Baker Hughes

First Quarter 2020 – Earnings Conference Call Prepared Remarks

Jud Bailey *Baker Hughes – VP of Investor Relations*

Thank you.

Good morning everyone, and welcome to the Baker Hughes first Quarter 2020 Earnings Conference Call. Here with me are our Chairman and CEO, Lorenzo Simonelli; and our CFO, Brian Worrell. The earnings release we issued earlier today can be found on our website at bakerhughes.com.

As a reminder, during the course of this conference call, we will provide forward-looking statements. These statements are not guarantees of future performance and involve a number of risks and assumptions. Please review our SEC filings and website for a discussion of some of the factors that could cause actual results to differ materially.

As you know, reconciliations of operating income and other non-GAAP to GAAP measures can be found in our earnings release.

With that, I will turn the call over to Lorenzo.

Lorenzo Simonelli *Baker Hughes – Chairman & CEO*

Thank you, Jud. Good morning everyone and thanks for joining us.

The first quarter of 2020 was challenging for Baker Hughes and the rest of the industry due to the turmoil and economic fall-out created from the COVID-19 pandemic, as well as the significant decline we saw in oil and gas prices. Even with these ongoing disruptions, we produced solid results in our TPS and OFS businesses during the quarter and generated over $150 million in free cash flow despite typical seasonal headwinds.

Overall, I am extremely proud of our team for their level of focus and perseverance through an extraordinary set of circumstances. The strength of our company and diversity of our product portfolio is most apparent in times like these. From the execution of our HSE, operations, and supply chain teams in the face of a crisis, to the continued emphasis on maintaining our balance sheet strength and the strong backlog of our work in our TPS segment, Baker Hughes is uniquely positioned to navigate the challenges we face as an industry.

Since we last spoke on our fourth quarter earnings call in late January, it is an understatement to say that the macro environment has changed rapidly. The sudden demand shock to global GDP from COVID-19 combined the with rising global oil supply drove a 67% decline in oil prices during the first quarter. Looking forward, the outlook for oil supply and demand appears equally uncertain.

On the demand side, US GDP is forecasted to decline by 40% or more in the second quarter while global GDP is expected to contract meaningfully for both the second quarter and the full year. This economic shock is estimated to negatively impact global oil demand by 20 to 30 million barrels per day in the second quarter and by 9 to 10 million barrels per day for 2020 as a whole.

On the supply side, recent events have proven even more dynamic, with initial indications in March of a likely increase in production from some of the world's largest producers during the second and third quarters. There are now signs that the dramatic collapse in oil demand and the quickly growing threat to global storage capacity could prompt a quicker supply response with production shut-ins in the US potentially complementing production cuts that were agreed to by the OPEC Plus countries last week.

For the natural gas and LNG market, the excess supply the industry encountered earlier this year is likely to be compounded by the decline in economic activity. However, we also agree with the view that the gas markets may correct slightly faster than oil markets, as the decline in associated US gas production could lift North American prices sooner than previously thought. Longer term, we remain positive on the medium to long-term outlook for natural gas and LNG prices as well as LNG's role as a transition fuel and as a destination fuel.

Considering these factors, 2020 will likely continue to be a very difficult year for the energy sector due to the magnitude of near-term oil demand degradation, regardless of the outcome on the supply side in the coming months. Looking into 2021, the outlook remains unclear, and it will largely be driven by the pace of economic recovery from the COVID-19 pandemic and the supply response that ultimately materializes.

As a result of this uncertain market, we at Baker Hughes are taking multiple steps to prepare for what is likely to be a sharp reduction in activity levels and delays to project FIDs.

For our OFS segment, we now believe that North America drilling and completion spend is likely to contract in 2020 by at least 50% versus 2019. This view is based on our conversations with customers, the wave of recently revised E&P budget announcements, and our own expectations that private operators are likely to act in a similar or more severe fashion than public E&Ps.

The higher percentage of production-related businesses in our North America portfolio typically acts as a buffer to the more volatile drilling and completion related product lines. However, we would caution that in the current environment we may not see as much resilience as operators look to conserve cash. We believe this could impact sales of ESPs and production chemicals as customers shut in wells and Lower 48 production likely declines over the next 12 to 18 months.
Internationally, we expect that the combination of lower oil prices and impacts from the COVID-19 pandemic to contribute to a double-digit decline in spending in 2020 versus 2019. Regionally, we expect Latin America and Sub-Saharan Africa to see the sharpest near-term declines followed by the North Sea. In the Middle East, we expect the combination of ongoing projects and the emerging natural gas focus could make spending modestly more resilient.

On a longer-term basis, we believe that a key consideration at the other end of this crisis will be the role of North American shale versus other low-cost producers in meeting global demand. While it is still too early to predict, we believe it is prudent to contemplate a shift in this balance over the next few years relative to what we have witnessed over the last decade.

For Digital Solutions, which is the other short cycle business in our portfolio, we expect revenue and margins to remain under significant pressure in the near-term, before normalizing in the second half of 2020 assuming improving economic activity. As a reminder, we have typically framed DS as a diversified GDP-plus business with exposure across a broad number of end markets from oil and gas to power and other industrial markets.

Given its presence in North America, Europe and Asia Pacific and its exposure to end-markets like aerospace and automotive, we expect that orders and revenue for DS will likely be meaningfully impacted by global GDP declines as well as oil and gas trends.

For the long-cycle businesses in our portfolio, which are primarily driven by LNG and offshore development, we expect that the combination of constrained customer cash flow and economic uncertainty will likely delay a number of projects. In our OFE segment, we expect to see industry subsea tree orders around 100 trees or fewer versus the last two years of approximately 300 trees ordered annually.

For TPS, we expect the uncertain environment to result in fewer LNG FIDs in 2020 as operators delay sanctioning decisions in order to better assess the economic and commodity price outlook. We expect to see a similar dynamic for the Onshore/Offshore Production segment within TPS, with only a few large-scale offshore projects likely to move forward this year.

In order to navigate this uncertain environment that will undoubtedly lead to lower activity levels, we have taken decisive actions in our effort to cut costs, accelerate structural changes, and deploy technology and optimize processes that can lower costs for our customers.

We have cut our expectations for capital expenditures by over 20% compared to our prior estimate and have also begun to execute on a restructuring plan that we expect will drive around $700 million in annualized savings across our organization. These cost savings will be derived from reducing our headcount, manufacturing footprint, and overhead costs for lower activity levels across multiple geographies.

These cost-out initiatives are designed to respond to near-term activity declines, as well as anticipated longer-term structural changes for the industry. Some of these actions are an acceleration of the broader structural changes we have outlined over the past two quarters in order to drive improvement in margins and a greater level of operating efficiency.

In addition to the acceleration of many of these initiatives, the early stages of this downturn have also encouraged the deployment of cost-saving technologies with a growing number of customers around the world.

One example of this is our capability in remote drilling and completion operations. After establishing a successful remote drilling track record in the Marcellus basin, the North Sea, and China, we are having promising discussions with several customers about utilizing this technology going forward in an effort to lower operating costs.

Another example of pushing forward with new technology is our ability to run a virtual string test, a process that proves the engineering, functionality, and performance of our turbomachinery equipment. We recently performed a virtual string test on the first compression train for Venture Global's Calcasieu Pass project, which used cutting edge virtual technology to connect 21 people in five cities around the world to facilitate, run, and observe the test.

Despite the downturn facing the industry and the cost-out initiatives we are executing, our corporate strategy remains clearly focused on being the leading energy technology company to help the industry facilitate the energy transition.

Now more than ever, our customers will demand technology and solutions for increased productivity and efficiency, both to achieve their carbon reduction goals and to navigate the current macro environment. This gives us an opportunity to engage with them on new commercial models focused on outcomes, and new technical and operational solutions focused on improving efficiency and maximizing value.

Alongside our commitment to energy transition, we will continue to execute on our portfolio evolution strategy to reshape the company over the coming years. The current market environment reinforces our view on this strategic objective.

Given the already challenged outlook for some product lines to generate financial returns, which will be compounded by the decline in commodity prices and forecasted reduction in activity levels, we are accelerating the exit of non-core product lines in multiple countries around the world. For example, in North America we are shutting down our full service drilling and completion fluids business and also ceasing operations in a number of smaller, commoditized completions-driven businesses.

Although the near-term focus on our portfolio are divestitures and some product line exits, we will continue to evaluate opportunities to invest or partner in areas that generate more stable earnings and higher returns. These actions align with our objectives of transitioning the portfolio to a higher mix of industrial and chemical end markets and capitalizing on energy transition-related growth opportunities.

Before I turn the call over to Brian, I want to emphasize that the Baker Hughes portfolio remains uniquely positioned; our strong backlog of longer cycle projects and aftermarket services provides stability while our shorter cycle businesses encounter pressure from the dramatic declines in activity. This balanced portfolio operates across the energy value chain and makes us uniquely positioned to navigate the challenging market environment the industry is currently facing.

With that, I will turn the call over to Brian.

Brian Worrell *Baker Hughes – CFO*

Thanks, Lorenzo.

I'll begin with an overview of how we are positioning Baker Hughes to navigate the challenges of this new macro environment. I will then walk through our results for the first quarter and provide an update on our outlook as we see it today for the remainder of 2020.

After protecting the safety and health of our employees, our focus is first and foremost to maintain the financial strength of the company as we manage through this downturn. We are committed to taking all necessary actions to right-size the business for the activity levels we expect to see over the coming quarters.

As a first step, we have approved a plan for restructuring and other actions totaling $1.8 billion, and we recorded $1.5 billion of this amount in the first quarter. These charges are primarily related to the expected costs for reductions in work force, product line exits in certain geographies, and the write down of inventory and intangible assets.

These actions are taking place across the business and our corporate functions as we align our workforce with anticipated activity levels and remove management layers. We expect cash expenditures from this restructuring plan to total approximately $500 million, and for the cash payback to be less than one year.

Given the projected magnitude of this downturn and other structural changes that could continue to evolve for the industry, we conducted a very thorough process to identify additional cost-saving opportunities and further improvements to our overall operating efficiency. We feel very confident in our ability to generate significant cost savings from these initiatives in a short period of time and believe that these actions position Baker Hughes to generate better returns and cash flows in the future.

These restructuring initiatives can be segmented into three major categories. The first, which is the largest, are reductions in our headcount and facilities footprint to adjust for lower levels of activity. The majority of these cost savings will come from OFS and OFE.

The second category is the acceleration of broader structural changes we were already planning and have outlined over the past two earnings calls. These initiatives include accelerating our transformation efforts in global procurement and supply chain, shifting and consolidating our manufacturing base, and expanding the use of remote operations and multi-skilling on a global basis.

The initial target of this plan was to drive significant operational and cost improvements in our service delivery capabilities over 24 months. Although volume levels will clearly be lower than when we initially developed this plan, we believe that we can still capture many of these cost savings.

Also included in this category are some of the product line exits that Lorenzo mentioned, which accelerates the portfolio initiatives we introduced last September. By exiting some of the smaller, commoditized business lines in our portfolio, we will be rationalizing a small percentage of our OFS revenue base that is dilutive to overall OFS margins and returns, allowing us to focus more on our core strengths. We will continue to evaluate the portfolio as this market cycle unfolds, acting where required to address businesses that do not meet our return requirements.

The third category is simplification across the product companies and our entire organization. Through this process, we have identified opportunities to streamline certain functions and are taking meaningful steps in accelerating the flattening of our organizational structure. Not only will these actions help to lower costs but should also lead to better-informed decisions and faster response times to customer needs and changes in the ever-evolving business environment.

Overall, we estimate that the annualized savings from these restructuring initiatives are around $700 million, which we plan to achieve by late-2020.

Next I will turn to liquidity and the strength of our balance sheet. Over the past two and a half years we have remained disciplined in order to prepare the company for potential periods of extreme volatility or a prolonged downturn. Based on the current macro outlook, we will likely be facing both.

Our goal through this downturn is to remain disciplined in our capital allocation, focus on liquidity and cash preservation, and to protect our investment grade rating while also maintaining our current dividend payout. While some strategic opportunities may arise from this downturn, we will remain diligent and financially conservative.

We continue to view our financial strength and liquidity as a key differentiator. Cash and cash equivalents totaled $3 billion at the end the quarter, which is further supported by a revolving credit facility of $3 billion and access to commercial paper and other uncommitted lines of credit. At the end of the quarter, we had no borrowings outstanding under the revolver, the commercial paper program, or uncommitted lines. Our next debt maturity is in December 2022.

We have taken several actions to help the company navigate through this uncertain environment from a cash perspective. Our revised expectations for lowering net capital expenditures by over 20% versus 2019 is an important part of our plan.

We also continue to evaluate our research and development spend and will be diligent to adjust where appropriate depending on market conditions.

We will continue to relook our cost position as this downturn unfolds, adjusting our resource levels as market conditions dictate.

Now, I will walk through the total company results.

Orders for the quarter were $5.5 billion, down 3% year-over-year. Remaining Performance Obligation was $22.7 billion, down 1% sequentially. Equipment RPO ended at $7.9 billion, down 3% sequentially and services RPO ended at $14.9 billion. Our total company book-to-bill ratio in the quarter was 1.0 and our equipment book-to-bill in the quarter was 1.0.

Revenue for the quarter was $5.4 billion, down 15% sequentially. Year-over-year, revenue was down 3% driven by declines in TPS, Digital Solutions and OFE, partially offset by growth in OFS.

Operating loss for the quarter was $16.1 billion. Our first quarter results included a number of one-time items, including a $14.8 billion goodwill impairment, $1.5 billion in restructuring, inventory and intangible impairment charges, and $41 million in separation-related expense.

We also estimate that the COVID-19 pandemic had a negative impact to our operating income of approximately $100 million. Both Digital Solutions and TPS experienced supply chain disruptions, primarily in China and Europe, that impacted volume levels. In addition, TPS, OFS, and OFE were negatively impacted by travel and work-related restrictions, as well as rig and site shutdowns related to the pandemic. Our efforts to perform customer-related activities remotely helped, but could not offset the volume declines.

Adjusted operating income was $240 million, which excludes $16.3 billion of impairment, restructuring, separation, and other charges. Adjusted operating income was down 56% sequentially and down 12% year-over-year. Our adjusted operating income rate for the quarter was 4.4%, down 44 basis points year-over-year.

Corporate costs were $122 million in the quarter. Depreciation and amortization was $355 million, flat sequentially and up year-over-year. We expect depreciation and amortization to be approximately $20 million lower per quarter going forward as a result of the impairments we booked during the quarter.

Tax expense for the quarter was $5 million. GAAP loss per share was $15.64. Adjusted earnings per share were 11 cents, down 4 cents year-over-year.

Free cash flow in the quarter was $152 million. We delivered $183 million from working capital, driven by strong receivables performance and progress collections.

Overall, we are very pleased with the cash performance in the first quarter. We continue to remain focused on improving our working capital processes and optimizing our cash performance.

As we look at the rest of 2020 for working capital, we expect to see lower levels of progress payments given the uncertain market outlook. We anticipate this to be largely offset by the improvements we have been driving in working capital processes across the franchise, as well as a release of working capital from lower expected revenues in OFS.

Now I will walk you through the segment results in more detail and give you our thoughts on the outlook going forward, recognizing that the current environment is extremely dynamic with potential risks coming from the COVID-19 pandemic, as well as the significant weakness in oil and gas prices.

Our expectations are based on the current weakness in commodity prices persisting for the rest of 2020 and we assume that economic conditions begin to improve in the third quarter. Importantly, our expectations assume that some form of travel restrictions, strict social distancing, and health and safety protocols remain in place until the middle of the year and gradually begin to ease in the second half of the year.

In **Oilfield Services**, the team delivered a solid quarter despite the dramatic slowdowns in activity in North America that began in March, and multiple COVID-19 disruptions that developed internationally over the last few weeks of the quarter.

OFS revenue in the quarter was $3.1 billion, down 5% sequentially. North America revenue was down 2% sequentially driven by declining rig count. International revenue was down 6% sequentially, driven by typical seasonality. OFS revenue in the first quarter was modestly impacted by COVID-19 related disruptions in supply chain, as well as lower demand in the Asia Pacific region during the extended economic shut down.

Operating income in the quarter was $206 million, down 12% sequentially with margins declining 55 basis points. Year-over-year, margins were up 69 basis points.

As I outlined earlier, we are making several significant changes to the cost structure of our OFS business.

As we look ahead to the second quarter, we expect the North America market to decline at least 50% as operators release rigs and frac crews at a rapid pace in response to significantly lower oil prices. Internationally, we expect a low to mid-teens sequential decline driven by lower oil prices and disruption from COVID-19 as travel restrictions and safety protocols impact the number of rigs working in multiple regions. We believe that the aggressive cost actions we are taking will help to soften expected margin pressures but believe that our overall OFS margin rate will be lower.

As we look at the remainder of 2020 and try to assess the impact for our OFS segment, we expect US E&P spending to decline more than 50% versus 2019. As Lorenzo indicated earlier, our North America OFS revenues could track industry spending and activity trends more closely than they have historically as operators cut spending across drilling, completions, and production.

Internationally, we believe that spending is likely to decline in the 10 to 15% range, and that our strong position in the Middle East should help our international revenues slightly outperform overall industry spending trends.

For margins, we believe that our cost actions can help to offset some of the activity pressures we are seeing in the market.

Next, I will cover **Oilfield Equipment**. The OFE team experienced challenges in the quarter from broader COVID-19 impacts, specifically in Europe, where mobility restrictions and supply chain delays impacted performance.

Orders in the quarter were $492 million, down 36% year-over-year driven by no major subsea tree awards in the quarter, offset by strong Flexibles orders in Brazil.

Revenue was $712 million, down 3% year-over-year. Revenue growth in Subsea Productions Systems was offset by declines in Surface Pressure Control in North America and lower Subsea Services revenues.

Operating loss was $8 million driven by supply-chain and mobility related delays from COVID-19, lower overall volume due to seasonality, and weaker results in our Surface Pressure Control business.

As mentioned earlier, we have implemented a number of restructuring projects in OFE to align our workforce and capacity with lower expected activity levels.

For the second quarter, we expect revenue to decline sequentially as growth in Flexibles revenue is offset by declines in Surface Pressure Control and Subsea Services. We also expect slower backlog conversion in SPS due to COVID-19 supply chain disruptions. With lower revenue and most of our cost actions not impacting OFE until the second half of the year, we expect sequential operating income to also decline modestly.

As we look at our OFE segment for 2020, we expect revenue in SPS and Flexibles to still grow as the team executes on current backlog, while Surface Pressure Control and Subsea Services will likely decline driven by broader market dynamics. Overall, we estimate that this likely results in margins below 2019 levels.

Moving to **Turbomachinery**.

Our TPS team delivered a strong first quarter, especially given the exceptional circumstances over the past few months in Italy, where, as you know, TPS has the majority of its operations. We received essential business designation from the Italian government and have been able to maintain operations through the quarantine period due to our importance to the oil and gas markets. While all of our plants are operational, we have not been running at full capacity and the situation remains very fluid.

Orders in the quarter were $1.4 billion, up 10% year-over-year. Equipment orders were up 8% year-over-year, and equipment book-to-bill was 1.4. We saw strong orders in our Onshore/Offshore Production segment, booking a number of FPSO awards.

Service orders in the quarter were up 11% year-over-year, mainly driven by growth in installations, upgrades and contractual services.

Revenue for the quarter was $1.1 billion, down 17% versus the prior year. Equipment revenues were down 24% driven by supply chain delays primarily related to COVID-19 and business dispositions. Services revenue was down 13% versus the prior year due to COVID-19 mobility related delays.

Operating income for TPS was $134 million, up 13% year-over-year, driven by product-line mix and cost productivity, which more than offset the impact we saw from COVID-19. Operating margin was 12.3%, up 326 basis points year-over-year.

For the second quarter, TPS faces continued volatility given the situation in Italy and the mobility-related challenges, as well as the overall macro backdrop, particularly for our shorter-cycle service businesses. Based on these factors, operating income will likely decline on a sequential basis.

As we look at the rest of 2020 for TPS, we face a number of challenges but expect the business to show resilience due to the record backlog built over the last two years. We expect growth in equipment revenue; however, we expect that lower oil and gas prices and COVID-related issues could impact service revenues versus prior expectations.

Based on these factors, we expect TPS operating income to be flat to modestly lower than 2019 levels.

Finally, **Digital Solutions** was heavily impacted by COVID-19, as a significant portion of both the customer base and supply chain was offline during the quarter. The team executed incredibly well given the unique and challenging circumstances.

Orders for the quarter were $500 million, down 24% year-over-year driven primarily by COVID-19 related demand disruptions. We saw declines in orders across all end markets, most notably aviation, automotive, and power.

Revenue for the quarter was $489 million, down 17% year-over-year primarily due to lower convertible orders and volume slippages driven by COVID-19. The Waygate Technologies and Bently Nevada product lines were most impacted as multiple deliveries in Europe, North America, and Asia Pacific were delayed as shutdowns spread.

Operating income for the quarter was $29 million, down 57% year-over-year driven by lower volumes related to COVID-19.

In response to the disruption caused by the pandemic and current macro environment, we have taken steps to furlough employees in some countries and we are implementing structural changes to our organization to operate more efficiently at lower costs.

That said, we still expect near-term results in DS to continue to be impacted by COVID-19 disruptions as well as the weak economic outlook and the oil and gas environment. As a result, we expect revenue and operating income to be flat to slightly down on a sequential basis in the second quarter.

For the full year, we expect revenue declines in the double digits as the current outlook for weak economic activity weighs on results.

With that, I will turn the call back over to Lorenzo.

Lorenzo Simonelli *Baker Hughes – Chairman & CEO*

Thank you, Brian.

Before we move to Q&A, I wanted to spend a few moments to recognize and thank the Baker Hughes team for what they are doing to take care of each other, our customers, and the communities around them impacted by the coronavirus pandemic.

We continue to support our communities with great acts of courage and kindness. Baker Hughes's global additive teams in the US, Germany, Italy, the UK, and Saudi Arabia have been working collaboratively for weeks with local partners to identify, test and now safely deliver 3D-printed parts critical for protective gear needed by first responders.

At our Additive Manufacturing Facility in Talamona, Italy, additive experts have started the production of 3D-printed components for respirators, such as valves and adapters. Kits for respirator masks have already been distributed in Italy and more kits will be produced in partnership with Baker Hughes Additive Manufacturing Labs in both Florence, Italy and Montrose, Scotland.

We are committed to these efforts and looking beyond our business to apply the highest and best use of our unique 3D-printing capabilities, to support the communities around us. All design time, labor and parts are being donated.

These efforts are inspiring, and I am extremely proud of our team in this difficult time. We are proud to be a part of a community of technologists who have come together to help contribute to mitigate the impact of this worldwide pandemic.

Finally, I want to highlight that with our solid backlog of longer-cycle projects, our balanced portfolio, and our strong balance sheet, Baker Hughes remains uniquely positioned to navigate the challenging market environment.

With that, let's open the call for questions.