  | 54%     | 43%     | 63%     | 93%     | 83%     |

9. Seitel's auditor was Arthur Anderson in Houston and now is Ernst & Young. Other peer group companies' auditors are as follows:

|                       |                        |          |
|-----------------------|------------------------|----------|
| Baker Hughes          | Deloitte & Touche      | Houston  |
| Schlumberger          | PricewaterhouseCoopers | New York |
| Petroleum Geo Service | PricewaterhouseCoopers | Houston  |
| Veritas               | PricewaterhouseCoopers | Houston  |

Many times a change in auditors occurs because a client wants a fresh perspective or expertise in the industry. If Seitel wanted expertise in the industry it would have hired PricewaterhouseCoopers. Occasionally companies will change auditors due to rising fees of one auditor to cash in on savings using a new auditor, although the fee structure is typically negotiated annually.

It makes most sense to change auditors at the end of a fiscal year and to start a new year fresh with a clean break. It does not make sense to change in the middle of the year for apparently no good reason at all, as Seitel seems to claim to have done. The timing of the change, December, 2000, shortly before Seitel's Q4 00 deadline for SAB 101 implementation, appears especially suspicious, and especially more so in conjunction with the very aggressive stance on revenue recognition that Seitel and Ernst and Young have agreed to.

10. Seitel management has an incentive to generate high reported pre-tax profits and strong sales growth. However, much of Seitel's pre-tax profit appears to be a function of an amortization policy for its seismic data bank that is far too slow and an aggressive revenue recognition policy. This raises the question of the fairness to investors of the incentive structure put in place by the compensation committee of the board of directors. This policy was recently adjusted, but it is still much as it was previously.

Page 11 of Seitel's October 19, 2000 proxy illustrates the problem:

Executives will receive the following bonuses based on the annual [pre-tax profit] of the Company and its subsidiaries above minimum thresholds:

|                     | % up to \$50 mm<br><u>pre-tax profit</u> | % above \$50 mm<br><u>pre-tax profit</u> |
|---------------------|--|--|
| Herbert M. Pearlman | 3.5%                                     | 3.71%                                    |
| Paul A. Frame       | 3.0%                                     | 3.1875%                                  |

By our estimate, had Seitel used an amortization policy more in line with others in the industry, reported EBIT for 2000 would have been \$30.2 million

lower. Estimated EBIT for all of 1999 would also probably be lower by around \$55.7 million. In other words, \$2.6 million of bonuses or \$0.07 per share (after tax) might be paid to these managers for profits through 12/31/2000 that do not, in a true economic sense, exist. The company will argue the problem has been solved because previously 17.5% of pretax profits up to \$50 million and a higher percentage for profits above \$50 million, would be distributed for bonuses under the old plan and now it is only 8.5% (2% for Ms. Valice up to \$125,000 plus additional as determined by the board of directors) and other additional amounts, but the problem is not solved. Managers still make out very well while stockholder profits may be entirely illusory.

11. It appears that Seitel is going to spend at least \$18 million to create Seitel Solutions to enable clients to retrieve data over the internet and to manipulate that data with tools on Seitel's website. Seitel will use IBM to build the infrastructure, and has acquired EDM Products, Inc., giving Seitel a suite of 24 software applications. Seitel has also acquired the rights to Lacey Digital Transcription software. The goal is to enable clients to access seismic data from anywhere and manipulate it with the suite of tools on the website, and thereby increase revenue from data sales.

Currently Veritas and WesternGeco are working together with Indigopool.com on what appears to be a similar project. As a result, we think it will be more costly for Seitel to have this facility versus its competitors.

12. Seitel may attempt to either sell off additional pieces of DDD Energy or spin it off entirely through Vision Energy. Over the past eight quarters DDD Energy has been a net user of approximately \$27.6 million. Even during the past nine months ended 9/30/2000 DDD has used \$2.4 million. Seitel would say it is because DDD has been trapped in hedging contracts, which was true until August. However, the total losses on the hedging contracts were only \$1.7 million, which would still leave a \$0.7 million cash hole from DDD Energy.

Table 7. DDD Energy quarterly cash flow information (\$mm's).

|                                     | <u>12/31/99</u> | <u>03/31/00</u> | <u>06/30/00</u> | <u>09/30/00</u> |
|-------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Cash from oil and gas operations*   | 3,380           | 5,648           | 2,162           | 3,314           |
| Oil and gas investment              | 2,417           | 5,639           | 5,008           | 2,920           |
| Cash flow from oil & gas properties | 963             | 9               | (2,846)         | 394             |

|                                     | <u>12/31/98</u> | <u>03/31/99</u> | <u>06/30/99</u> | <u>09/30/99</u> |
|-------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Cash from oil and gas operations*   | 1,703           | 3,036           | 2,655           | 1,290           |
| Oil and gas investment              | 9,343           | 10,786          | 11,574          | 3,080           |
| Cash flow from oil & gas properties | (7,640)         | (7,750)         | (8,919)         | (1,790)         |

\*Calculated as a percent of total cash flow from operations as a percent of total income

A bull might say that operating cash flow from oil and gas is trending up. However, with very high oil and gas prices if DDD can not be cash flow positive, when will it? We also would only need to look at how marginal the trend in fact is: just one positive quarter in 1999 and two in 2000, with one large negative quarter in 2000.

The net revenues of oil and gas have recently provided about one third of Seitel's earnings. When Seitel does sell DDD Energy, be it in pieces or as a whole, some investors may be very disappointed when they realize just how much of Seitel's earnings is attributable to oil and gas interests.

Table 8. DDD Energy quarterly net revenue information (\$mm's).

|   | <u>12/31/99</u> | <u>03/31/00</u> | <u>06/30/00</u> | <u>09/30/00</u> |
|---|-----------------|-----------------|-----------------|-----------------|
| Revenue oil and gas                         | 5,677           | 5,412           | 6,087           | 6,065           |
| Amortization                                | 2,767           | 2,572           | 2,970           | 2,418           |
| Cost of sales                               | 980             | 1,573           | 1,154           | 1,027           |
| Net revenue oil and gas                     | 1,930           | 1,267           | 1,963           | 2,620           |
| <i>SEI Reported earnings before taxes</i>   | 5,492           | 3,854           | 4,240           | 11,129          |
| <i>Net revenue as a percent of earnings</i> | 35%             | 33%             | 46%             | 24%             |

  

|   | <u>12/31/98</u> | <u>03/31/99</u> | <u>06/30/99</u> | <u>09/30/99</u> |
|---|-----------------|-----------------|-----------------|-----------------|
| Revenue oil and gas                         | 5,635           | 3,959           | 4,587           | 4,813           |
| Amortization                                | 2,175           | 2,081           | 2,057           | 2,188           |
| Cost of sales                               | 1,180           | 1,227           | 1,121           | 1,392           |
| Net revenue oil and gas                     | 2,280           | 651             | 1,409           | 1,233           |
| <i>Reported earnings before taxes</i>       | 10,154          | 1,598           | 7,754           | 1,674           |
| <i>Net revenue as a percent of earnings</i> | 22%             | 41%             | 18%             | 74%             |

DDD Energy appears to be a dying business. Production volumes have been decreasing for the past three years and appear to be continuing that trend for 2000. Based on the latest press release from Seitel regarding seven new wells drilled in California one would expect the downward trend to continue. Combined daily net production is expected to “increase by 2.7 mmcf/d” with the addition of the new wells which are expected to reach 11.0 mmcf/d at full production, which is expected within six months. The net production increase of 2.7 mmcf/d would suggest that production in the first half of the year will be substantially lower than in the second half, which could have a significant effect on revenue if prices do not stay at their current high levels.

Table 9. DDD Energy production information.

|                                     | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>12/31/00</u> |
|-------------------------------------|-------------|-------------|-------------|-----------------|
| Natural gas production (mmcf)       | 6,926       | 6,216       | 5,693       | 4,390           |
| Oil and natural gas liquids (mbbls) | 420         | 386         | 346         | 303             |

According to one source familiar with the spinning off of DDD Energy, Seitel would have received approximately \$150M from the spin off at the beginning of 2000, but, according to this source, Seitel was greedy and wanted \$200 million at the last minute, but the investment bankers could not get that amount. According to some industry sources the investment bankers were also not 100% confident about the accuracy of reported reserve amounts.

Oil and gas prices are higher now, but it appears that DDD is still worth about \$150M. Perhaps fourth quarter prices will allow Seitel to fetch a bit more for DDD, but we think \$150M-\$175M is the right range.

The effect of the sale of DDD Energy at an assumed \$175M, which we view as optimistic, is that Seitel will be able to pay down most of its \$200M of debt. This will still not help Seitel make money or become a profitable enterprise. Seismic data sales is a net user of cash. It will help to eliminate around \$3 million of quarterly interest expense, until debt begins to climb again.

13. The company announced on Dec. 7, 2000 that it had been buying back stock in the last week of November. Two days prior, insiders filed Form 424B3 noting their intention to sell shares of Seitel. Within 12 days of the announcement insiders began to sell holdings of approximately \$2.9M after the company had expended \$1.6M to buyback stock, with Mr. Pearlman selling an additional \$2.9 million in February. The company purchased 110,000 shares and insiders sold 259,106 shares.

We examined amounts sold in relation to shares beneficially owned, which represent shares owned and options and warrants that are exercisable for each of the inside trades. We also examined shares sold in relation to actual shares owned by two of the largest shareholders of Seitel stock.

Table 10. Insider stock sale information.

|                  |                                   | Beneficially<br>Owned<br>12/5/2000<br>Form 424B3 | Amount<br>Sold | Percent<br>Sold |
|------------------|-----------------------------------|--|----------------|-----------------|
| Herbert Pearlman | Chairman of the board             | 1,358,827  | 136,826        | 10.1%           |
| Paul Frame       | CEO, President, Director          | 1,762,730  | 52,280         | 3.0%            |
| Marcia Kendrick  | Chief Accounting Officer          | 150,625  | 20,000         | 13.3%           |
| Russell Hoffman  | VP of Corporate<br>Communications | 216,667  | 50,000         | 23.1%           |

|                  |                          | Amount<br>Owned<br>12/5/2000* | Amount<br>Sold | Percent<br>Sold |
|------------------|--------------------------|-------------------------------|----------------|-----------------|
| Herbert Pearlman | Chairman of the board    | 403,029                       | 136,826        | 33.9%           |
| Paul Frame       | CEO, President, Director | 506,932                       | 52,280         | 10.3%           |

\*Amount calculated from beneficially owned amounts at 12/5/2000 less option and warrants at 9/19/2000 Proxy Statement, the information was not available for Ms. Kendrick or Mr. Hoffman in Proxy Statement

14. We estimate that Seitel's EPS in 2001, as reported, will be \$1.17. versus the 2001 "street" estimate of \$1.30.

Our estimate assumes that the company's library data sales growth slows over the next year and begins to level off. During 2000 Seitel was boosted by increasing oil and gas prices as well as the release of previously restricted Amoco seismic data acquired in the Olympic Seismic purchase. Many oil and gas companies currently have a deep backlog of prospects which will hinder the continued growth of Seitel's seismic data sales.

Although Seitel may manage to report earnings growth early in 2001, it will probably require additional significant seismic data acquisitions, since data acquisition has been down over the past year. We estimate negative cash flow in 2001 after seismic data purchases.

Table 11. Seitel estimated cash flow 2001

| Cash Flow from Operations  | <u>3/31/2001 E</u> | <u>6/30/2001 E</u> | <u>9/30/2001 E</u> | <u>12/31/01 E</u> |
|--|--------------------|--------------------|--------------------|-------------------|
| <b>OPERATING CASH FLOW:</b>  |                    |                    |                    |                   |
| Cash from CUSTOMERS  | 40,648             | 44,409             | 45,722             | 47,604            |
| Cash paid SUPPLIERS  | (11,158)           | (10,614)           | (11,739)           | (12,208)          |
| Interest Paid  | (3,098)            | (3,098)            | (3,098)            | (3,098)           |
| Interest Received  | 300                | 300                | 300                | 300               |
| Cash Taxes Paid  | (258)              | (325)              | (312)              | (359)             |
| Cash From Operations   | 26,434             | 30,672             | 30,872             | 32,239            |
| Seismic Data   | (27,000)           | (28,000)           | (29,000)           | (28,000)          |
| Oil/Gas Prop. Invest   | (3,800)            | (3,800)            | (3,800)            | (3,800)           |
| Cash flow from operations<br>after seismic and oil and gas<br>spending | (4,366)            | (1,128)            | (1,928)            | 439               |

Seitel's "true" book value, by our estimate is about \$5.50. Even at a \$5.50 share price, Seitel's enterprise value would still be 6.2 times our 2001 EBIT estimate of \$56.0 million.

Our EBIT estimate, however, still assumes Seitel's current accounting methodology is used. We estimate that if Seitel applied an amortization schedule closer to industry standards to its income statement, it would actually have

earnings of \$0.13 in 2000 and \$0.48 a share in 2001, and perhaps lower with a change in revenue recognition policy.

#### 15. Income Statements:

|                                      | <u>3/31/00</u> | <u>6/30/00</u> | <u>9/30/00</u> | <u>12/31/00</u> |
|--------------------------------------|----------------|----------------|----------------|-----------------|
| <i>Data Bank revenue</i>             | 23,019         | 33,980         | 38,762         | 43,586          |
| <i>Oil and Gas revenue</i>           | 5,412          | 6,087          | 6,065          | 6,900           |
| TOTAL REVENUE                        | 28,431         | 40,067         | 44,827         | 50,486          |
| <i>Data bank amortization</i>        | 10,288         | 15,461         | 17,560         | 18,309          |
| <i>Depletion of oil and gas prop</i> | 2,572          | 2,970          | 2,418          | 2,989           |
| TOTAL DD & A                         | 13,159         | 18,722         | 20,214         | 21,614          |
| Cost of Sales                        | 1,650          | 1,557          | 1,072          | 1,291           |
| SG&A                                 | 6,670          | 8,011          | 9,397          | 10,837          |
| Restructuring Charge                 | 0              | 4,394          | 0              | 0               |
| Expense related to IPO               | 0              | 0              | 0              | 833             |
| EBIT                                 | 6,952          | 7,383          | 14,144         | 15,911          |
| Interest expenses                    | (3,098)        | (3,143)        | (3,018)        | (2,947)         |
| Dividend Income                      | 0              | 0              | 0              | 22              |
| EBT                                  | 3,854          | 4,240          | 11,126         | 12,986          |
| Taxes                                | (1,349)        | (2,374)        | (3,894)        | (4,172)         |
| Net Income                           | 2,505          | 1,866          | 7,232          | 8,814           |
| EPS                                  | \$0.11         | \$0.08         | \$0.30         | \$0.36          |
| Shares Out                           | 23,625         | 23,661         | 24,037         | 24,306          |

|                          |       |       |       |       |
|--------------------------|-------|-------|-------|-------|
| Seismic gross margin     | 55.3% | 54.5% | 54.7% | 58.0% |
| Oil and gas gross margin | 52.5% | 51.2% | 60.1% | 56.7% |
| Cost of sales            | 5.8%  | 3.9%  | 2.4%  | 2.6%  |
| SG&A                     | 23.5% | 20.0% | 21.0% | 21.5% |
| EBIT                     | 24.5% | 18.4% | 31.6% | 31.5% |

|                                      | <u>3/31/2001 E</u> | <u>6/30/2001 E</u> | <u>9/30/2001 E</u> | <u>12/31/01 E</u> |
|--------------------------------------|--------------------|--------------------|--------------------|-------------------|
| <i>Data Bank revenue</i>             | 37,920             | 40,953             | 41,772             | 44,279            |
| <i>Oil and Gas revenue</i>           | 7,245              | 7,317              | 7,391              | 7,465             |
| TOTAL REVENUE                        | 45,165             | 48,270             | 49,163             | 51,744            |
| <i>Data bank amortization</i>        | 17,064             | 18,019             | 18,380             | 19,925            |
| <i>Depletion of oil and gas prop</i> | 3,283              | 3,316              | 3,349              | 3,383             |
| TOTAL DD & A                         | 20,652             | 21,731             | 22,139             | 23,798            |
| Cost of Sales                        | 1,355              | 1,448              | 1,475              | 1,552             |
| SG&A                                 | 9,936              | 10,909             | 11,111             | 12,211            |
| EBIT                                 | 13,222             | 14,182             | 14,438             | 14,183            |
| Interest expenses                    | (3,098)            | (3,098)            | (3,098)            | (3,098)           |
| EBT                                  | 10,124             | 11,084             | 11,340             | 11,085            |
| Taxes                                | (3,543)            | (3,880)            | (3,969)            | (3,879)           |
| Net Income                           | 6,581              | 7,204              | 7,371              | 7,206             |
| EPS                                  | \$0.27             | \$0.30             | \$0.30             | \$0.30            |
| Shares Out                           | 24,306             | 24,306             | 24,306             | 24,306            |

|                          |       |       |       |       |
|--------------------------|-------|-------|-------|-------|
| Seismic gross margin     | 55.0% | 56.0% | 56.0% | 55.0% |
| Oil and gas gross margin | 54.7% | 54.7% | 54.7% | 54.7% |
| Cost of sales            | 3.0%  | 3.0%  | 3.0%  | 3.0%  |
| SG&A                     | 22.0% | 22.6% | 22.6% | 23.6% |
| EBIT                     | 29.3% | 29.4% | 29.4% | 27.4% |

|                                      | <u>2000</u> | <u>2001</u> |
|--------------------------------------|-------------|-------------|
| <i>Data Bank revenue</i>             | 139,347     | 164,924     |
| <i>Oil and Gas revenue</i>           | 24,464      | 29,418      |
| TOTAL REVENUE                        | 163,811     | 194,342     |
| <i>Data bank amortization</i>        | 61,618      | 73,389      |
| <i>Depletion of oil and gas prop</i> | 10,949      | 13,332      |
| TOTAL DD & A                         | 73,709      | 88,320      |
| Cost of Sales                        | 5,570       | 5,830       |
| SG&A                                 | 34,915      | 44,167      |
| Restructuring Charge                 | 4,394       | 0           |
| Expense Related to IPO               | 833         | 0           |
| EBIT                                 | 44,390      | 56,025      |
| Interest expenses                    | (12,206)    | (12,392)    |
| Dividends                            | 22          | 0           |
| EBT                                  | 32,206      | 43,633      |
| Taxes                                | (11,789)    | (15,271)    |
| Net Income                           | 20,417      | 28,362      |
| EPS                                  | 0.85        | 1.17        |
| Shares Out                           | 24,306      | 24,306      |
| <br>                                 |             |             |
| Seismic gross margin                 | 55.8%       | 55.5%       |
| Oil and gas gross margin             | 55.2%       | 54.7%       |
| Cost of sales                        | 3.4%        | 3.0%        |
| SG&A                                 | 21.3%       | 22.7%       |
| EBIT                                 | 27.1%       | 28.8%       |