National Oilwell Varco, Inc.
Second Quarter 2020 Earnings
Conference Call Remarks

BLAKE MCCARTHY
Vice President, Corporate Development & Investor Relations

Welcome everyone to National Oilwell Varco's second quarter 2020 earnings conference call. With me today are Clay Williams, our Chairman, President, and CEO, and Jose Bayardo, our Senior Vice President and CFO.

Before we begin, I would like to remind you that some of today's comments are forward-looking statements, within the meaning of the federal securities laws. They involve risks and uncertainty, and actual results may differ materially. No one should assume these forward-looking statements remain valid later in the quarter, or later in the year. For a more detailed discussion of the major risk factors affecting our business, please refer to our latest Forms 10-K and 10-Q filed with the Securities and Exchange Commission. Our comments also include non-GAAP measures. Reconciliations to the nearest corresponding GAAP measures are in our earnings release available on our website.

On a U.S. GAAP basis for the second quarter of 2020, NOV reported revenues of $1.5 billion and a net loss of $93 million. Our use of the term EBITDA throughout this morning's call corresponds with the term "Adjusted EBITDA" as defined in our earnings release. Later in the call, we will host a question and answer session. Please limit yourself to one question and one follow-up to permit more participation. Now, let me turn the call over to Clay.

CLAY WILLIAMS
Chairman, President, and Chief Executive Officer

Thank you, Blake.

The second quarter of 2020 brought the full weight of the COVID-19 pandemic shutdown on the global economy, driving oil contracts to negative prices and the U.S. rig count to levels never measured before, perhaps the lowest dating back to the nineteenth century. Consequently, NOV's consolidated revenue declined 21% sequentially, and EBITDA fell to $84MM, or 5.6% of sales, as everybody in the oilfield hunkered down, cut costs, and prayed this storm would pass.

In the past, we've stressed that the ability to re-size quickly and aggressively is an essential skill in our cyclical business and is a core competency of NOV's line managers. In a few moments, Jose will detail for you our cost-reduction progress and expectations for the remainder of the year. As bad as this quarter was, it certainly would have been far worse without their decisive, aggressive actions. However, our customers are also pretty good at reducing costs and preserving cash, so, in addition to the operational headwinds brought about by COVID-19 facility closures, quarantine requirements, and travel bans, we also faced the rapid deceleration of business in many areas, as customers halted all but the most necessary purchases. In North American land in particular, the violent reaction felt almost involuntary, like a reflex. While a couple of our non-oilfield businesses showed growth in the second quarter, nobody in the oilfield was immune to this unprecedented collapse in the industry, as evidenced by all three of our segments reporting sequential EBITDA declines.

Even to those who have been through many downturns, the pace at which operators curtailed rig, completion, and even production activity during the second quarter was breath-taking. The average U.S. land rig count fell 50% sequentially in the second quarter, and the decline in U.S. completion activity was even more severe—well completions were down more than 70% quarter-over-quarter. The oilfield in North America reached a whole new level of pain.

On a consolidated basis, our NAM revenues fell 35% sequentially and mix declined to 28% from 35% during the previous quarter. Our Wellbore Technologies segment's revenues declined by 49% sequentially in NAM, accounting for nearly half of NOV's overall consolidated sequential decline of $387MM. Wellbore's products and services tied to drilling—downhole tools, bits, solids control services, and tubular inspection—were hit hard and hit immediately, falling 40-to-60% across NAM, as compared to the 57% decline in the average Baker Hughes rig count from Q1 to Q2. Pricing pressure ramped quickly as well, up to 15% in certain products, but desperate competitors grasping for liquidity are discounting far more, trying to hang on for one more payroll cycle.

Fortunately, pricing is holding up much better in most international markets, even though they, too, are experiencing steep declines in activity. Nevertheless, many of NOV's competitors won't quite make it to that next payroll cycle, and bankruptcies and liquidations are accelerating. For NOV, the silver lining of this is that our customers are shifting work to NOV because they know we will make it through this downturn and will be here for the long haul. We are seeing meaningful market share gains across many key product lines, albeit in much smaller markets.

Remarkably, the flood of oilfield assets onto the market at distressed pricing is leading to start-up companies. We are quoting equipment and consumables to a handful of fearless entrepreneurs seeking to augment fleets they've purchased at pennies on the dollar. And we're rooting for each and every one of them.

In past downturns, our Tuboscope business would typically see its tubing and sucker rod lines hold up better than drilling activity, as these are more closely tied to workover and production activities, and operators get quick paybacks and high rates of return on workovers. However, with millions of barrels shut in across the U.S., we saw workover- and production-related activity fall just as hard as the decline in drilling activity. The total number of joints and rods inspected in NAM fell 51% sequentially, and OCTG inventories exceed 12 months, as compared to 5-6 months in normal times. This has led to the shutdown of many domestic pipe mills for whom we work.

There is essentially no demand for drillpipe, rig spares, or coiled tubing strings in NAM land, as contractors are cannibalizing stacked assets aggressively, including pulling reels off of idled coiled tubing units. Additionally, coiled tubing strings are being run well past established fatigue life limits before they are being replaced, a trend that is further eroding demand. Eventually, this will lead to service failures, potentially lost wells, and heartbreak, but I guess desperate times call for desperate measures.

We are hearing that leading-edge dayrates for land drillers have fallen to $15-$18k per-day range, down from the low- to mid-twenties. This new, materially-lower level is likely only marginally above cash costs to run a drilling rig for all but the most efficient drilling contractors, and may in fact be cashflow negative when fully burdened for maintenance capex and direct rig-support overhead in areas like safety, logistics, insurance and sales support. The good news is that we are also hearing from many unconventional operators that they plan to add a rig or two in the second half, and will likely try to lock in these bargain dayrates. Additionally, NOV is being asked to bid one-year term pricing on certain wellsite services—historically a good leading indicator that some customers are planning on increasing drilling activity. While we may see a modest uptick in activity later this year, we intend to stay our charted course of continuing to re-size to the new market, having heard mythical stories of greenshoots at the bottom of prior downcycles. Hope springs eternal, and, sometimes in the oilfield, hope gets a little exaggerated.

Within the Completion and Production Solutions segment, our fiberglass and composite pipe business saw a similar sharp decline in NAM demand as oil and gas orders simply stopped. While international demand fared better, COVID-19 shutdowns prevented us from securing vessels to ship pipe overseas from our domestic plants, and a couple of our primary international plants, Saudi Arabia and Malaysia, were shut completely due to government mandates. While our team heroically pivoted supply out of Malaysia to China for our growing scrubber business, we found scrubber demand softening as shipyards slowed, and shipowners found conversions less economically necessary, at least for now, due to the tightening spread between diesel and bunker fuel prices. Offsetting some of the NAM oil and gas pressures was a very robust fuel handling market, where we are actually getting price increases.

Not surprisingly, demand for chokes, valves, completion tools, and pumps for North America also slowed very sharply. Although there are virtually no orders being placed domestically for pressure pumping equipment, we are hearing from customers that dual-fuel capabilities and other ESG-friendly offerings will be required by some customers on all future work. The offshore drilling space is experiencing a similar trend, which is driving more interest in our Powerblade and other ESG-friendly solutions from NOV. More broadly, customers, specifically majors, are mandating certain upgrades and capabilities as a requirement of new contracts. Even though the service sector has scant capital to invest in its service fleet, their customers, the oil companies, are requiring new and better kit because, well, they can. They have the negotiating leverage, and they use it in times like these to get what they really want.

We've seen this in the past: oil companies demanding—and getting—better capabilities and features in the equipment they hire. Don't be surprised to see this pressure grow and drive future orders for NOV. I believe that downturns sometimes force the service industry to up its game. The Varco top-drive product is a great example. It became a required feature if you wanted your rig to be competitive in tenders in the late 80s and 90s, at a time when rig margins were under similar pressure as today. This pressure by oil companies transformed the fleet and drilling techniques and, consequently, safety and efficiency. And despite the additional investment, this can be a good thing for the oilfield service companies that can pass this test: build, buy or rent, but somehow secure the necessary capability, win the contract, and emerge into a world where a few survivors with better kit will make up a more consolidated oligopoly with better long-term returns on capital.

Latin America is a mess, with widespread COVID-19 shut-downs, and our consolidated revenue there fell 29% sequentially. Excluding Latin America, the international markets have held up better than North America, declining about 8% sequentially overall. Nevertheless, at 750, the international rig count is the lowest since 2003, so markets remain challenging literally everywhere.

In the Middle East, mandated facility shutdowns are easing, but closed borders and logistical headaches remain. Our Rig Technologies segment's aftermarket business was hit hard by COVID-19 restrictions, falling 26% at high decrementals. In an effort to reduce COVID risks, offshore drilling contractors dramatically cut back any personnel going to or from their rigs that weren't drilling-related (or more bluntly: revenue-generating). Inspection, certification, upgrade, and, even, repair and maintenance activities were deferred and curtailed as a result. Spare parts orders fell 42% sequentially, hitting land more than offshore. Certain shipyards were also affected by COVID-19, further weakening our aftermarket business. On the cost side, requirements to quarantine two weeks before a job, as well as two weeks after a job, certainly didn't help our decrementals. Needless to say, against such a disrupted backdrop that also included oil company contract cancelations, not many offshore drillers felt like buying much.

Inquiries for offshore wind installations remained a notable exception for Rig Technologies. While orders in this area were low during Q2, it is clear that incumbent participants and new entrants alike are determined to move forward on vessels to support growing demand for offshore wind turbines in Asia and the U.S.

Back to oil and gas, many IOCs and NOCs are delaying projects, but we believe most are determined to eventually move forward with these. There is no doubt that FIDs will decline materially in 2020, but many customers are communicating their plans to move forward in 2021 or 2022, perhaps hopeful that they can squeeze more costs out of their supply chains in the meantime. The pipeline of projects we are monitoring for our Wellstream Processing business has actually grown YTD, underpinned by offshore gas, Brazil development, and LNG projects that need our proprietary MEG technologies.

With 35 years in oil and gas, I can't recall a more challenging time: the near-term logistical challenges of COVID-19 shut-downs; the collapse in oil demand and oil prices; the bankruptcies of so many good companies; the loss of jobs by so many wonderful hard-working people and friends; the tragedy of the many who have lost loved ones to this terrible virus. 2020 is a crucible for all of us, a year that is testing what we're made of. It's a year that will remake us, and a year that is remaking NOV.

Despite all the remarkable challenges, our NOV organization continues to improve efficiencies and business processes because our leaders are focused on what they can control and resisting distraction from issues they cannot. They continue to support the operations of our customers who are facing similar challenges. I can honestly say that I have never been prouder of this organization and the people I have the honor of working with.

In every corner of NOV, the organization remains focused on cost reduction and cash flow. We're adjusting our portfolio of businesses, improving our returns by exiting or divesting certain product lines. We're improving our capital deployment processes. We're expanding in higher growth areas like Saudi Arabia. And despite the operational pressures and disruptions, we're also continuing to invest in technology and new products.

As we pass through this crucible, this organization gets better every day, and when the phone starts ringing again, NOV will be the best company it has ever been. One day, the global economy will come out of this downturn and realize just how much it needs oil and gas. And when that happy day comes NOV will be there to supply the industry that makes the world go, with even better technology delivered by the best professionals in the world.

To all our employees listening, thank you for your perseverance during these difficult times. Your attention to detail, creativity, and willingness to go the extra mile during this crisis amazes me every day. Jose, Blake, and I appreciate all that you do. Stay safe and know that better days lie ahead.

With that, I'll turn it over to Jose.

JOSE BAYARDO
Senior Vice President and Chief Financial Officer

Thank you, Clay.

NOV's consolidated revenue decreased $387MM, or 21% sequentially as the global slowdown in oil and gas activity precipitated by the COVID-19 pandemic impacted all three of our operating segments. Despite the sequential fall in revenue, an intense focus on cost reductions and strong execution on existing backlog limited decremental margins to 24%, resulting in a $94MM decrease in EBITDA to $84MM.

In early 2019, we began an extensive effort to better align our cost structure with anticipated market realities, and when we saw early indications that the COVID-19 pandemic would drive economic shut-downs and an associated collapse in oilfield activity, we materially expanded the scope and accelerated the implementation of our cost-out initiatives. During the second quarter, we achieved an additional $320MM in annualized savings, bringing the total achieved to date to $570MM.

Despite nascent indications that North American drilling and completions activity could increase later this year, we do not anticipate that any near-term improvements would be large enough to move the needle associated with the massive current supply-demand imbalance for oilfield service tools and equipment; therefore, we continue to manage the organization with a lower-for-longer mentality. In doing so, we challenge every aspect of our organization to deliver ways in which we can drive further efficiencies and achieve acceptable levels of profitability and returns on capital, regardless of how difficult the environment. Yes, our actions involve implementing the traditional oilfield services downsizing playbook, a requirement to simply survive in this industry, but we're also pushing well above and beyond that game plan to drive every area of the company to execute faster, cheaper, and better than ever.

As Clay suggested, our customers, employees, and other stakeholders know that NOV is in this business for the long-haul, and we intend to emerge from this downturn stronger and more efficient. We are thoughtfully streamlining our operations, exiting product lines, and geographical markets that don't meet our return thresholds; driving more shared services; and investing in automation. All of which drive towards our ultimate objective, which is to provide better technology, tools and equipment for our customers from a smaller and leaner footprint, a more nimble and responsive supply chain, and a business that requires lower levels of working capital.

We are not cutting into the bone of our engineering and R&D capabilities, instead we are leveraging those talents to drive improvements in our product designs, not just so they operate more efficiently for our customers in the field, but also so they are less costly to manufacture. Our approach is iterative and relentless; we are always looking to improve.

This mentality drove us to identify another $75MM in annualized cost saving opportunities during the second quarter, increasing our year-end target to $700MM.

During our last call, we provided percentage breakouts of savings from direct labor, indirect labor, facilities, and other areas. Since then, we've received a few follow-up questions from individuals trying to better understand the composition of the cost savings and understand future implications. The simplest way to put it is that our reported cost savings number is the amount of cost we have intentionally and actively removed from our organization. The cost savings number does not include expenses that automatically decrease when volumes fall, like raw material costs and "normal" changes in direct labor hours. In other words, our stated savings are 100% structural changes that reduce expense above and beyond what is naturally embedded within normal decremental margins.

If you look at the change in our cost of goods sold and SG&A, excluding depreciation and amortization, since we began our cost savings efforts in early 2019, you can see that these expenses have decreased by more than $2B on an annualized basis, of which $570MM came from structural changes to our operations – this is the number we will continue to update through year-end.

Now moving on to cash flow.

Cash flow from operations was $378MM for the quarter and capital expenditures totaled $56MM, resulting in $322MM in Free Cash Flow.

Working capital continues to be a source of cash and declined $435 million, despite certain metrics that deteriorated due to customers fighting to preserve liquidity and an increasing proportion of our business coming from international markets, which typically have longer cash conversion cycles. In the second quarter of 2020, 72% of our revenue came from outside North America, which compares to 65% in Q1 and 59% in Q2 of 2019. We expect to generate positive free cash flow during the second half of the year despite the ongoing market challenges.

At June 30, our net debt totaled $582MM with $1.447 billion in cash and $2.0 billion in senior notes, of which $400MM mature in December 2022. We expect to pay the $400MM with our cash on hand prior to the maturity date, which would then put our next maturity at December of 2029.

Moving to results from operations and outlook.

Our Wellbore Technologies segment generated $442MM of revenue during the second quarter, a decrease of $249MM or 36% sequentially. Revenue from North America declined 49%, and international revenue fell 21%. Segment revenues declined less than overall drilling activity levels in every geographical region except for the Middle East, which was disproportionately affected by COVID-19-related facility closures. EBITDA declined $61MM sequentially to $42MM, representing 25% decremental margins, which would have been much higher were it not for quick and decisive actions taken by our team within Wellbore Technologies.

Our ReedHycalog™ drill bit business realized a 41% sequential decrease in revenue as a result of the collapse in drilling activity in the Western hemisphere and due to government-mandated shutdowns in the Middle East, which impacted bit manufacturing throughout most of the quarter and prevented deliveries in Saudi. Imploding demand is causing desperation and fierce competition, particularly within the U.S. where we are seeing certain competitors aggressively cut pricing. Our bit technologies have allowed us to steadily capture market share over the past several years and that technology differentiation is now helping us avoid having to match detrimental pricing concessions, a testament to the business' engineering team and their R&D efforts. While Western Hemisphere activity will continue to weigh on this business' results, the resumption of manufacturing operations in the Middle East, the start-up of recently-awarded tenders in the Eastern Hemisphere, and the flow-through of facility consolidation efforts are expected to result in a small sequential improvement in this business' results in the third quarter.

Our MD Totco business unit saw a 30% sequential decline in revenue due to the dramatic reduction in activity levels. Revenue from the unit's rig instrumentation offering declined 39% but was partially offset by continued growth from MD Totco's digital drilling automation and optimization solutions, which continue to gain greater adoption. During the quarter, we began executing on two additional multi-year contracts in the North Sea for our eVolve optimization and automation services utilizing our wired drillpipe technology. We also commenced several additional jobs using our KAIZEN™ surface drilling optimization software that uses artificial intelligence with continuous learning capabilities to optimize drilling performance. The business also recently commercialized its Data-While-Tripping tool, which enabled the first-ever formation pressure test using a high-speed real-time connection tool while the pipe was tripping. MD Totco has a deep pipeline of digital solutions under development that we're excited to tell you more about later this year.

Our Grant Prideco drillpipe business experienced a low double-digit revenue decline as the operation continued to execute on existing backlog. Outside of booking an order for a three-million-pound landing string, which will be the largest ever built, new order flow fell sharply. Q2 quoting activity was 73% lower than in Q1. Demand from the North American land market is near zero, where we expect it to remain so long as there is ample pipe available from stacked rigs to cannibalize. We are still pursuing multiple large, international tenders, but we expect many projects to push to the right and are therefore proactively preparing for volumes to drop significantly over the next few quarters.

Our Tuboscope business experienced a revenue decline of approximately 30% as its pipe coating and inspection operations were negatively impacted by falling drilling activity and sharply reduced demand from steel mills. Results in our Tuboscope operation are typically less volatile than other businesses within Wellbore Technologies, due to a slightly heavier weighting to workover and production activities; however, negative oil prices and shut-in wells didn't allow any of our operations to find shelter during the second quarter.

Our Wellsite Services business unit saw revenue decline approximately 50% sequentially, driven by the full quarter impact of our exit from the North American Fluids business, the sharp decline in North American drilling activity, and COVID-19-related shutdowns in Latin America and West Africa. While demand for solids control services will remain challenged near-term, we are seeing competitors exiting the business and customers coming back to NOV because they know we will be there for them over the long haul.

Revenues in our Downhole business unit fell 41% sequentially, resulting from the rapid decline in U.S. drilling activity, and COVID-19 lockdowns in Latin America and the Middle East. While we do not expect activity levels to improve in the second half, customers are focused on maximizing cash flow through any means possible, and we expect our leading-edge downhole technologies that improve efficiencies and lower costs to garner additional share.

For the third quarter, we expect the benefit of fewer COVID-19-related disruptions to be more than offset by meaningfully lower average drilling activity levels. As a result, we expect revenues for our Wellbore Technologies segment to fall another 15 to 20 percent with decremental margins in the mid-twenty to thirty percent range.

Our Completion & Production Solutions segment generated $611MM of revenue in the second quarter, a decrease of $64MM or 9% sequentially. Effects from the rapid deterioration in market conditions were mostly offset by strong execution on project backlogs built throughout 2019. Proactive measures to drive efficiencies and contract the footprint of our operations limited decremental margins to five percent. As a result, EBITDA declined only $3MM to $68MM or 11.1% of sales.

The economic contraction caused by the COVID-19 pandemic pushed many project awards to the right. Orders for the segment fell 42% to $196MM, resulting in a book-to-bill of 51%. Backlog at quarter end was $1B, down 16% from the first quarter. Most customers are telling us that they are not canceling projects, but rather postponing awards until the massive disruptions and uncertainty from the pandemic abate. While we take some comfort in this, we do not expect a near-term resolution of these issues and are planning for continued order weakness through at least the end of 2020.

Our Subsea flexible pipe and XL systems businesses each realized low 20% sequential increases in revenue due to strong execution on what were viewed as healthy backlogs coming into the year. Unfortunately, bookings were light in the second quarter with Subsea only achieving a 76% book to bill and XL systems realizing its lowest order intake on record. While backlogs are sufficient to support volumes near current levels through Q3 and we expect bookings to begin improving as more customers return to their offices, without a sizeable improvement in near-term orders, we expect our revenues to decline slightly in Q3 and see potential for a more pronounced decline in the fourth quarter.

Revenues in our Production and Flow Technologies business unit declined 6% sequentially. Strong execution on backlogs within the unit's offshore and industrial related businesses was more than offset by a 33% revenue decline in its production and midstream operations, which saw a sharp decline in demand from North America, and COVID-19 related disruptions, which limited the ability to deliver products and complete final customer acceptance testing for deliveries in the Middle East, Latin America, and Africa.

Our Fiber Glass Systems business unit realized a 21% decline in revenue due to significant disruptions caused by the COVID-19 pandemic. Multiple international manufacturing locations, including our new plant in Saudi Arabia, were shut down for several weeks, and products shipping overseas from our U.S. operations encountered extended delays.

Our Intervention and Stimulation Equipment business realized a 21% sequential decline in revenue as demand for coiled tubing and other consumables took a sharp step down and a number of international deliveries slipped into the third quarter. Strong execution of focused cost savings and efficiency improvement initiatives by our ISE team helped to mitigate margin erosion.

For the third quarter of 2020, we anticipate revenue from our Completion & Production Solutions segment will decline 2 to 5 percent with EBITDA margins decreasing between 200 to 400 hundred basis points.

Our Rig Technologies segment generated revenues of $476 million in the second quarter, a decrease of $81 million or 15% sequentially. EBITDA fell to $14 million, or 2.9% of sales, representing 52% decremental leverage.

Second quarter results reflect a small sequential increase in revenue from capital equipment sales, with a less favorable mix, and a 26% sequential decline in the segment's aftermarket business. The sharp drop in global rig counts caused many of our rig contractor customers, which were already under financial duress, to immediately cut spending on everything that would not result in a material disruption to active drilling operations. The large sequential decline in Aftermarket, coupled with operational challenges brought about by COVID-19, were the primary reasons for the unusually high decremental margins for the segment.

Last quarter we mentioned that bookings for spare parts fell sharply in March, and, unfortunately, we saw no improvement during the second quarter, which resulted in a 31% sequential decrease in revenue from spare part sales and a 42% decline in spare part bookings. Aftermarket services were also inordinately hard hit by the COVID-19 pandemic, not only due to intentionally deferred surveys, maintenance, and other non-essential spending, but also due to the logistical headaches caused by COVID-19. Closed borders, mandatory quarantines for crews coming on or off rigs, and delayed projects were part of a perfect storm that caused havoc for the operation's work schedule during the quarter. The only good news in this is that we believe current spending levels on aftermarket parts and services are not sufficient to sustain even the currently depressed levels of activity and must rebound in the future. Additionally, while lockdowns and mandatory quarantines remain an issue, more countries are attempting to reopen their economies.

The segment realized a 49% sequential decline in capital equipment bookings resulting in $74 million of orders and a book-to-bill of 34%. The segment ended the second quarter with approximately $2.8B of backlog.

The outlook for our traditional capital equipment business remains challenged near-term as drilling activity remains depressed and our drilling contractor customers do all they can to preserve cash while they fight for survival. However, we continue to see relative strength in the offshore wind market where we believe that up to 12 heavy wind-installation vessels will be ordered by the industry over the next few years. The prominent industry trend of improving offshore wind economics by using larger turbines, which use much longer blades, requires installation vessels that are substantially bigger than those built for the prior generation of wind turbine technologies. Each new installation vessel represents a revenue opportunity to NOV that is roughly equivalent to a high-spec jackup rig. We believe we are well positioned in this market and expect to win our fair share of the coming awards.

For the third quarter, we expect aftermarket sales to remain in-line with the second quarter and lower revenues from capital equipment projects, resulting in a four to six percent decline in revenue for our Rig Technologies segment. We also anticipate that ongoing cost rationalization efforts, a slightly improved product mix and fewer COVID-19 related extraordinary costs to result in EBITDA margins that are flat to up 300 basis points relative to Q2 levels.

With that, we will now open the call up to questions.