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NOV - Q2 2012 National Oilwell Varco Earnings Conference Call

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OVERVIEW:

NOV reported 2Q12 revenues of $4.7b and EPS of $1.42.

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PRESENTATION

Operator

Welcome to the National Oilwell Varco 2012 second quarter earnings call. My name is Christine, and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. Please note that this conference is being recorded. I will now turn the call over to Loren Singletary, Vice President of Investor and Industry Relations. You may begin.

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

Welcome, everyone, to the National Oilwell Varco second quarter 2012 earnings conference call. With me today is Pete Miller, our Chairman, CEO and President of National Oilwell Varco, and Clay Williams, our Chief Financial Officer.

Before we begin this discussion of National Oilwell Varco's financial results for its second quarter ended June 30, 2012, 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 statements 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 affecting our business. Further information regarding these, as well as supplemental financial 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 I will turn the call over to Pete for his opening comments.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Earlier today, National Oilwell Varco announced second quarter 2012 earnings of $1.42 per share on record revenues of $4.7 billion. Excluding one-time transaction costs of $28 million, earnings were $626 million, or $1.46 per fully diluted share. Operating profit for the second quarter was a record $907 million, or 19.2% of sales. These results compare very favorably to the results of the second quarter of 2011, and are continuing proof of the efficacy of our business model, our M&A strategy, and our extensive product and service offerings to our customers. Additionally, today we announced a quarter-ending backlog of $11.3 billion. Organic new orders for the quarter were $2.2 billion, and new orders through acquisition totaled $500 million, for total new orders of $2.73 billion, or 1.5 times of book-to-bill ratio. We are very excited about these results, and they demonstrate the continued excellent execution and performance of our employees around the world. I will come back in a few moments with some brief comments regarding our operations, but at this time I will turn it over to Clay to provide more color on our results. Clay?

Clay Williams - *National Oilwell Varco Inc - CFO*

National Oilwell Varco produced solid results in the second quarter, delivering $1.46 per fully diluted share in earnings, up 28% from a year ago and up $0.02 or about 1% from last quarter, excluding transaction charges from all periods. Revenues were a record $4.7 billion, up 35% from the year earlier quarter and up 10% from the first quarter of 2012. All three segments produced record quarterly revenue during the second quarter. Operating profit ex-transaction charges was a record $907 million, up 27% from the second quarter of last year, and up 3% sequentially. And consolidated operating margins for the second quarter were 19.2%, excluding transaction charges. EBITDA was a record $1.084 billion for the second quarter. We have been investing heavily in our businesses, both organically and through M&A, and our second quarter results include a partial quarter for six businesses acquired during the period. These, together with a seasonal downturn we see every year in Canada, resulted in sequentially lower margins, down 130 basis points from the first quarter.

Operating leverage, or flow through, was 6% on the sequential revenue gain and 16% on the year over year sales increase as a result. Within our distribution and transmission segment, we were very pleased to acquire the Wilson distribution business from Schlumberger, and ENGCO, a Canadian electrical wire and cable distributor, which together contributed about $190 million for a few weeks during the quarter. And just last week, we completed our previously-announced acquisition of CE Franklin, another leading Canadian distribution business. These three businesses will serve to more than double the size of our distribution and transmission segment and, more importantly, enhance NOV's distribution channels across North America, opening up new channels for NOV products into midstream and downstream markets. We expect to achieve meaningful efficiencies over the next 18 months through combining ERP systems and securing greater volume purchasing leverage. Integration has proceeded quickly smoothly so far, and we are pleased to welcome the CE Franklin, Wilson and ENGCO employees into the NOV family.

Within the Rig Technology segment, the second quarter saw us add NKT Flexibles to our Subsea production equipment business, which compliments our APL turret mooring systems and other FPSO package components. Demand for Subsea equipment appears to be building after a slow 2011, and we have signed contracts for about $200 million in turret mooring systems since June 30, following a light bookings quarter in Q2. Recent third quarter -- third party reports from Quest Offshore, DDB Bank, Douglas-Westwood and others point to 100-plus FPSO installations through 2016, which would nearly double the existing fleet. With leading products in turret mooring systems and flexible flow lines, risers and jumpers for the Subsea, NOV is well-positioned to support this future growth.

The Rig Technology segment also acquired Enerflow, a leading provider of well servicing equipment in Canada, during the second quarter, which is being integrated into our well intervention and stimulation equipment group. We are excited about the new frac blenders and pumpers and cementers and other well service products and capacity this business brings for our franchise. We are effectively sold out of coil tubing equipment for the remainder of 2012. During the second quarter, we began to see a decline in new orders for pressure pumping equipment, but rising orders for coil tubing and Wireline units nearly completely offset this decline. Same-store bookings ex-acquisition effects fell only 3% sequentially for this group, so the businesses held up reasonably well. Nevertheless, we expect demand for pressure pumping equipment to continue to face headwinds in the short run, given slowing demand for pressure pumping services in North America. We expect this to be partly offset by international markets. Demand has continued to grow in Russia, China and the Middle East.

Enerflow, together with recent expansion CapEx, further strengthens NOV's already formidable position in the supply of critical hydraulic fracturing stimulation technologies that make shale play economics work. The Petroleum Services and Supplies segment acquired Zap-Lok pipeline systems within our Tuboscope unit late in the second quarter. Its revenue contribution during the quarter was therefore minimal, but we expect its low-cost mechanical pipe connection technology to contribute meaningfully to Tuboscope's Thru-Kote and UB sleeve connections, and internal tubular coating products in the future, by growing through our extensive international infrastructure.

Finally, the well site services unit of PS&S acquired a small company which holds patented technology using our water-based drilling fluid products. All in, we spent $2 billion in cash for these businesses in the second quarter, at an expected after-tax return on capital of approximately 14%. We expect to continue to find and close attractive acquisitions, and believe we find ourselves in a sweet spot in M&A. Sellers have the right mix of prosperity and fear, and we have a high level of conviction in our outlook for oil field markets. We also have a strong balance sheet and a proven record of solid cash flow.

As a group, these acquisitions closed in the second quarter illustrate well our expected returns and our strategies around capital deployment. First, they are all in oil and gas, and touch customers in markets we know well. Second, they are simple business plans. Some are large consolidating transactions, which we expect to yield meaningful efficiencies and economies of scales. Others are investments in new adjacent technologies that we can bring to market faster through our extensive worldwide infrastructure. Many bring follow-on opportunities for further growth investment. Still others are new additions to product packages where we seek to standardize offerings to reduce risk and complexity for our customers. In each case, they represent strategies we successfully applied many times in NOV's past. Third, we believe we bought these businesses at fair and reasonable valuations. We have acquired nearly 300 businesses between National Oilwell and Varco over the past 15 or so years and, on average, we close one transaction for about every seven that we look at.

We are making acquisitions full time, all the time, with a staff devoted to the effort, to ensure that we stay in practice and that the process remains as dispassionate and objective as we can make it. We remain close to the market so that our investment decisions are informed, objective and well reasoned, so that this isn't an ad hoc process subject to highjack by emotion. We run our discounted cash flow models through the pain and stress of down cycles and we press for good value. In short, we know the market. Fourth, we are experienced at executing due diligence and focus closely on what matters most. We usually avoid stepping in bear traps.

Finally, our operations managers are exceptionally good at integrating businesses, tackling organizational questions first, moving quickly and decisively. 300 acquisitions in 15 years means 300 integrations in 15 years. We have probably done everything wrong that you can do wrong on an acquisition, and frankly I wouldn't trade that experience for anything. Our integration processes are empirical and practical and they work. In addition to acquisitions, NOV has continued to invest in organic opportunities around the world, expanding manufacturing facilities for blowout preventers, top drives, drill pipe, tubular coating, coil tubing and units, pumps, power sections, downhole tools, composite pipe, marine connectors and after-market services. We are moving forward with a new test well research facility to ensure NOV's continued technical leadership on a variety of products. Our NKT acquisition brought with it a new flexible pipe manufacturing facility in Brazil. We expect our capital expenditures to total about $700 million this year, including a large flexible pipe plant in Brazil that NKT has underway. In the long run, deploying capital is arguably the most important function that management teams perform.

Investment decisions, both organic and transactional, have a profound impact on the profile of an organization 10 years hence. We make these decisions with precisely that long view. The deployments you see are the seeds of future cash flows and technologies and capabilities that will bring opportunities to continue to build and grow our Company. And they reflect a responsibility to our share holders, our customers and our employees that we take very, very seriously. We also rarely -- actually, we never -- time transactions perfectly. We serve cyclical markets and recognize that, soon after closing, we may be faced with more challenging market conditions than we expected out of the gate. We nevertheless proceed confidently for two important reasons. First, our business model is diversified within oil and gas. Early cycle distribution in Petroleum Services and Supplies businesses are juxtaposed on later cycle Rig Technology businesses, which empirically lag about seven quarters. And this has demonstrated compelling durability.

I point you to our performance during the 2009 downturn if you'd like to analyze this for yourself. NOV's balance between late and early cycle businesses enables us to shift resources from shrinking markets to expanding markets, making it incrementally easier for us to manage through down cycles than our peers. Second, and most importantly, our strategies around capital deployment at National Oilwell Varco work mostly because of the terrific employees that Pete, Loren and I have the pleasure of serving. It is tough to assume the leadership of a business just acquired, with lots of new, nervous employees, and take these new teammates to a new place of productivity and contribution. It is tough to open new plants in exotic locations, hundreds or thousands of miles outside of established supply chains, and smoothly deliver the high-quality products our customers expect. But we make capital investment decisions confidently, because we know our exceptionally capable operational leaders in the field will jump right in and make it look easy. We know that our teams can and will respond to market ups and downs decisively and appropriately. An for all these NOV professionals we work with, we are very, very grateful. They do a super job.

Turning now to our segment operating results, Rig Technology group generated revenues of $2.4 billion in the second quarter, up 6% sequentially and up 27% compared to the second quarter of 2011. Operating profit was $571 million, yielding operating margins for the group of 23.7%, down 70 basis points from the prior quarter. Incremental leverage, or flow through, was 14% sequentially and 11% year over year. Excluding the partial-quarter results from the NKT and Enerflow acquisitions, revenues increased 2% sequentially, and flow throughs were 31%. Operating margins on this basis were 24.5%, up slightly from the first quarter.

After-market sales increased 5% subsequently and 20% year over year and comprised 21% of the mix during the second quarter. We expect continued growth for spares and after-market services, given our recent capital investments in this area, along with the steadily growing installed base of new, high-technology rigs. Importantly, the very first floating rigs delivered this construction cycle are now approaching their fifth birthday, and we expect these rigs to begin to march into shipyards for their inspections soon, which will present NOV with new opportunities to sell spares and replacement, and upgrade capital equipment to these rigs.

Interest in new offshore rigs remains strong and steady. With limited deep water and harsh environment jack-up availability, IOCs and NOCs anxious about their production targets, leading edge day rates moving higher across a number of categories, ample capacity and pervasive hunger, and highly qualified Asian shipyards, and available financing, at least for established enterprises, our offshore drilling contractor customers find themselves in a uniquely attractive place. What I said earlier about capital deployment decisions having profound implications for the success of a business 10 year hence applies to them too, and they are planting the seeds for their future earnings and cash flow through fleet expansion.

The land business is a little slower. Our North American land customers are continuing to build rigs to which they have previously committed, but flattening to slightly declining day rates, very low gas prices, and slightly lower oil prices appear to us to have curbed their enthusiasm, at least partly. Five years ago, such a market mixture would probably resulted in a dead stop, but interestingly, I think they are merely dialing back a little now. The difference is, that there is a higher level of conviction amongst them in their need to retool their fleets to modern AC-powered, quick-move, electronically controlled, tier one rigs. Market conditions are moderating the pace of retooling, but retooling is moving forward nonetheless.

International land prospects are brighter. Markets are strong in Latin America, the Middle East and Southeast Asia in particular. These markets lag North America in adoption of modern rig technology, but if history is a guide, international markets will fully embrace these new technologies, and that trend appears to be moving forward. Second-quarter revenue had a backlog for the entire group increase 6% sequentially and 31% year over year, totaling $1.817 billion. This is more than offset by new capital equipment orders of $2.2 billion, plus another $511 million of backlog that came in with NKT and Enerflow acquisitions, for a total of $2.733 billion in new orders flowing into the backlog.

Second-quarter new orders included drilling equipment packages for six new floaters, including one for a shipyard in Brazil and five jack-up drilling equipment packages. Ending backlog as of June 30, 2012 was $11.280 billion, of which 14% was for land and 86% offshore, and 8% domestic and 92% international. Of orders on the books at June 30th, we expect approximately $3.9 billion to flow out as revenue during the remainder of 2012, $4.9 billion to flow out in 2013, and the balance to flow out thereafter. We delivered five floaters during the second quarter, bringing our total to 137 offshore rigs supplied to the industry since 2005.

Our order outlook for the third quarter is strong, as there are a number of drilling equipment packages for Brazil that have not yet been awarded. Additionally, there is interest in construction of floaters in Asia to fill the gap between now and delivery of the rigs out of new shipyards in Brazil, plus growing interest in new deepwater frontiers in West Africa, East Africa, a recovering Gulf of Mexico, the North Sea, and Southeast Asia. Included in these are inquiries around harsh environment semis. Most jack-up inquiries have come from smaller national oil company-aligned drilling contractors, who tend to be very price sensitive. Despite NOV's strong market position, we still face strong price competition from aggressive competitors, and overall drilling equipment pricing has never returned to 2008 levels.

Looking forward into the third quarter of 2012, we expect strong sequential sales growth, up in the high single digit percentage range, at roughly flat operating margins as compared to Q2. We expect startup costs associated with plant expansions in the US, softening shipments of North American service rigs, frac spreads, land drilling rigs, and higher revenues from lower margin FPSO products to be roughly offset by rising high margin new rig project shipments. The Petroleum Services and Supplies segment generated record revenues of $1.776 billion, up 4% sequentially and up 31% year over year. Operating profit was a record $393 million, and operating margins were 22.1%, down about 70 basis points sequentially. Compared to the first quarter of 2012, the $72 million revenue increase produced only 7% operating leverage, or flow through, due to Canada breakup and some mix changes I will detail in a moment.

Year over year flow through normalized for the seasonal Canada effect, and were therefore a more normal 35%. From a regional perspective, US revenues grew 5% sequentially, and totalled 55% of the segments mix in the second quarter. Canada declined 14% and totaled 7% of the mix, and international revenues increased 5% and totaled 38% of the segment second quarter mix. International growth was highest in the Middle East and Africa. As is typical for the segment, seasonal declines in Canada due to break up came at very high detrimentals, north of 70%, particularly in sales of downhole products and services. But these sales declines were more than offset by strong sequential performances from other parts of PS&S, including mission products and XL Systems. Drill pipe production increased 7% sequentially, to new record levels, driving sharply higher margins helped by favorable mix of premium four inch XT pipe. However, orders for drill pipe have slowed in recent weeks, and we are very cautious about the remainder of the year.

Demand for Tuboscope tubular inspection and tubular coating in North America, together with sequentially higher sales of mill equipment, led to slightly higher sequential revenues and margins there. Sales of composite and fiberglass pipe increased sequentially as well, with lower oil field demand in North America, more than offset by eastern hemisphere sales into FPSO construction projects carrying strong margins. Continuing incremental soft cost savings from the Ameron acquisition drove operating margins higher there as well. Well site services posted slightly higher revenues, but margins fell, due primarily to the Canadian break up effect and some pricing pressure in the US. As we enter the third quarter of 2012, we expect Petroleum Services and Supplies segment sales to begin to face some more headwinds in the North American markets, partly offset by continued growth overseas.

As US rig counts have flattened and may be trending downward, we are beginning to see what we believe will be a modest downturn in activity. Specifically, bookings for new drill pipe, drilling and well servicing pump products, and composite line pipe have all seen declines in the US in recent weeks, while other products within the segment, notably downhole tools, XL systems, and certain well site service lines, have seen sales trend higher lately. We believe commodity price softness will probably have an impact on drilling activity and potentially limit rig count recovery out of break up in Canada through the second half of the year. However, we could be wrong. With gas back up over $3, and with WTI now flirting with $90, the North American rig count may well stabilize, potentially even grow.

The Gulf of Mexico is marching steadily back to a robust level of activity, and we know of 58 new offshore rigs that we expect to order drill pipe over the next year and a half. Nevertheless, as of today, we see a little more caution in our North American customers' spending. Given that backdrop, with nearly 60% of segment revenues derived from North America, we foresee Petroleum Services and Supplies revenues declining 1% or 2% from the second quarter to the third, and post slightly higher -- sorry, we -- posting slightly lower margins.

Driven by acquisitions, the distribution and transmissions segment posted 38% higher sequential sales from the first quarter to the second, and 84% higher year over year sales. Revenues were $780 million and operating profit was $54 million. Operating margins were 6.9% of sales. Sequential flow through, or operating leverage, was 5%, and year over year operating leverage was 8%. Mix for the group's second quarter was 79% North American and 21% international. Almost all of the sequential growth was accounted for by the acquisitions of Wilson and ENGCO.

The legacy NOV distribution services portion of the segment saw its Canadian revenues decline 26% due to breakup, but its US and international operations offset the declines dollar-for-dollar. The recovery of offshore drilling in the Gulf of Mexico, project-driven valve sales into Azerbaijan, and higher North Sea activity contributed to the quarter sales. Higher sequential transmission sales of Ameron products were partly offset by lower Mono sales of industrial products and delays in international artificial lift projects in Latin America. Demand for Mono power sections for drilling motors remains very high. As you can imagine, the group is very busy integrating all of the acquisitions made through the past couple of months, and they are making great progress.

NOV's combined purchasing power across its now more than double distribution business is substantial, and we are working to capture additional savings from migrating to a single ERP platform. All in, we expect meaningful savings from the integration, which will make our new combined business more efficient. Looking into the third quarter of 2012, we expect distribution and transmission group revenues to increase substantially as we pick up a full quarter's results from Wilson and ENGCO, and almost a full quarter's revenue from CE Franklin. We expect margins to decline into the mid-5% range onto the new mix of business, along with North American activity headwinds I discussed earlier.

Turning to National Oilwell Varco's consolidated second quarter 2012 income statement, gross margin declined 160 basis points and SG&A increased $24 million, primarily due to the impact of acquisitions made during the quarter. SG&A as a percent of sales was 8.7% in Q2, down from 9.1% last quarter and down from 10.7% last year. Interest expense of $9 million is expected to rise to about $12 million or $13 million in the third quarter, due to debt taken on related to acquisitions. Equity income in our Voest-Alpine JV was $19 million, up $2 million sequentially on higher sequential OCTG and line pipe volumes. We expect equity income to decline in the third quarter, due to scheduled mill maintenance.

Other expense improved $8 million from the first quarter, due to FX and lower bank charges. The book tax rate for the second quarter was 32.1%, close to our expected rate for the remainder of the year of about 33%. Unallocated expenses and eliminations on our supplemental segment schedule was $111 million in the second quarter, up $10 million sequentially due to higher inter-segmental sales eliminations. Depreciation and amortization was $157 million, up $9 million from the first quarter due to new acquisitions. EBITDA excluding transaction charges was a record $1.084 billion, up $46 million sequentially to 22.9% of sales.

National Oilwell Varco's June 30, 2012 balance sheet includes total debt of $1.4 billion, an increase of $938 million sequentially, to finance acquisitions and domestic tax payments made during the quarter. Cash was $1.9 billion at quarter end, with approximately 88% of the balance located overseas. Consolidated working capital, excluding cash and debt, was $5.9 billion, or 31.2% of annualized sales, up $1.6 billion from the first quarter, due mostly to taxes and acquisitions. Inventory accounted for about 60% of our working capital growth, up $973 million, with $689 million of that flowing in from acquisitions in the quarter. Legacy NOV business has increased inventory $284 million, mostly in Rig Technology to support backlog requirements. Faster shipyard construction cycles are accelerating (inaudible) deliveries from us.

Other inventory growth occurred across numerous plant expansion initiatives we are getting up and running across all three segments. Domestic and international income tax payments drove accrue taxes down $441 million sequentially, and were a significant use of cash in the quarter. Cash flow used by operations was $253 million for the second quarter, due primarily to the income tax payments and other working capital items. CapEx was $140 million in the second quarter, and we expect it to rise in Q3 and finish in the range of about $700 million for the full year. So now let me turn it back to Pete.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

I want to make a few brief comments on some issues that I think are very important as we look to the future. On the last three or four conference calls, you've heard me expound loquaciously on shale, so I am not going to talk too much about shales today. But needless to say, for every segment of our business, shales are exceedingly important. They continue to be important -- I think especially in North America, and they are something that could continue to provide growth for us.

But the three things I'd like to emphasize today are, number one is our organic growth and what we are doing in plant expansion around the world. We really have some neat things going on. In particular, we have just started construction of a new facility in Russia. That facility will be building rigs. The Russians are in dire need of the technology that we have, and I think it's really going to be very, very important that we are able to do some things. When you see companies like Exxon moving into Russia, you know that the demand for quality equipment is going to improve, and I think that is something that is going to be important for us. And we are situating ourselves within about 1 year to 1.5 years, we'll be producing, I think, some fine equipment into that Russian market. But it's not just Russia.

We are doing things in Southeast Asia. We're expanding our fiberglass facilities down there. We're doing things in the Middle East. Basically, all over the world, we are expanding our facilities and our ability to be able to help our customers there. And what that really does -- and you will start to see that, I think, as we go out 1 year, 1.5 years, is it reduces our transportation costs tremendously. It puts us in a position to be able to take advantage of a lot of things that we have going on, and building the products that we are building and putting them in there, so that organic expansion is very, very important. And it really is important when you look at on a 5- to 10-year basis. Clay pointed out a lot of the things that we are doing on M&A but really, that organic expansion is one of the things that's really, really going to be a growth thing for the future.

Secondly, I think, is deepwater again. We are starting to see the Gulf of Mexico come back. That will be very beneficial to every one of the elements that we have in our Company. Every division is going to do well. But more importantly, look at the day rates that companies like Seadrill just signed up for. That is one of the reasons that we are very bullish on the fact that there will be more deepwater rigs constructed, and we like our position in that marketplace. So I think deepwater will continue to be a big theme for us as we move forward.

Finally, the thing I want to talk about is technology. We have so many good things in technology today, and when you are looking at this, everybody out there that's drilling wants the best they can get. And we are doing some really, really cool things. I talked last time about our Nova control systems, and we were able to show that to a lot of our customers at OTC, and they were very, very impressed. And I think that's a game changer.

That's going to be a product that, I believe, is going to be -- allow people to do so many things with automation and the like on drilling rigs that it really is going to position ourselves for wonderful growth into the future.

Secondly, you're looking at things like BOPs. We've completed, organically, a lot of R&D facilities over the last couple of years. We've invested heavily in this, because we know the industry needs the best products they can get. They need the most reliable products. They need the highest-quality products, and we are positioning ourselves to be able to maintain that status as we move forward. We have Helios bids, we have our vertical drilling machines, we have pipe handling for land rigs. We are continuing to raise the bar. When people say, well, we're going to compete with NOV because we're going to have these products, that's okay, because we're going to continue to raise that bar and have new products out there that are really going to guide us to the future.

I think those are the three things operationally that we are excited about right now. It is that organic growth, the resurgence, we believe, both in deepwater, the building continues, but the drilling is going to improve around the world, and then finally the technology. Those are the things we are excited about. We like where we are going. I think this quarter was a good quarter for us, especially in the order arena. And the good news is, every time we deliver one of those rigs, we have to support that rig for the next 25 years. And so, we like where we are. Christine, with that, I will open it up for questions that our listeners might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) David Anderson, JPMorgan.

David Anderson - *JPMorgan - Analyst*

Clay, did I hear you say $200 million award for a turret this quarter that just came in?

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes. It didn't show up in Q2, David. It was after the close of the quarter.

David Anderson - *JPMorgan - Analyst*

Okay, so this --

Clay Williams - *National Oilwell Varco Inc - CFO*

So, this will -- and actually it's not one turret. There's a number of pieces of equipment there, and a couple customers. But they aggregate to a lot of signings of orders here in just the past couple of weeks. It will show up in Q3.

David Anderson - *JPMorgan - Analyst*

Okay, because that was actually what I was wondering about. When you guys are bidding on rig packages, are you generally bidding on FTS? I think you and I have talked about this. Is it generally piecemeal? How -- what is the bidding process like right now with FPSO? It's sort of a new business for you. When you go into that, are you selling a package, are you offering a package, or is it individual pieces? And maybe you could also provide a little context in terms of what that bidding activity has been like in FPSOs now compared to -- I don't know -- six months ago or so.

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes. That is a great -- well, first, the answer to your first question is, the bidding process has been painfully slow here the last few quarters. (laughter) It's a market that's -- we're still recovering, I think, to some degree, from the downturn from '09. The good news is, though, it's distinctly recovering. Inquiries are rising and the like. We -- as you know, our strategy here is to try to offer more of a packaged offering of FPSO components and, in some way, change how that industry views these projects and execute these projects. And we think by doing that, we can improve the efficiency, we can drive more standardization. We are having a number of conversations that are very interesting, and some enthusiasm in those, with shipyards and others, about how -- what that might look like.

But that is a slow evolution and process, and so that is going on behind the scenes. In the meantime, we're in there bidding still more on a component-by-component basis and slugging it out. But our outlook is improving. NKT came in, and we've seen rising interest in their products for flexible flow lines which, of course, plug into FPSOs, and APL has a lot of good things going on, too. So our bullish outlook on market demand is as enthusiastic as it ever was, and pretty excited about what's out there over the next couple of years. One -- a final point to make here, though, is that I think the owner-operators of that PSOs -- there's a couple of large ones that have some -- it's well-known that they are struggling a little bit with their business models, and I think that's what our customers are sorting through right now. Who's going to own and operate these things, and how they're going to make money at it.

David Anderson - *JPMorgan - Analyst*

Kind of an opportunity from competitor weakness?

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes. Partly. Some of those owner-operators are vertically integrated. You know --

David Anderson - *JPMorgan - Analyst*

Right.

Clay Williams - *National Oilwell Varco Inc - CFO*

As you know, we don't want to own and operate --

David Anderson - *JPMorgan - Analyst*

Yes.

Clay Williams - *National Oilwell Varco Inc - CFO*

And we just want to sell components into them, but we are also taking a look at their business model and figuring out, what can we do to help them make a better return on investment? Ultimately, that's going to be the keys -- the path to success for us. If we can transform what we sell, make it more standardized, reduce the risk around building these large, complex vessels, and so that all parties have a better idea of what it's going to cost. There's less uncertainly for shipyards. There's less uncertainty for the owner-operators of these things. And that's a -- again, I will stress, it's a very long-term strategy that involves a lot of evolution of thinking across everybody that participates in this space. But the end goal is, I think, is an attractive place where the -- everyone involved here can make good returns and good profits on these projects.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

David, I might add, too, if you take a look at what we have done with drill ships, it's really been the exact model. If you go back to the mid-'90s and look how drill ships were built, and you look at how they are built today, it's totally different. And that's one of the reasons you aren't having the cost overruns, you aren't having all the issues you had back in the mid-'90s. We -- it's our desire, and I think it's our vision and we will get there, that we are going to replicate what we have done for drill ships with the FPSO market.

David Anderson - *JPMorgan - Analyst*

Great. Speaking of profitability, you're talking about Rig Tech margins being basically flat in 3Q (sic). I assume flat from the 24.5% number that you guys -- that's acquisitions, I assume, that was the number you were talking about.

Clay Williams - *National Oilwell Varco Inc - CFO*

We are going to quit reporting ex-acquisitions, because now everybody is part of NOV, but no, on -- let's say around 24% is what our forecast calls for right now.

David Anderson - *JPMorgan - Analyst*

Okay.

Clay Williams - *National Oilwell Varco Inc - CFO*

If you recall, as we move into Q3, we are going to have a larger contribution from a couple of acquisitions, NKT and Enerflow, because big margins, but they are not up where Rig Technology margins are. So as the mix moves more in that direction in Q3 compared to Q2, that will offset some of the margin improvements that we are expecting in the other parts of the base NOV business in Rig Technology.

David Anderson - *JPMorgan - Analyst*

Right. That was what I was actually getting at. I was just -- maybe if you could just help us understand a little bit of how the mix is shifting. Of course, we're all looking back at the past for --

Clay Williams - *National Oilwell Varco Inc - CFO*

Right.

David Anderson - *JPMorgan - Analyst*

To looking towards the future (laughter), and things are always changing with you guys in terms of your acquisitions. And, by the way, you don't have to justify your acquisitions with us (laughter). But, in terms of as we are looking out there with these different components, it sounds like your work through the lower price backlog on the rig equipment, and now the higher priced backlog is coming through. Can you just help us understand so -- I don't know, the last -- next year or so, how you see that playing out, and how margins start to uplift, and what we should be expecting?

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes. I think margins are going to gradually improve here, but I will stress gradually. And that may be after moving sideways again for another couple of quarters. The factors driving this are -- you cited a big one. We did get improved pricing on rig DEPs through 2011, mostly in the drill ship end of things and semi end of things. But that improvement is going to be mitigated by a couple of things. One is these two acquisitions coming in with a little lower margins involved, a pick up in results coming from APL. The turret mooring business, again, good margins but not as strong as the base Rig Technology margins. Headwinds in the land business, particularly in -- coming from our North American customers that I highlighted in my comments.

And that affects all things from drilling rigs to well servicing rigs to frac spreads and pressure pumping equipment. So its -- a couple of offsetting factors there. I would also throw in the fact that, with all the plant construction and expansion that is going on around the world, we have a lot of start-up costs and just took on, within KT, a very large plan in Brazil that's got some start-up costs that are going to -- it's going to carry as well. As opposed to where we were three months ago, six months ago, in terms of margin outlook, some negatives have popped up in the market. And also we have added in these businesses -- great businesses, good long-term growth prospects, but they are going to be a little more limiting on the margin here in the short run.

David Anderson - *JPMorgan - Analyst*

Great.

Operator

Marshall Adkins, Raymond James.

Marshall Adkins - *Raymond James & Associates - Analyst*

I'll try to keep it relatively quick here. The -- I think the biggest surprise for all of us was how well PS&S and distribution did, particularly given the declining North American rig count that we have seen. I certainly think of is, if the US rig count is falling in a meaningful way, and certainly Canada falling seasonally, that sequentially things will be pretty ugly but you're one of the guys that -- you put up pretty good numbers here, so (laughter) you did --

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Clay Williams - *National Oilwell Varco Inc - CFO*

Mark, you can take as much time as you would like [on that]. (laughter)

Marshall Adkins - *Raymond James & Associates - Analyst*

Well, I wanted a little more color on -- you mentioned drill pipe was one of the reasons why that happened. But just give us a little more color on both of those divisions, on why we didn't see the normal decline of business with the decline of rig count.

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes, drill pipe was the biggest single P -- I will focus on PS&S. Drill pipe is the biggest single piece. They just had a great quarter. There were some headwinds operational last quarter -- last couple of quarters that they worked their way through, and record level of production of drill pipe this quarter. They have never done as much. And also it's more focused in North America. That is not without much contribution from our Chinese plants. Just a super job by that group, and that drove great incrementals and good margins there. The other two standouts in the quarter, I would add, would be our XL Systems business, which we probably don't talk enough about. These are marine connectors offshore. They had a real solid quarter as well.

And thirdly, just an outstanding performance by our fiberglass pipe group. They took on the Ameron acquisition late last year, and that's -- this is a great little case study about some of the themes that I was speaking to earlier, in terms of how well we -- our guys can integrate businesses and make them profitable. They have just done a super job of rationalizing costs, of moving glass purchases over to lower-priced contracts, resin purchases over to lower-priced contracts to really get benefit the economies of scale. Doing away with duplicative overhead structures, that sort of thing. They had a terrific quarter as well. I would highlight those -- I would say all of our businesses did really well, but I would highlight those three in particular.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

And I might add, Marshall, when you look at the PS&S business -- and we've talked about this a lot -- everybody knows our position in the drilling rigs, and everybody knows what we do on drill ships and semi-submersibles. But when you start talking about names like Tuboscope, and Brandt, and ReedHycalog, and our downhole motors, and our fiberglass and all that, those are all market-leading names. And I think we have such good presence in the market that, even though there is some softness with the declining rig count, those market-leading names are going to be the last business that people get rid of. They're going to get rid of some of the folks that are chasing those market-leading names, but not those. And that's one of the reasons we're had -- we've had success.

Marshall Adkins - *Raymond James & Associates - Analyst*

And you aren't getting any -- on the distribution side -- you aren't getting any of the cost savings from Wilson blowing through yet. There's no way.

Clay Williams - *National Oilwell Varco Inc - CFO*

(multiple speakers) Not much.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Not yet. But we'll get it. But, again, we had -- what -- predominantly there wasn't that much of Wilson in the distribution numbers, and our distribution guys continue just to do a phenomenal job of what I call rubbing the buffalo off the nickel. Those guys control -- they control their costs about as well as anybody. And I think, as we integrate quicker and quicker with the Wilson deal, you will see the same sort of results coming out of that.

Operator

Jim Crandell, Dahlman Rose.

Jim Crandell - *Dahlman Rose & Co. - Analyst*

You mentioned a couple of times in your remarks about -- for perspective rig orders, that there was a fair amount going on in Brazil. Would that be for floaters built by Hyundai and Samsung, or would it be more orders for you out of yards in Brazil?

Clay Williams - *National Oilwell Varco Inc - CFO*

Actually we are seeing both. We are seeing a lot of interest on the [Seche] Atlas project that Petrobras is -- has sponsored in Brazil to be built in Brazil, but we're also seeing interest by drilling contractors who see an opportunity here to, as I described here earlier, to fill the gap. It's going to be a while. It will be several years before those rigs start flowing out of the shipyards in Brazil. And so, I think there is opportunities for drilling contractors to build reels with -- build rigs with Samsung, and Hyundai, and DSME, and others in Asia to potentially go to work in Brazil for three, four, five, six years before those Brazilian rigs come on. I think it's influencing demand in Asia as well.

Jim Crandell - *Dahlman Rose & Co. - Analyst*

Okay. Pete, is there any change in your view about how your traditional customers are approaching the new order market for drill ships in harsh environment semis? It seems that, as soon as they accept delivery, they're ordering more or exercising options and placing new options. Ensco with two more today. Do you just see this thing keeping -- barreling along and companies -- there will be a number of drill ships on the books for your traditional customers for 15 delivery in the next few months.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Yes, Jim, I think our outlook is really pretty consistent with what we talked about the last six months, and you are seeing it happen as some of these rigs come out, as they get contracted, people are ordering more. And if you look at the economics on it, the beauty of this -- and I tell everybody, just look at what the day rates are getting and then you can back into what these things are selling for, and the economics are pretty darn compelling. I think the number one -- we talked about this a lot, people need a newer rig fleet. They need the new technology that's out there and, if they are able to just keep churning and bringing these things on every couple of years the way they are, I think that's going to repopulate the rig fleet. It's going to increase the deepwater fleet, which is what you need. And so, we don't see any abatement in that, and we like where our position -- and being able to provide those rigs to our customers. So I'm pretty bullish that this is going to continue for some time.

Jim Crandell - *Dahlman Rose & Co. - Analyst*

Pete, correct me if I'm wrong, but have you said in the past that if Hyundai and Samsung keep their prices flat more or less, you will probably keep your prices flat too, especially given that many customers cite the lower cost of rigs as one of the reasons that they are in there ordering. Does that create any margin issues for you by -- if that is, in face, your strategy? Keeping your prices flat in here?

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

I think, Jim, our strategy, again, is going to be -- it's pretty simple. We watch what the drilling contractors are getting, and we know if they are getting a certain level, then our pricing can adjust accordingly. And so I think that is one of the things that we certainly are going to look at. If you start seeing rigs going out at $700,000 a day, that indicates that maybe you ought to be raising your prices some. But at the same time, the real advantage to us is efficiency. One of the things that, when I was talking about my comments earlier about the organic growth that we have had, one of the things we have done is invest and buy some companies in Korea. And that allows us to be able to reduce our costs. So, as we're reducing our costs, and even if we keep the pricing flat, that's going to give us margin enhancement. And that's really the key to everything that we try to do, because pricing -- as I tell everybody -- is somewhat ephemeral. It can go up and it can go down, but efficiency gains stay with you. And if you can do that, that's going to help your margins. We watch that pricing very, very closely, and we will adjust accordingly based upon what we think the economics that can be handled by our customers.

Jim Crandell - *Dahlman Rose & Co. - Analyst*

Okay. Last question, Pete. What has been your experience recently in terms of deepwater rig orders from traditional customers, in terms of them ordering additional VOP stacks?

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

It's happening, Jim. I think a lot of them are taking a couple of stacks per rig. We are having some of our traditional customers that are coming in and ordering one-off stacks now. I think everybody realizes the need for that, and I think that is going to be a business that is going to continue to be very, very strong for ourselves in that arena.

Jim Crandell - *Dahlman Rose & Co. - Analyst*

Okay. Great.

Operator

Brian Uhlmer, Global Hunter.

Brian Uhlmer - *Global Hunter Securities, LLC - Analyst*

I have two specific questions. Number one, we are talking about the five-year surveys and rigs coming back into the yard, and also want to address what potential upgrades and the opportunity per rig looks like? Are we talking about BOP control systems upgrades? Pipe handling? What type of equipment, and what do you think the opportunity per rig is on the five-years. And then number two -- or hitting some ten-years from the previous cycle, do you think there is some major upgrade opportunities, like the diamond rigs where you have $100 million-plus opportunity with those rigs?

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Brian, obviously the older the rig -- and especially a rig that's ten years older -- is going to have a lot more of an opportunity. And probably the biggest reason is because a lot of the equipment that's out there has changed so dramatically in technology. You're going to want to -- you might even want to swap out a top drive, and you might want to get a new age control system or a new age pipe handling system. And clearly you would want to look at the BOP and get the most recent muck system that you could have them -- the control system. So, the ten-year-old rig would be certainly, I think, a little bit more lucrative. The five-year-old rig, what you are talking about there is probably going to be a lot more of just refurbishment, and almost like taking your car in to get it tuned up and different things like that. And we are always reluctant to put a number, simply because there is differing levels of how equipment is taken care of.

And that's -- you might have one top drive that may be -- the diligence on the maintenance wasn't quite as good as it should have been, and that could -- a top drive overhaul could cost as much as $0.5 million. But another top drive may have had things going on continuously and a little bit better maintenance program. And so that overall might not be anywhere near as much. Might be $125,000, numbers like that. I will say this, they will be good numbers, but it's very difficult for us to give you something that says, this is absolutely what we would be looking at because there is too many variables. It's kind of a set-up quadratic equation. There's so many variables in there. But it is business that I think will be very good for us in the long term.

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes, a lot of the sales we make into these overhaul cycles, too, are dictated by E&P customers. The rig goes into the shipyard every five years -- probably most people are aware, but those that aren't -- they will get inspected for insurance certificates, for Coast Guard certificates, and the like. And most rigs are on a five-year cycle. While they're in, that's an opportunity for us to do this work. The customer that they are going to go to work for next, as they come out of the shipyards, will often specify equipment changes, upgrades and the like. And so that drives a lot of the equipment that we can sell into that project. Another potential opportunity for us is what we were talking about just a moment ago. I think some of these rigs are probably going to be looking at adding a second BOP, and looking and seeing whether that's feasible and the like. And so, that's a developing trend that may give this next round of five-year overhauls a little different flavor, too.

Brian Uhlmer - *Global Hunter Securities, LLC - Analyst*

Great. For my second question, a little bit on artificial lift. You mentioned delays there that had an impact on it. And they also mentioned, obviously, mono on the power section business remains very high. I would imagine that's also true for the progressive cavity pumps. I'm curious what product lines, outside of hydraulic lift and PCPs if you're expanding artificial lift, and how -- what order of magnitude that can grow to as we look through the next -- back half of the year?

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes, that's mostly within our distribution business, and so we are mostly selling items made by others there. But, along the way, our mono business manufacturers progressing cavity pumps, so that fits well. And we have, over the years, developed drive heads for those, rod pumps, some other technologies along the way. So I think we are gradually adding a few products here and there to expand our offering. But obviously, artificial lifts is a big market. We have a pretty interesting position in our distribution and channels to that market, and the specific things I was referring to in my comments were some -- we often sell into large projects overseas. And in this instance, we had one or two of those in Latin America that were delayed out of Q2 into Q3. So, that is what is going on there.

Brian Uhlmer - *Global Hunter Securities, LLC - Analyst*

Okay. I'll turn it back over after two.

Operator

Robin Shoemaker, Citi.

Robin Shoemaker - *Citigroup - Analyst*

Wanted to ask about Brazil. You had a rig order for -- a deepwater rig order. Was that a fully integrated package like the seven that you booked last year?

Clay Williams - *National Oilwell Varco Inc - CFO*

Yes.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Yes.

Robin Shoemaker - *Citigroup - Analyst*

It was, okay. Just in terms of timing of additional -- we keep hearing about the 33 rigs that are planning to build in Brazil. Sounds like seven plus one, eight, have been awarded the rig equipment package. What is the timing on the remainder, to your knowledge?

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Robin, if we could answer that with clarity, we would be certainly clairvoyant. (laughter) Our experience -- and we have a lot of experience in Brazil -- is, you work on their time. I would hope that probably you would see a lot of awards this year, through the remainder of the year, but that is a hope and not a certainty. The certainty is that awards will be made, but whether they are made through the remainder of this year, first part of next year, you never -- time has a different meaning. And this isn't something that's -- and I don't mean to be critical. It's just the process down there. It's the way it works. The good news is, rigs are going to be ordered and we like where we are. But the medium news is that, to give you an exact timing would be pretty close to impossible.

Robin Shoemaker - *Citigroup - Analyst*

Yes. Okay. I guess the eight that you have in backlog now. Are -- do you have specific scheduled delivery dates on all of those?

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Absolutely. Yes. We have -- just like we do when we work with a shipyard in Korea, Robin, we've got milestones. We know exactly how we are going along, what we're going to be doing, when certain things are going to be delivered. These projects are very, very complex, and we have milestones for both payments and deliveries of certain things. So we know exactly when these things should be delivered and how they are going to impact us. And that's one of the reasons, when clay talks about revenues out of backlog, we are able to figure that, because we have so many projects. We just backtrack through our milestone list to be able to give you the numbers.

Robin Shoemaker - *Citigroup - Analyst*

Okay. My other question had to do with the North America market. The drill pipe sales are slowing down and so forth. Are you seeing evidences that drilling contractors, land drilling contractors, are doing what they have done previously, which is to take equipment, drill pipe and other equipment off of vital rigs -- the so-called cannibalization phenomenon -- as more rigs are laid down? Or do you think that is less likely to be a factor? Because, when it does happen, it tends to exacerbate the sales drop of certain -- of drill pipe and other equipment more than, really, is the underlying demand, if you know what I mean.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Robin, I think you will see less and less of that. Actually I would say this. Number one, the drilling contractors have been very disciplined, especially when you look at other downturns. They have been able to maintain their day rates probably at a higher level than one would expect. But secondly, the real player over the last few years in the shales has been technology. And a lot of the rigs that you see that may get laid down, quite frankly might not come back to work again. Because it's the worst rig is the one that's going to be released. And even if one of the good rigs is drilling one of the wells that you want to stop on, you would still move that good rig to another well and release one of the older rigs. So I don't think you will see quite the same phenomenon.

Now, drill pipe is a little bit more fungible, and you will move drill pipe around. But I don't think you will see it when it comes to the rest of the equipment. And if anything, I would argue that, if there is a slowdown and then you come back up again, that bodes well for the equipment manufacturers because they're going to want to bring out the best equipment they can get, and that's where the technology factor comes in. You see things like the rapid rig and the ideal rig that we do. You see all the different rigs like the Helmerich & Payne and Patterson and Nabors all have out there. It's always, the best rig wins. So we think that, in the long run, that will probably bode well for us.

Operator

I would like to turn the call back over to Mr. Miller for closing remarks.

Pete Miller - *National Oilwell Varco Inc - Chairman, President, CEO*

Well, thank you all very much for listening in, and we look forward to talking to you at the end of our third quarter. Thank you very, very much.

Operator

Thank you, ladies and gentlemen. A playback for this call will be available through August 25, 2012 at 1-888-843-7419. This concludes today's conference. Thank you for participating. You may now disconnect.
