National Oilwell Varco, Inc.
Second Quarter 2019 Earnings
Conference Call Remarks

LOREN SINGLETARY
Vice President, Investor and Industry Relations

Welcome everyone to National Oilwell Varco's second quarter 2019 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 2019, NOV reported revenues of $2.13B and a net loss of $5.39B or ($14.11) per share.

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, Loren.

I'll begin by briefly summarizing our second quarter results, then I'll discuss working capital, the impairment charge, and our cost savings progress, before handing it over to Jose to delve into each of these topics in greater detail.

As Loren mentioned, in the second quarter of 2019 NOV generated $2.13B in revenue, an increase of 10% sequentially and an increase of 1% year on year. Adjusted EBITDA was $195MM, up $55MM sequentially, representing 29% incremental leverage to our first quarter 2019 results. EBITDA fell 14% YOY on mix and pricing pressure.

Each of our three business segments improved sequentially. Incremental demand for our capital equipment, consumables, and services from international markets drove sequential consolidated growth of 18%, which lifted our mix from international markets from 55% in Q1 to 59% in Q2. Revenues from North America were held flat sequentially, despite the second quarter pullback in activity in North America. Company-wide bookings grew for the third consecutive quarter as international operators continued to steadily grow activity around projects that have been waiting on the sidelines over the past few years.

NOV put up better sequential growth at the topline, but we did a poor job managing working capital this quarter, which was a use of cash due to slower payments from customers, declining payables balances, and modest inventory builds related to new orders and delayed acceptance of completed equipment by customers. This was disappointing in view of changes we have made and discussed publicly around better working capital management.

As a brief reminder, when NOV's revenues were declining in 2015, we implemented an economic-value-added compensation metric to increase the organization's focus on capital returns, including working capital. In late 2017, we observed that our working capital intensity was still too high, so we changed to a working capital specific modifier to incentive compensation, while keeping the economic value-added concept for longer term compensation. We witnessed some success in this arena during 2018 as working capital decreased as a percent of annualized revenue from 44% to 37%. However, our first half 2019 results reversed this trend and are going the wrong direction. NOV has a long track record of free cash flow generation, owing to the low fixed-asset-intensity of our business model. We will improve free cash flow through the second half of 2019 by making additional modifications and driving higher levels of accountability among our managers. Our working capital intensity remains too high and we will bring it down through the second half, which will improve cash flow, and Jose will expand on this more in a moment.

Next, during the second quarter the Company recognized a significant impairment of the carrying value of its goodwill and intangible assets arising from, among other factors, the higher cost of capital that many of our oilfield services customers are now facing. The second quarter saw the OSX index of publicly traded oilfield service firms trade off 14% sequentially, to levels not seen since the early 2000's, indicative of the challenging market expectations our oilfield services customers now face, as their customers, the E&P operators, adopt capital austerity and are doing more with less. Most of the intangible and goodwill impairment charge stems from large, public-to-public transactions that occurred in a vastly different market environment - one in 2008 and another in early 2013. Right-sizing the balance sheet in the second quarter was a necessary step, triggered by developments in the marketplace, that brings us in-line with current market expectations.

Turning to cost savings, last quarter we announced our intention to achieve a new annualized cost savings target of $120MM a year by further right-sizing of our organization, both corporate functions as well as operations. Through the first three years of the downturn we reduced personnel related costs $3B, and SG&A $1B per year, so these latest initiatives are additive to earlier efforts. During the second quarter the company enacted a voluntary early retirement plan, and embarked upon the redesign of several administrative functions, to move NOV closer to a shared services model. We achieved approximately $7MM in annualized savings that contributed partially to our Q2 results; more importantly, we identified and are executing dozens of changes to our processes to capture significantly more savings. We currently estimate that we can achieve $160MM in annualized savings based on these steps, which should be fully completed by the end of 2020. As we mentioned on the last call this is a heavier cost-savings lift than we've executed previously, since most involve some level of process redesign, and will take six or so quarters to fully enact.

NOV has always sought to cultivate an entrepreneurial culture, where our operating managers have real authority and autonomy over the critical strategic resources they need to execute their business plans. We will continue to give them this, in exchange for accountability and responsibility for earning a return on the shareholder capital, including the working capital, that they are entrusted with managing. We do not intend to change this formula. Rather, we are seeking to drive better efficiency from administrative functions, less overhead, and better pricing for common, non-strategic inputs they utilize in their business. Our revised cost savings target is expected to be comprised of roughly half coming from the corporate/shared services, and half from operational initiatives that will improve cost-of-goods sold and gross margins, including several facilities that we have closed year to date. While further reducing our footprint, these changes will not reduce our ability to respond to future increases in demand for the products and equipment that we are best known for. However, we are also currently reviewing certain products and businesses that are not earning an acceptable return, for possible closure or divestiture.

Before I hand it over to Jose, I do want to point out that I found much in the second quarter to be encouraged about. Topline outperformance versus the change in rig count, both in North America as well as international markets, together with sequential improvements in margins in all three segments, was enabled by new products and technologies we've brought to market through the downturn, many of which are highlighted in our significant achievements. Our organization is finding new markets for our technologies, in places like marine construction and offshore wind. Our targeted investments in areas like fluids and gas processing technologies, composite piping systems, the disaggregation of directional drilling services from equipment, etc., are built on our view that returns on capital, in the long run, are determined principally by competitive advantage. We continue to position NOV's businesses in thoughtful strategic ways, including the organic development of new products and technologies, to maximize competitive advantage and economic performance, and improve capital efficiency. We are encouraged by our improved order rates, and steady recovery overseas, and the internal steps being executed to drive better results.

To our employees listening: your hard work, perseverance and professionalism make NOV special, and I appreciate how you've responded to all that you have been asked to do to enable NOV to weather a tough oilfield downturn. Thank you. We have many friends here who will be retiring, and to our teammates who will be leaving us - NOV is a better organization for your having served here. Thank you.

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

JOSE BAYARDO
Senior Vice President and Chief Financial Officer

Thank you, Clay.

NOV's consolidated revenues improved 10%, or $192MM, sequentially as momentum continues to build in international and offshore markets, benefiting NOV's longer cycle capital equipment businesses. Revenues from international markets improved 18% sequentially, with all three segments posting double-digit growth outside North America. Consolidated company book to bill of 1.3x also reflects the improvement in international and offshore markets. U.S. revenues improved 2% sequentially but were offset by the Canadian spring breakup, resulting in flat sequential revenues in North America.

EBITDA increased $55MM sequentially to $195MM on 29% incremental margins. As Clay mentioned, we began executing on our cost savings initiatives in late Q2, realizing $7MM of annualized savings, which translated into a $2MM direct benefit to the quarter. We anticipate our realization of cost savings will accelerate over the next couple quarters and expect to see an additional $7.5MM benefit to the third quarter, or another $30MM in annualized savings.

During the second quarter, SG&A increased by $113MM, the vast majority of the increase was due to severance charges associated with our cost savings initiatives. We are required to record the expense when the company commits to an action, creating mismatches between when expenses are reported and when cost savings are realized.

As Clay mentioned, during the second quarter we took $5.8B in charges primarily against goodwill and intangible assets. The impairment will reduce our Q3 depreciation and amortization expense by approximately $45MM in comparison to the second quarter, which will result in total depreciation and amortization expense of approximately $110MM in the third quarter.

While 10% sequential revenue growth and the impact from impairments resulted in a slight improvement to our working capital as a percentage of our annualized revenue run rate, we were disappointed by the $73MM use of cash from operations.

The shift of our revenue base from North America to international markets, where time to build capital equipment and receipt of payments take longer, certainly create headwinds related to working capital; however, we know that we need to execute better. We are redoubling our efforts to improve management of working capital and continue to work toward our year-end goal of reaching a working capital to revenue run rate in the mid-30% range, which underpins our expectation of generating $300 to $500MM in free cash flow through the back half of the year. After improving our capital intensity through 2018, we've seen the first half of 2019 fall off trend, concurrent with our customer's hoarding of cash, but as Clay said, we are laser focused on reducing the capital intensity of our working capital through the second half of the year.

Turning to our results of operations.

Wellbore Technologies

Our Wellbore Technologies segment generated $850MM in revenue in the second quarter, an increase of $43MM, or 5%, sequentially. Improved volumes and cost savings drove incremental EBITDA margins of 40%, resulting in a $17MM increase in EBITDA to $134MM, or 15.8% of sales.

Revenue improved slightly in North America, where 2% sequential growth in the U.S. was mostly offset by the Canadian spring break-up. The segment capitalized on improving international market conditions to post a 14% sequential increase in revenue from international operations.

Our Grant Prideco™ drillpipe business recorded a sharp sequential improvement in its Q2 results. Customers in North America that deferred deliveries in Q1 took receipt of their pipe, and we continue to capitalize on improved demand from international and offshore markets. Inventories of drillpipe have fallen below record low levels, but customers in all major markets are capital constrained and are doing all they can to avoid spending. In North America, customers are slashing capex while rigs are coming out of service, but international and offshore customers have been forced to increase their spend to support rising activity levels and rig reactivations.

In the second quarter of 2019, international markets accounted for 66% of our drillpipe business unit's revenue, up from 42% in Q2 2018. Revenue from offshore markets reached 45% in Q2 2019, up from 17% a year ago. The shifting mix presents challenges, including longer lead times and payment terms, that are more than offset by the opportunities realized from a higher percentage of larger diameter premium products.

Our ReedHycalog™ business unit also realized strong sequential growth in its international operations, particularly in the Eastern Hemisphere, where revenues improved over 10%. This growth was led by the Middle East, Asia Pacific, and FSU regions and by a rapid expansion in the number of eVolve optimization service projects in the North Sea. Despite two quarters in a row of declining rig counts, the business unit posted a 6% sequential improvement in the U.S. during Q2 after realizing 7% growth in Q1. Technology leadership that delivers record results for our customers allows us to gain market share and grow our revenue. An example of how this works took place in the Midland Basin during the second quarter, where an operator tried out our technologically advanced 8½-in. Tektonic™ drill bit. The customer was able to drill an entire lateral section in one bit run at a rate of 283 ft/hr. Since 2016, this operator used five different bit companies and dozens of bit types to drill over 200 wells, yet our Tektonic bit significantly exceeded all previous lateral records.

Last quarter, we mentioned that our ReedHycalog business unit began executing on efficiency initiatives that could achieve over $20MM in annual margin improvements by the end of 2019. These initiatives helped drive incremental margins in excess of 70% during the second quarter.

Revenue in our Downhole business unit increased 4% sequentially. Strong growth in Asia, the FSU region, Africa, and Norway drove 14% sequential growth in the Eastern Hemisphere. In the U.S., growing operator preference for our line of advanced drilling motors, which continue to command premium prices, offset declining drilling activity. Improvement in Latin America was offset mostly by the Canadian spring breakup, resulting in relatively flat revenue in the Western Hemisphere.

Similar to ReedHycalog, technological innovation in our Downhole business unit drives our ability to gain share and grow revenue. Our Series 50 motors and high-flow ERT power sections continue to help operators set records for drilling efficiencies, and we believe our SelectShift™ downhole adjustable motor is ready to drive additional growth for this business. After extensive in-well testing at our R&D Technology Center and 30 field trials, the tool has drilled over 110,000 feet, run over 1,300 drilling and circulating hours, and completed more than 260 downhole shifts. With its ability to eliminate trips and improve both hole quality and ROP, it's not hard to foresee this tool becoming an industry standard for U.S. unconventional wells.

Our Downhole business unit is also making progress improving operational efficiencies. The unit is consolidating into fewer operational and manufacturing hubs and rationalizing in-field support infrastructure to better match activity levels in key markets. The changes serve to improve responsiveness to customers, streamline product development and deployment, lower costs, and reduce inventory levels. Efficiencies associated with these initiatives more than offset growing pricing pressures in North America for select products and services and allowed the business unit to post 36% incremental margins during the second quarter.

Our Tuboscope™ business unit posted a small sequential increase in revenue on increasing demand for pipe coating in international markets and further penetration of our TK® Liner product line in the Eastern Hemisphere. Improving international demand was partially offset by softening conditions in North America as well as downtime that resulted from two separate natural disasters that affected production at mills where we provide inspection services.

Lastly, our WellSite Services business unit saw a small sequential decline in its revenues. Strong sequential growth in the Eastern Hemisphere did not fully offset lower activity in North America, which impacted our solids control and fluids product offerings. While revenues contracted slightly, we received meaningful, multi-year awards in select international plays, including Argentina and West Africa, that will help lay the groundwork for future growth.

In the third quarter of 2019, we expect further declines in U.S. activity to offset continued growth in our international operations. As a result, we expect revenue for our Wellbore Technologies segment to decline between one to three percent. We expect cost savings will limit margin erosion to roughly 10 basis points.

Completion & Production Solutions

Our Completion & Production Solutions segment generated $663MM in revenue in the second quarter, an increase of $82MM, or 14%, sequentially. Revenue from international markets improved 23%, and revenue from offshore markets rebounded 18% from the bottom we established for our offshore businesses during the first quarter of this year. Higher revenues drove 29% incremental EBITDA margins, resulting in a $24MM increase in EBITDA to $52MM, or 7.8% of sales.

As we described last quarter, order inflows improved significantly during March, and the increased pace continued through the second quarter, resulting in total bookings of $548MM, the largest quarterly order intake we've captured since the third quarter of 2014. Our offshore-oriented businesses accounted for a disproportionate amount of the bookings, replenishing what we previously described as an uncomfortably low level of backlog and giving us confidence that our offshore businesses found bottom in Q1 of 2019. Orders outpaced the $379MM in shipments, providing us with a 145% book-to-bill. Total segment backlog at quarter end was $1.22B.

Our Fiber Glass Systems business unit realized a sharp pickup in revenues with strong incremental margins by executing on sizeable orders that came in late in the first quarter. Strong order inflows continued in the second quarter, allowing the business unit to post a 112% book to bill. The business continues to see healthy demand for large diameter composite pipe for produced water infrastructure in West Texas and for spoolable pipe in the Middle East. We've also seen a material pick-up in demand related to offshore vessel scrubber systems that are needed to comply with IMO 2020 regulations. During our fourth quarter call, we highlighted the potential opportunity associated with retrofitting scrubber systems for larger, modern vessels. That opportunity is playing out with bookings of over $30MM in the second quarter associated with the provision of highly customized, high-grade composite solutions for customers seeking an economic means to comply with this important regulation.

Revenue for our Process and Flow Technologies business unit improved 7% sequentially on strong demand from international and offshore markets. Our production and midstream product line realized market share gains in certain key products, helping offset declining activity in North America. The Wellstream Processing business within PFT realized a healthy pick-up in project activity, driving strong incremental margins. We were also awarded two additional LNG project-related monethylene glycol units in June, bringing the year-to-date total to three secured project wins, as well as two awards for FEED studies associated with potential future projects. We also won a sizeable award to supply a submerged turret production (STP™) system for a major deepwater gas and condensate project in the Bay of Bengal. The orders helped drive the business unit's book to bill of 2.7x and helped us achieve a record high backlog for this business unit at quarter end.

Our Subsea Production Systems business unit rebounded from a historical low in Q1, posting a 5% increase in revenue. Strong orders at the end of the first quarter continued into Q2 and resulted in a 38% sequential increase in bookings.

Finally, our Intervention and Stimulation Equipment business grew 16% sequentially despite the smallest contribution from pressure pumping related-equipment sales we've seen in roughly two years. Beginning in the second half of 2018, demand for newbuild pressure pumping equipment fell sharply, yet our order book remained strong as orders for our market-leading coiled tubing equipment surged, initially in the U.S. and more recently in international markets. During this time, we also maintained a steady stream of demand for wireline equipment, flow iron, support equipment, and the control systems that differentiate our completion equipment and that will drive our success as technology advances in the completion equipment space. The business unit is much more than a fabricator of pressure pumping equipment in the U.S. market, a fact that is reflected in our revenue mix, where more than half of our sales come from international markets and more than half comes from aftermarket and consumable product sales.

Looking at the third quarter, we expect our Completion & Production Solutions segment to execute well on the highest backlog we've had since the first quarter of 2015 and deliver topline growth in the upper single-digit range. We also expect our cost savings initiatives will push incremental margins into the mid-to-upper 30% range.

Rig Technologies

Our Rig Technologies segment generated $671MM in revenue in the second quarter, an increase of $68MM, or 11%, sequentially. Higher volumes drove an $18MM increase in EBITDA to $74MM, or 11.0% of sales.

Increasing offshore project revenues from two large projects booked in Q1 and early Q2 more than offset land revenues that declined due to the completion of two sizeable land projects and fewer land rig sales. The net result was a 14% sequential increase in capital equipment sales for the segment.

Rig Technologies capital equipment orders totaled $310MM, a sequential increase of $39MM, or 14%. Bookings outpaced shipments of $284MM, providing us with a book-to-bill of 109%. Total segment backlog at quarter end was $3.17B.

Headlining our order book were orders for the industry's first two 20,000 psi blowout preventers. The 20K BOP stack is designed for use in extremely high-pressure, deep-water reservoirs and will be an enormous technological advancement for the offshore industry as we seek to safely and efficiently drill more challenging reservoirs. Another order of note booked in Q2 was a record jacking system for an offshore wind construction vessel in Europe. NOV has played an instrumental role in the construction of wind installation vessels that have installed over 75% of offshore wind capacity in Europe. While this falls outside our traditional oil and gas markets, we have been able to leverage our core expertise in lifting and handling and in naval architecture to serve this rapidly growing industry.

In addition to the sizeable niche opportunities we've captured over the last few quarters, we continue to see healthy demand from our offshore customers for replacement equipment, for BOPs and cranes needed to equip new rigs that have been waiting for work in shipyards, and for upgrades such as crown-mounted heave compensators, multi-speed blocks, and advanced automation technologies.

We've also seen rapidly increasing demand for our NOVOS™ process automation system for the offshore markets and are scaling up our talented team of service technicians and software engineers to respond to the opportunity. To get a sense of the speed of adoption offshore, we installed our first system in September of 2018, and offshore systems now comprise 20 out of the 120 NOVOS packages we've sold to date. Operators and contractors are realizing the efficiency and safety benefits of our NOVOS system and are pushing to accelerate installations. Two anecdotes serve to capture the excitement we are seeing from our customer base with respect to NOVOS. First, a drilling contractor recently informed us of their intention to have NOVOS as a standard feature on every rig in their fleet within the next few years. Second, and perhaps more importantly, one large operator is now spec'ing NOVOS into their tender requirements.

In our land business, North American drillers continue to slow their pace of rig upgrades. As rigs come out of service, oil and gas operating companies are taking the opportunity to "high-grade" their fleets, replacing older, less capable rigs with higher grade rigs, allowing the Tier I AC Super Spec rig fleet in North America to remain well utilized, giving us confidence that upgrades will pick up once rig counts stabilize.

International land rig count is on the rise, and we continue to see pent-up demand for modern drilling technology; however, budgets are also tight in the international markets, and tenders continue to push. We are pursuing opportunities in the Middle East, Argentina, India, and other regions, but timing for when projects will be awarded remains uncertain.

Lastly, in our aftermarket operations, we continue to benefit from our installed base of equipment around the globe. Aftermarket sales increased nine percent sequentially and achieved 55% of segment revenue. Sales of spare parts continue tracking higher on steadily improving bookings. Q2 orders reached the highest level we've seen since the first quarter of 2015, a result of increased offshore rig tendering activity and the normalization of maintenance expenditures by customers that had deferred spending through the downturn. This normalization in maintenance spending is driving meaningful improvements in our repair business. We are working on 32 offshore rigs that are undergoing recommissioning, reactivation and/or upgrades, a slight sequential improvement. In addition to the pickup in active projects, we are also seeing a marked increase in the amount of capital equipment our customers are actively staging at our service centers. They are positioning their equipment so that we can begin work the moment they have line of site to a customer contract.

For the third quarter, we expect continued improvements in our aftermarket operations and increasing revenue from offshore projects to more than offset continued softness in our land capital equipment business, resulting in segment revenues improving between one and three percent with incremental margins in the 40% range.

I would like to turn the call back to Clay for few additional comments before we take questions. Clay?

CLAY WILLIAMS
Chairman, President, and Chief Executive Officer

Thank you, Jose.

Before we open it for questions, I want to take the opportunity to thank our Chief Investor and Industry Relations Officer, Loren Singletary, as he transitions to a customer-facing sales role in Wellbore Technologies. Loren has guided our investor relations effort for the past decade, and, Loren, our investors, Jose and I all appreciate the great job you've done here and wish you the best in your new role. IR responsibilities will be assumed by our Vice President of Corporate Development, Blake McCarthy, who will be joining us on future calls.

With that, we'll now open the call to questions.