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NOV - Q2 2015 National Oilwell Varco Inc Earnings Call

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**OVERVIEW:**

NOV reported 2Q15 revenues of $3.9b, consolidated operating profit (excluding other items) of $455m, GAAP fully diluted EPS of $0.74 and fully diluted EPS (excluding certain items) of $0.77.





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## PRESENTATION

**Operator**

Good morning and welcome to the National Oilwell Varco earnings call. My name is Kevin, and I will be your operator for today's call.

(Operator Instructions)

I will now turn the call over to Mr. Loren Singletary, vice president, investor and industry relations. Mr. Singletary, you may begin.

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**Loren Singletary** - *National Oilwell Varco Inc. - VP of Investor and Industry Relations*

Thank you, Kevin, and welcome, everyone, to the National Oilwell Varco second quarter 2015 earnings conference call. With me today is Clay Williams, President, CEO and Chairman of National Oilwell Varco. Before we begin this discussion of National Oilwell Varco's financial results for its second quarter ended June 30, 2015, please note that some of the statements we make during this call may contain forecasts, projections and estimates including but not limited to comments about our outlook for the Company's business.

These are forward-looking statement within the meaning of the federal securities laws based on limited information as of today which is subject to change. They are subject to risk and uncertainties, and actual results may differ materially. No one should assume that these forward-looking statements remain valid later in the quarter or later in the year.

I refer you to the latest forms 10-K and 10-Q National Oilwell Varco has on file with the Securities and Exchange Commission for a more detailed discussion of the major risk factors effecting our business. Further information regarding these as well as supplemental financial information and operating information may be found within our press release on our website at www.nov.com or in our filings with the SEC.

Later on this call we will answer your questions which we ask you to limit to two in order to permit more participation. Now let me turn the call over to Clay.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Thank you, Loren, and welcome, everyone. This morning we announced that National Oilwell Varco earned $0.74 per fully diluted share in second quarter ended June 30, 2015 on a US GAAP basis. Excluding $17 million in pretax charges or $0.03 per share after tax related to severance and facilities closures, earnings were $0.77 per fully diluted share down 32% sequentially the first quarter of 2015 and down 48% from the second quarter of 2014 excluding other items from all periods.

Revenues were $3.9 billion in the second quarter of 2015 down 19% sequentially and down 26% year over year. Consolidated operating profit excluding other items was $455 million or 11.6% of sales in the second quarter. Decremental operating leverage was 26% sequentially and 36% year-over-year. EBITDA, excluding charges in the second quarter was $627 million or 16% of sales down 25% sequentially and down 45% year over year.

Almost all of our business units posted lower sequential sales due to lower oil prices and lower activity around the globe with only a few areas like Argentina and the Middle East bucking the trend. We also felt the full quarter effect of customer discounts implemented during the first quarter along with cost absorption challenges in manufacturing facilities. Generally, we still see some pricing pressures in certain products mostly in international markets, but most North American business units are reporting that pricing is stabilizing at new lower levels as the rig count flattens.

Consolidated revenues for the US declined 29% sequentially. Canada was down 37% sequentially, and international revenues fell 14% sequentially. Orders improved 33% sequentially for Rig Systems, but they still remained low at $313 million. The second quarter included a jack-up drilling package and a production platform drilling rig. The Rig Systems backlog declined 13% sequentially to $9 billion.

At this point we are expecting orders to remain roughly flat in the third quarter but start to pick up in the fourth quarter driven by higher demand for land rigs and rising inquiries around capital components. Offshore order recovery is still many quarters away, and we expect National Oil Company driven jack-up demand to recover before floaters do. But in completion and production solutions orders fell 19% to $264 million leaving the backlog a18% lower sequentially.

We expect orders to remain low in the third quarter although we may get some incremental help from flexible pipe orders. The oilfield services industry we sell to is very good at stopping expenditures when oilfield activity turns down which they are demonstrating right now.

We believe these spending levels are not sustainable, because they support ongoing operations by depleting their inventories of consumables and equipment they have on the shelf or by raiding idled rigs for parts, components, and drill pipe. As oil field service companies gradually de-stock, they will eventually run out of opportunities to cannibalize their existing fleets, and we expect orders to begin to flow again to NOV given that oil and gas remains a highly capital intensive undertaking and that NOV is one of its largest capital manufacturers and suppliers of technology.

Our visibility into how long they can live destocking in cannibalizing varies by product. We know drill pipe for instance is cannibalized from idled land rigs by some but not all drilling contractors. And drill pipe is probably a year away from meaningful recovery. On the other hand some products feel much closer to the turn. We are beginning to see some inquiries come in for drilling motor part and relines. Last week we begin to see some new orders for fiberglass pipe. Our XL Systems conductor pipe unit which sells mostly into the offshore had a record quarter for inquiries during the second quarter. Demand for wireline units is holding up pretty well with a brightening outlook for the second half.

After declining every single month since last October, spare parts orders within our Rig Aftermarket market group finally picked up the first time after July. A few weeks of improved order increase does not necessarily signal the turn around, and we're hesitant to call bottom yet.

But we know from past downturns that once the rig count stabilizes, the end of destocking and capitalization is just a matter of time. I would add too, that I don't believe fastidious equipment maintenance for the long run is at the top of our customers' priority list right now. Equipment is being run hard in the field and parked next to the fence and hosed-down. Customers living hand to mouth aren't sure that if that particular unit will ever get another job and sure don't want to put cash into equipment without a firm job on the board.

Just about everything on land can be cannibalized, but offshore typically only top drives, racker arms and iron roughnecks can be cannibalized cost-effectively. This time around we will be helped by the fact that a lot of new generation equipment has flowed into the fleet so the large overhang of mechanical equipment and SCR equipment will be less usable and less relevant on the new tier 1 AC rigs that the industry is migrating to.

We also believe that the level of drilling we are stabilizing at is not sufficient to grow production which will one day be required to meet rising demand. Unfortunately, North American shale production is not rolling over yet like we had hoped as operators are apparently high grading their drilling into core areas of the shale plays and as completions slowly catch up with drilled wells. And now we are dealing with slowing economic growth in China and the potential return of 700,000 barrels of oil per day from Iran meaning that our outlook for recovery gets pushed back at least a couple more quarters into the future.

So, in the meantime, we have three areas of focus. One of which is to manage what we can. We're cutting costs. In second quarter we reduced SG&A 14% sequentially and 21% since the end of 2014. Within our cost of sales structure we are in-sourcing much more of our work from outside suppliers, seeking to present our core NOV employee base and utilize NOV machine shops and fabrication capabilities as much as possible.

Our downhole tools business decreased outsourced manufacturing spend 58% sequentially. Year-to-date we've insourced 36,000 hours into one of our large Rig Systems manufacturing plants. By reducing over time, winning discounts from our suppliers and high grading our supply chain across the organization, we were able to increase the margins we achieved on existing project work in Rig Systems.

The segment posted 120 basis point margin improvement sequentially despite the 24% sequential reduction in revenues. Our drill pipe business is pacing production to match orders at about half of capacity to preserve our core team and core capabilities. These reductions were difficult but necessary and effective. We will emerge more efficient when the inevitable recovery finally does arrive.

Second, we continue to invest in our long-term strategic plans which will shape our opportunity set when we ultimately emerge from the current downturn. We're striking a balance between prudent cost reductions in the short run and investments in a future which will see the oil and gas industry continue to rely on sophisticated technologies to supply an energy hungry world. We intend to emerge a better company in that world. These initiatives include for instance within our Completion and Production Solutions segment constructing a more comprehensive package of equipment for floating production systems by acquisition, by investing in R&D, and working with industry partners,

Over the past few years we've quietly added promising new technologies to our Process and Flow technologies group that separate oil from produced water, separate sand from production streams and injects seawater into deepwater reservoirs. These have been added to our offering of pumps, valves manifolds, and other products and they complement offloading systems, cranes, deck machinery, composite piping systems, turret mooring systems and flexible pipe and a patented design for an FPSO hull that can reduce fuel costs by as much as 20% and mooring costs by as much as 25%.

By offering a more complete package of components and by developing standard modular packages for floating production units, we are simplify the supply chain for these complex vessels reducing both the cost and the construction risk. This is precisely what our deepwater E&P customers are looking for. We continue to work a handful potential our FPSO projects as the sponsors reword and reduce costs. Our engineering activity has risen year-over- year, and generally we are seeing larger vessels, buoys, and turrets within these projects.

Elsewhere in the deepwater arena we see demand for gas pipe conductor connections we have developed within our XL Systems product line which helps fuel higher sequential sales in the second quarter at strong incremental. We have been steadily investing in technology and adding capacity in this product in West Africa and the Gulf Coast. Likewise our flexible pipe capacity additions in Brazil led to slightly higher sequential results for this group in the second quarter, although pricing pressure on this product remains very high.

Our Completion and Production Solutions segment has also assembled the global leading supplier of coil tubing and coil tubing units, pressure pumping, blending, mixing and other fracture stimulation equipment; along with wireline units and composite piping systems, including quick installation, reeled composite pipe that are impervious to corrosion; technologies which are enabling the shale revolution for which we see further growth internationally in the long run.

Our large installed base of equipment offers opportunities for NOV to investment in aftermarket support and periodic recertification of high pressure frac fleets and wireline equipment through the next few years. Our Wellbore Technologies segment is pressing new developments in big data, software answer products, closed loop drilling automation systems, and managed pressured drilling within the dynamic drilling solutions business unit to continue to drive safer, faster drilling operations to drive higher returns for our customers.

Lately we've seen large directional drillers bring new technology to lower tier marketplaces to win businesses. We believe this will create new opportunities for our downhole tools unit to also sell new technologies into these areas as well. We began operating our new test rig in Navasota, Texas earlier this year which provides us a great new laboratory to pioneer new technologies like these, and we expected to undertake a half dozen or so drilling automation jobs through the remainder of 2015.

Within the segment these new transformative technologies build on several trusted global franchises like Grant Prideco, which pioneered premium drill pipe designs that are able to execute the challenging horizontal well paths that are fueling the shale revolution. Earlier this year Grant Prideco launched a new intervention riser product, and it sold three strings already including the industry's first 7 5/8" strain.

Our Tuboscope franchise worked closely with Grant Prideco to inspect, coat, hardband, and repair drill pipe along with providing critical coating, threading and quality assurance services for tubing, casing and line pipe globally. Shale programs are highly consumptive of both drill pipe as well as production tubulars which has helped drive good growth within Tuboscope for the past several years.

Likewise our Wellsite Services business foresees longer term growth prospects in solids control to improve drilling speeds, drilling fluids technology, waste management around drill cuttings and water handling and management; some of the largest and most costly challenges faced by operators both onshore and offshore. NOV is for instance the leading provider of thermal desorption cuttings treatments units globally, and we're seeing new markets emerge in places like North Dakota, West Africa, and China which is a implementing zero discharge rules.

Our Rig Aftermarket segment declined more than we expected through the first half of 2015 due to the cannibalization I mentioned earlier. Spare parts purchases in particular continued to slip which rising SPS work failed to fully offset. We expect to see the SPS project count increase again in the third quarter but at a lower rate than we would otherwise expect as customers are scrapping some rigs scheduled for SPS and postponing others until they get a contract.

Customers are also trimming the scope of SPSs moving forward to be bare-bones rather than seeking to upgrade and differentiate their rigs. We expect Rig Aftermarket segment revenues to be roughly flat from the second quarter to the third quarter and fourth quarter, but to again resume growth in 2016 due to its large and growing install base of sophisticated equipment requiring close OEM support.

We've invested in training and support facilities closer to our customers' operations around the globe and in condition monitoring technologies that will further differentiate NOV's level of support. Extraordinary install base of NOV equipment in the oil field following a decade of intensive retooling and the nature of this equipment and the high level of sophistication it embodies creates a remarkable aftermarket support opportunity unique to NOV which we will continue to vigorously prosecute.

Turning to Rig Systems we also see the potential for future opportunities despite a very weak order environment today. Our Rig Systems segment continues to invest in rig designs for tomorrow: configurable rig floors, low-cost vessels, more highly automated land rigs, NOVOS control systems that enable third-party developed apps, and retrievable subsea BOP pods. While offshore rig new builds demand is expected to remain low for an extended period, we believe demand for land rigs, specifically AC tier 1 walking electronic controlled, high pressure mud system capable land rigs, could resume in earnest as early as late 2015 driven by several conversations we have underway in the Middle East, Latin America and in North America. We see the new rig technology strategy, AC powered, electronic controls, high levels of automation, prevailing strategically in all rig categories, land and offshore.

So, to summarize, our second current initiative is to recognize that the industry will recover and to make sure that we have continued to invest in technology that will maximize our position in that recovery. NOV is unique in its ability to pioneer new technologies, new business models and capabilities to serve the industry, and we will not let this downturn distract us from our long-term vision.

Our third initiative is to deploy capital into acquisition opportunities which will emerge in this downturn. The strategies I outlined earlier can be enhanced and accelerated by combining businesses. We are actively seeking M&A opportunities, but, to be clear, we will be disciplined in our approach. We have closed three bolt-on acquisitions so far this year and have letters of intent with several more. But thus far we find making the bids and ask converge continues to be a challenge. As most of you know we have a long history of building NOV through acquisitions, and we have a lot of experience in this area. That experience teaches us to be patient until it's time to be otherwise.

In preparation for potential opportunities, we expanded our revolving line of credit to $4.5 billion during the second quarter. So, to summarize, we are reducing costs. We are continuing to invest in our long-term plans, and we are pursuing M&A opportunities to accelerate and enhance those long-term growth opportunities, all to position NOV for future growth and profitability. This could not happen without the terrific employees that make up NOV, and I want to thank them for their hard work and leadership through this difficult time. In a challenging market our customers need us more than ever to provide great service and technology and crisp execution. And I'm proud to be part of the team that does that better than anybody.

Now let me touch on a couple more subjects before I turn it over to Loren. Unfortunately in Brazil we don't have a lot more clarity on the resolution of Sete's rig building financing than we did last quarter. While there have been press reports of reductions of rig building, we have not received any cancellations from our customers on the 22 floater packages for which we have binding contracts in hand to provide. Consequently, we continue to report these contracts in our backlog and at June 30, 2015 they totaled $3.1 billion within our Rig Systems backlog. And during the second quarter we recognize $80 million in revenue related to the shipyard where we continue to be paid.

We have suspended activity in the other three shipyards. Next, the liquidation of working capital is proceeding more slowly than we would like for a couple of reasons. We had extraordinarily large cash tax payments in the quarter related to a foreign tax matter that we reported in the first quarter.

The unwind of our Rig Systems backlog and associated customer financing will naturally soak up calculated working capital as we earn revenue against projects for which we've already been paid. Second the negotiation -- or third, the negotiated delay of several rigs in the shipyard means we will hold inventory piece projects longer than we originally planned. But, as we noted in our last call, we expect the margins that we earn on these projects to benefit, as a result, as you saw in the second-quarter.

Finally our customers have been slower to pick up their equipment, given market conditions, resulting in inventory remaining on our books a little longer than normal. We remain focused on improving cash conversion and expect to make better progress over the next few quarters. We are also aggressively pursuing more repatriation of cash from overseas after good progress last year on this front. We believe the second half of 2015 will see further improvements in this area.

At this point, let me turn it over to Loren to discuss our second-quarter performance and outlook in more detail. Loren?

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**Loren Singletary** - *National Oilwell Varco Inc. - VP of Investor and Industry Relations*

Thanks, Clay. I will now discuss our segment operating results for the second quarter of 2015. NOV Rig Systems generated revenues of $1.9 billion down 24% sequentially and 19% compared to the second quarter of 2014. Revenue out of backlog was down 24% sequentially to $1.7 billion. We completed eight offshore drilling equipment packages in the quarter.

Improved project execution and the impact of several cost reduction measures including, renegotiating vendor pricing, improved logistics, and supply chain optimization allowed for an increase to the segment margins. Operating profit for the segment was $395 million yielding operating margins of 20.5% up 120 basis points from the first quarter of 2015 on improved margins on projects. Decremental leverage was 16% sequentially and 24% year over year well below normal leverage for the business in the 30% to 40% range due to cost reductions. EBITDA was $419 million or 21.7% of sales, and EBITDA margins increased 140 basis points as a result of these cost-saving measures.

Q1 to Q2 offshore revenue declined 18% and land revenues declined 35%. Now let's discuss capital equipment orders and the resulting backlog for NOV Rig Systems. In the second quarter we received $313 million in new orders resulting in a book to build of 18%, a moderate increase from Q1. We ended the quarter with a backlog of $9 billion down 13% sequentially. Of the total $9 billion backlog, approximately 91% is offshore, and 92% is destined for international markets.

As we move into the third quarter of 2015, we expect total NOV Rig Systems revenues to decline approximately 20% into the $1.5 billion to $1.6 million range. We expect to see revenue out of backlog slowing to the range of $1.3 billion as we will ship fewer land rigs and continue to work through deliveries of offshore rigs which have been rescheduled for delivery later than originally planned.

We continue cost-cutting reduction initiatives to reduce overtime, to increase supply chain cost, which has helped by easing congestion in the shipyards, but lower volumes are expected to lead segment operating margins to decline into the mid- to high teens for Q3. Right-sizing and efficiency savings will likely be more than offset by under-absorption resulting from revenue declines.

We expect orders for offshore newbuilds to remain low, but we do see a few opportunities for specialized equipment like 20,000 psi and Arctic offshore rigs and jackups for drilling contractors to go into National Oil Company programs through the next 18 months or so. On land, we're seeing rising inquiries and international bright spots in Latin America in the Middle East as there is growing appetite for high-horsepower desert rigs suited for those regions.

We also have North American customers committed to their long-term strategies of high-grading the technology of their rig fleets to tier 1 AC rigs with high pressure mud systems, and we believe we will begin to see meaningfully higher land rig orders later this year. We also expect capital equipment orders to slowly recover later in the year and into 2016 to support the ongoing rigs continuing to work. Nevertheless, we expect book to bill for the segment to remain below one for at least the next several quarters.

Our NOV Rig Aftermarket segment sales declined more than we expected in the second quarter. It generated revenues of $657 million down 9% sequentially and down 16% compared to the second quarter of 2014. As Clay noted, the sharp decline in both offshore and onshore drilling activity led to sharp reductions in cash exposure by drilling contractors, most notably in spare parts sales as customers continued to consume inventories and cannibalize equipment off stacked rigs before making any new purchases.

Customers are doing the absolute bare minimum in terms of maintenance and repair - only what's necessary to continue to keep their fleets running. Operating profit for the segment was $145 million resulting in operating margins of 22.1%. Margins were down 560 basis points sequentially and 550 basis points year over year. And sequential decremental leverage was an extraordinary high 87% due to lower revenues, pricing pressure, and inventory charges relating to older equipment. Excluding the charges sequential decremental leverage would have been in the mid-50s range.

EBITDA was $152 million or 23.1% of sales. Land sales were approximately 25% of the total segment revenues, very consistent with Q1. As we move into the third quarter, we believe Rig Aftermarket revenues will be roughly flat with Q2 with slight increases across most spare parts product lines and additional repair [work]. This will be offset by less demand for field services and fewer manifold and expendables sales from our Mission product line. Operating margins are expected to increase slightly from Q2 on a higher mix of spare parts sales and on reduced charges.

Long-term our outlook for this segment remains very bright as the industry is high grading its fleet of equipment with much more NOV technology within the installed base. When worldwide drilling activity recovers drilling contractors who are currently delaying purchases will need this segment to respond quickly. And an increase in demand accompanied with efficiencies and cost reductions currently being implemented will position this segment for sharp improvement.

For the second quarter of 2015 Wellbore Technologies generated revenues of $956 million down 18% sequentially and down 34% compared to second quarter of 2014 on lower global drilling activity. Operating profit for the segment was $47 million resulting in operating margins of 4.9% down 570 basis points sequentially and 1370 basis points from the second quarter of 2014.

Segment-wide cost reduction efforts, in the face of falling rig counts, helped mitigate some of the intense price pressure felt across the group, which helped hold sequential decrementals to 36%. Pricing appears to have stabilized across North American markets as rig count has more or less stabilized and has ranged from low single digits on up. Some international markets are continuing to receive invitations to discount as international activity has slowly declined.

EBITDA in the second quarter was $146 million or 15.3% of revenue. As we've noted in the past, drilling activity tends to drive results for the segment overall, but portions of this business are more related to production and well servicing, so areas like tubing reclamation and line pipe coating within Tuboscope are hoping offset drilling related declines. Looking into the third quarter of 2015 we believe Wellbore Technologies revenues will be down in mid-single-digit percentage terms as backlog for drill pipe and other manufactured products from the group have declined through the second quarter. As Clay noted earlier, our customers a destocking inventories, and some of our products within Wellbore Technologies are closer to resumption of orders than others. We expect margins to decline slightly from the second quarter on mix and continued discounting in certain areas.

Nevertheless, we are also continuing to implement strategies to reduce cost while also increasing operational efficiencies around the world, and we are defending our strong market positions within the Wellbore Technologies segment by investing in R&D and innovating new technologies to position ourselves for inevitable upturn.

NOV Completion and Production Solutions generated revenues of $873 million for the second quarter of 2015 down 8% sequentially and 23% compared to the second quarter of 2014. Operating profit for the segment was $81 million resulting in operating margins of 9.3% down 210 basis points sequentially and 470 basis points year over year. Sequential decrementals were 36%, and second quarter EBITDA for the segment was $141 million or 16.2% of sales. Sequential sales across this segment varied widely, with XL Systems and NOV Flexible both posting improvements while sales of coil tubing and pressure pumping equipment declined sharply on lower backlogs and on customers delaying pick up of equipment they order in prior periods.

Turning to our capital equipment orders and resulting backlog for NOV Completion and Production Solution, the second quarter saw an order intake of $264 million and recognized $538 million of revenue, out of backlog, resulting in a book to build of 49%; and a quarter ending backlog of $1.2 billion down 19% sequentially. Orders were down 19% from the $327 million won in Q1, and of the total $1.2 billion backlog approximately 71% is offshore and 82% is international.

As we move into the third quarter of 2015 we believe revenues will be roughly flat with Q2 results. We expect revenue out of backlog to be in the range of $450 million. Lower revenues and continued pricing pressures across the segment should offset cost reduction efforts which will result in a slight margin decline in the third quarter.

We expect the next few quarters to be challenging in the FPSO space, but we expect to continue to help NOCs and IOCs develop cost effective solutions to improve the economics of offshore projects. Low oil prices have prompted these customers to reevaluate project scoping and seek ways to reduce cost. The Completion and Production Solutions segments is well-positioned to help.

Now let's discuss our financial statements. Working down the consolidated statement of income for the second quarter 2015 you will see the gross margin declined to 22.3%, generally reflecting pricing pressure partially offset by cost reductions. SG&A decreased 14% or $69 million sequentially due to cost reductions and was 10.7% of revenue. Other items were $17 million in the quarter due primarily to severance and facility closing cost costs.

Equity income decreased to $7 million, and we believe that will continue to fall through the remainder of the year due to the sliding demand for OCTG. Other expense for the quarter was $30 million which represents a $26 million delta sequentially, primarily due to fewer foreign-exchange losses and asset write-offs during the second quarter of 2015. The effective tax rate for the second quarter was 26.9% down from the 37.6% rate that we posted in the first quarter of 2015.

The first quarter's rate included a discreet foreign exposure which did not recur. The low second quarter rate reflects a much higher mix of income for low rate foreign jurisdictions which we expect to have a smaller effect later in the year. Looking forward to Q3 we expect the tax rate to be a little higher in comparison to the second quarter. EBITDA for the second quarter, excluding other items, was $627 million or 16% of sales.

Turning to the balance sheet our June 30, 2015 balance sheet employed working capital, excluding cash and debt of $6.1 billion, up $343 million or 6% sequentially. The increase was driven entirely by accrued taxes which declined $408 million in the quarter on a large cash tax payment. Other movements within working capital saw accrued liabilities and accounts payable decline which were offset by a decrease in accounts receivable down $548 million sequentially. Net customer financing, the net of prepayments and progress billings and cost in excess of billing was a use of cash of $124 million in the quarter due to our declining backlog in Rig Systems. Inventory ticked-up slightly due to delays in customers picking up frac equipment and negotiated delays in offshore rig deliveries partially offset by inventory reductions in almost all of our business units.

For the quarter, the Company generated $194 million in cash flow from operations, and capital spending was $104 million down 20% sequentially and 41% year over year. In the quarter, we also made dividend payments of $178 million and spent $447 million to repurchase 8.6 billion shares of NOV stock for a total of $2.6 billion in shares under our current $3 billion authorization.

Debt increased $60 million to $4.3 billion, and our net debt to capitalization was 9.3%. As a result we ended the second quarter of 2015 with a cash balance of $2.5 billion down $480 million sequentially. Of that $2.5 billion in cash 3% percent of the balance was in the US as of June 30, 2015.

With that we'd like to open it up for questions.

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## QUESTIONS AND ANSWERS

**Operator**

Thank you.

(Operator Instructions)

Jim Crandall, Cowen & Co.

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**Jim Crandell** - *Cowen Securities LLC - Analyst*

Good morning, Clay and Loren.

Clay, my first question was about acquisition strategy. And you've been great in terms of bolt-on acquisitions, but how is your acquisition strategy changing given the collapse of the industry? And is NOV becoming more proactive in regards to larger acquisitions?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes, I would say generally in a cyclical downturn, and this is one of many we've been through, our view is that it becomes much more of a buyer's market. The risk, I think, in transactions tends to go down a little bit. But it can be a challenging market to get deals done, because most companies don't particularly want to sell at the bottom. So it is a challenge making bids and asks come together and to reach a price that all parties view as fair and move forward.

So the way we have adjusted our strategy here is to increase the number of conversations that we are having, and these include both the smaller bolt-on deals that I referenced. I think we have had three close so far this year, and we've got another half-dozen letters of intent that we've entered into along with some larger transactions that we've reached out to some companies to begin to explore.

So what we are trying to do is approach this from really a portfolio standpoint. NOV is diverse in terms of what we do. We operate through 4 reporting segments and 15 business units, and we have exposure to a lot of areas. So there are a lot of potential targets that are interesting that can potentially answer strategic positioning, and statistically what we want to do is stay close to the hoop across multiple conversations to be ready when the stars align and when both parties can reach a price that we can both view as fair.

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**Jim Crandell** - *Cowen Securities LLC - Analyst*

Okay. Good. Okay. That's a good answer.

Secondly, Clay, it would seem that most companies who have ordered offshore rig packages from you have asked to stretch out the timetables under which those would be delivered, which would mean a sharper drop in the near term, but a more gentle decline as we get out into maybe 2018, 2019 and 2020.

Can you talk to that phenomenon, and how much it might affect -- or what kind of a drop you're looking at maybe in the next year or two in your offshore rig package deliveries, and how you would expect decremental margins to perform in that environment?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Well, you are seeing that phenomenon unfold here in real-time, Jim. In the second quarter results we have Rig Systems down 24% sequentially at 16% decremental leverage. So the group is done a great job managing decrementals down, and actually you saw a lift in their EBIT margin despite 24% lower revenues. But the shape you're describing is exactly what we foresee. As we push those deliveries out, it spreads the revenue recognition across more quarters.

As we explained on our last call, we benefit operationally because it enables us to execute these projects with our A-team and allows us to utilize our top-tier suppliers and execute the projects more systematically, less overtime, less interference between for instance our installation and commissioning teams and shipyard activities that for a quarter or two were going on in parallel, and we're trying to schedule around and step around each other on these rigs. So it actually is a better world to execute these projects and maximize the efficiency and returns on the projects, but the impact of on the top line is really baked in our guidance.

So we have -- we saw Q2 down 24%. I think for Q3 we are forecasting top line for Rig Systems to be down another 20%. I think then we maybe start to level out a little bit, and the quarter to quarter transitions become a little smoother. Not to say that revenue would continue to decline with backlog barring a big influx of orders, which we don't foresee at this time. So that's probably the most likely outcome.

But that's kind of the general shape of things. But again, I would stress we have great, experienced, teams managing this business. It is not our first choice to delay things, but the silver lining on that is that we are able to execute these projects more efficiently to manage costs of these projects, and you saw evidence of that in our second-quarter results we just reported.

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**Jim Crandell** - *Cowen Securities LLC - Analyst*

Okay. Good. Thank you, Clay

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

You bet. Thanks, Jim.

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**Operator**

Marshall Adkins, Raymond James.

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**Marshall Adkins** - *Raymond James & Associates, Inc. - Analyst*

It sounded, Clay, like you are somewhat optimistic about order recovery and Rig Systems back half of this year and going into next year. We've been running $250 million, $300 million a quarter. Did I hear that right? And if so could give us a little more color on why you think things could improve, at least on the order side, for Rig Systems?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes, a couple of things. There's a lot of conversations underway around land rigs, and I think generally our land rig customers are much more optimistic about recovering commodity prices driving higher levels of activity. And against that I would add it is almost unanimous now. The drilling contractors that we speak to all want to convert their fleets to AC power tier 1 rigs. And they recognize we are in a cyclical downturn, it gets tough to do.

They are cutting CapEx budgets, but longer-term they see this is where the market is going and to be relevant to remain competitive in that market they really need to offer the latest and greatest technologies. And, it's a way for them to differentiate themselves against smaller competitors who cannot who cannot afford to write a $20 million check to buy an AC tier 1 land rig. So I would say their strategic plans to upgrade their fleets are largely intact in North America. And then we've also seen that interest in AC land rigs spread to other markets.

So the Middle East is moving hard in this direction as well, adopting to new technology. Those tends to be bigger rigs, higher horse power, bigger ticket items. And then in South America there is still a lot of interest in the Vaca Muerta shale in Argentina and opportunities to add rigs there. So, generally, a higher level of optimism and a growing number of conversations with land drillers that could result in orders. I don't think it'll be a Q3 phenomenon, but Q4 we might start to see some orders flow in around land.

And then on the offshore, I think we are going to see a rising demand for offshore components going into the rigs that are working. And then we also have some conversations going on with drilling contractors that are affiliated with national oil companies. And these are drilling contractors that many on Wall Street have never heard of, but interested in buying more specialized rigs, rigs that are more fit for purpose to go to specific drilling programs around the globe.

We plunged into this deep freeze here through the first half of 2015, and I think midway through 2015 we're starting to have conversations now around -- with some customers that are looking past this maybe, and that gives us cause for hope that -- again, this won't be a Q3 phenomenal, but maybe Q4, and once we get into 2016 a little brighter outlook for orders.

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**Marshall Adkins** - *Raymond James & Associates, Inc. - Analyst*

Perfect. That's helpful. Follow-up, unrelated.

Where are we on the cost reduction curve? What inning or however you want to phrase it? Are we still fairly early in the game, or have forgotten most of the cost reductions in place?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Pretty well into it. It is unfolding through the year, but I would say we have got great leadership across our business units who have rolled up their sleeves and tackled the difficult challenge of reducing costs, having been through downturns themselves, and so I applaud the leadership of pushing through that.

There are additional measures to come, but I think a lot of -- perhaps most of the cost savings that we foresee are done. It also varies by business unit out there a lot. But it is well underway.

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**Marshall Adkins** - *Raymond James & Associates, Inc. - Analyst*

Seventh or eighth inning?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes, I'm going to stay clear of using baseball, other than you are seeing I think pretty good management of decrementals and sliding revenues showing up in the income statements. So I think there is good evidence that so far we are managing things closely.

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**Marshall Adkins** - *Raymond James & Associates, Inc. - Analyst*

Perfect. Thanks.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Thank you.

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**Operator**

Jeff Tillery, Tudor, Pickering Holt.

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**Jeff Tillery** - *Tudor, Pickering, Holt & Co. Securities - Analyst*

As I think about the more medium-term decremental margin potential within Rig Systems, so the guidance for Q3 would imply something in that high 30% range decrementals. As we think about longer-term backlog continuing to erode into 2016, is that a reasonable range to think about the absorption issues impacting margins?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes, there is a wide range of variable margins within the products that Rig Systems sells. Did ask about Rig Systems, right, Jeff?

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**Jeff Tillery** - *Tudor, Pickering, Holt & Co. Securities - Analyst*

Yes.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Okay. And so we foresee in the third quarter is we are going to revert to what is a more normal level of operating leverage for the business ex price pressure and some extraordinary cost things that were done. I would say in the absence of all other factors, that that business would normally move up and down somewhere in the mid to 30% range, and our guidance for Q3 really embodies that natural operating leverage.

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**Jeff Tillery** - *Tudor, Pickering, Holt & Co. Securities - Analyst*

I think about the potential cash generated out of working capital over the next two or three quarters, what order of magnitude you think is a reasonable expectation?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

We think we're going to make good progress. Our working capital has a lot of unusual moving pieces. As I've mentioned on my comments, we were a little disappointed it went up sequentially. That was entirely due to large cash tax payments, which was an extraordinary item that we had in the second quarter.

But even beyond that we have costs in excess of billings on our balance sheet and billings in excess of costs, both related to our POC projects, and they're a little unusual in that they represent, in the case of billings, an excess of cost cash payments our customers have made which -- it works like a deferred revenue concept. So as we worked that down we have already been paid the cash.

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**Jeff Tillery** - *Tudor, Pickering, Holt & Co. Securities - Analyst*

Sure.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

To be of use of cash as we execute those projects. We also have a couple other moving pieces here that I referenced in the call. Inventory was up just a little bit in Q2 which is unusual, given the decline in revenues, and that's related to the fact that as we have slowed delivery of these big offshore rigs we cannot slow our supply chain down to the degree that we would like. We are slowing it, but -- so we continue to take inventory in associated with those projects. We've got customers slow picking up equipment along the way, and so those two things contributed to inventory rising slightly.

The third may not be completely obvious, but for the last couple quarters we've referenced insourcing into our own machine shops and fabrication facilities, and if you think about that that actually uses working capital, because you are buying raw materials for your machine shops to process, and you're also paying your employees in real-time as opposed to outsourcing those to a vendor that may be buying raw materials, and a vendor that gets paid in a normal payable cycle. So a lot of moving pieces in our working capital. We do know it will come down, and I think it was predictable that the turn in working capital would be delayed a quarter or two. So we think directionally it is going to be coming down and become a source of cash, but I'm going to pull up short of quantifying it for you.

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**Jeff Tillery** - *Tudor, Pickering, Holt & Co. Securities - Analyst*

Okay. Thank you.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

You bet.

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**Operator**

Kurt Hallead, RBC Capital Markets

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**Kurt Hallead** - *RBC Capital Markets - Analyst*

I was curious. You bought back a chunk of stock here in the quarter. It has been 10% was what you stated since you implemented the program; average price $50, now stock price is $40. At what point do you think about sitting tight for a little while and gearing it more toward M&A?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Last quarter you remember Kurt, we said we're going to dial back the rate of share repurchases in view of M&A opportunities. We'll be watching it closely through the quarter now, too. But working at that more reduced rate. I think we have about a little over $300 million left on our authorization to go.

But, yes, what we're doing is balancing the opportunities we see on the M&A landscape and other opportunities to deploy capital against what we think is a terrific company trading below book value and an extraordinary buying opportunity. So that is a judgment call, but that is the calculus we will continue to be going through.

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**Kurt Hallead** - *RBC Capital Markets - Analyst*

All right. I appreciate that, and maybe to follow up on Rig Systems. The guidance range for some declined a couple hundred basis points or so plus a decline in margins, and again you're in that mode of excellent execution and delivery on the margin front and rate systems like you were in the prior cycle period. So what is the thought on the opportunity for your execution to actually deliver better than expected margins going forward?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes. You probably remember 2009, 2010, where -- I hope they're not listening, but our Rig Systems guys are really good at under promising and over delivering. You saw it in this quarter right? In the second quarter.

So just terrific execution by that team, and so yes we are guiding to more normal operating leverage for the third quarter. But they are very good at finding ways to reduce costs and improve efficiency. So frankly, I would not be surprised if we do a little better than that if history is a guide. But for the time being we will stick with our official guidance of margins down.

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**Kurt Hallead** - *RBC Capital Markets - Analyst*

That's all good. Thanks, Clay, I appreciate it.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Thanks.

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**Operator**

Jud Bailey, Wells Fargo.

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**Jud Bailey** - *Wells Fargo Securities - Analyst*

Thanks. Good morning.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Good morning.

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**Jud Bailey** - *Wells Fargo Securities - Analyst*

A question on aftermarket. Clay, I think you indicated you believe that your aftermarket business stabilizes in the second half of the year and then can potentially grow in 2016. Is that based on an expectation that the offshore rig count stabilizes. Can that still play out if the offshore rig count continues to trend down well into 2016?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

It gets more challenging with the rig count coming down, but really the basis for it is the fact that the installed base of NOV equipment is rising. The new rigs that are still being built, I think, there are outside of Brazil more than 50 floaters coming into the marketplace.

The new rigs have a much higher content of high technology NOV equipment that should be more aftermarket consumptive and a better opportunity for us as compared to the old rigs that are more likely to be laid down and scrapped. So the mix of rigs is the main basis for our optimistic outlook for Rig Aftermarket in the future. It is not purely a rig count-driven phenomenon.

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**Jud Bailey** - *Wells Fargo Securities - Analyst*

Okay. Thanks for that.

And then my second question is, just thinking about your revenue out of backlog, and it is a little bit early, but looking into next year, this year, you'll be pulling less revenue out because of customer delays from Petrobras and some of your other customers. But looking into next year, some of those delays, I assuming, could continue as operators or contractors push the rig deliveries out. But you'll also have more shorter cycle business that will be flowing through.

Do you think your revenue out of backlog increases from that low 50% range, or is more reasonable to keep it in the low 50s, or does it start to tick up with more shorter cycle businesses. How should we think that through?

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

I think you laid out the factors there pretty well. It's all very fluid right now. So I'm hesitant to get too many quarters out in terms of providing guidance around that. But you are right.

And the component work that should come back after opportunities to cannibalize begin to diminish for contractors both land and offshore, as well as maybe a little more demand on the land side. Depending on how that all plays out, I think that's going to drive the revenue out of backlog and the size of our backlog.

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**Jud Bailey** - *Wells Fargo Securities - Analyst*

All right. Thank you.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Thank you.

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**Operator**

Sean Meakim, JPMorgan.

**Sean Meakim** - *JPMorgan - Analyst*

We've heard quite a bit throughout the earnings season thus for from other parties of offshore talking about greater willingness on the part of E&Ps to re-examine how they are planning offshore projects. You touched on this in your opening remarks.

But could give us a better sense of how much of a delta heavy seen in terms of receptivity from FPSO customers in terms of costs saving solutions? Are we seeing -- it seems like it will take a bit of time before orders come through, but are we seeing a real step change, given the commodity price?

**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes, and honestly it's a real step change in attitude, but there are still a ways from signing purchase orders and sanctioning these projects. So you go back a couple years ago and a $100 a barrel world, there were problems with returns on some of the deepwater developments, but frankly, I think, less openness or less willingness on the part of our customers to consider more radical or more revolutionary approaches to changing how those projects are executed.

The silver lining of a $50 a barrel world has been we are now welcomed into those conversations with those customers. We're seeing our volume of engineering work, of FEED study type work around these projects within our FPSO group rising, and that's good, but we're not getting to the point where our oil company customers are necessary the trigger and sanctioning these projects and moving forward.

But the good news is it all starts with a re-engineering, retooling, re-scoping of these projects. You've heard of lots of examples in the E&P world that you referenced of oil companies taking out 20% -- 25% out of their development costs by resetting how they're going to execute these projects. I can only think that has probably helped in a lower day rate environment for rigs in a pretty hungry shipyard universe that can fabricate big steel structures for not much above cost these days.

So I think that will all help the economics of the deepwater. But suffice it to say huge reserves discovered in the deepwater, a lot of smart people at the oil companies with motivation to find new and better ways to develop those fields, and I think NOV is really well-positioned to help them through. And we are very pleased at the progress we have in conversations with a few of those oil companies here through the last few quarters.

**Sean Meakim** - *JPMorgan - Analyst*

All right. That all makes sense. Just to shift gear back to M&A for a second. Has the pending HAL-Baker merger and the pending divestments changed the strategy towards M&A at all? Does the outcome delay any other potential deals as folks wait to see what happens?

**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

Yes it's also a large merger. It spans a number of different subsectors in oilfield services, so there's implications for specific spaces within the industry specific marketplaces specific geographies. And so we are watching very closely how that comes together.

And so I would tell you strategically certainly it shaded our thinking. And what we would always try to do is think three or four moves out into the chess game. So what are the perhaps nonobvious implications of the Hal Baker merger? And so straight answer is yes, it has certainly shaded our strategic thinking. But they are both customers and we wish them well and we will see what happens.

**Sean Meakim** - *JPMorgan - Analyst*

Fair enough. Thanks Clay.

**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

You bet.

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**Operator**

Ladies and gentlemen, this does conclude today's question and answer portion of the conference. I would now to turn the call back over to Mr. Williams for closing remarks.

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**Clay Williams** - *National Oilwell Varco Inc. - President, Chairman, and CEO*

I want to thank all of you for joining us this morning and in particular I thank our employees for the terrific job that all of them do. So we look forward to updating you on our call in October. Thank you.

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**Operator**

Thank you ladies and gentlemen this concludes today's conference thank you for your participation. You may now disconnect.

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