Baker Hughes

Fourth Quarter & Full Year 2019 – Earnings Conference Call Prepared Remarks

Jud Bailey *Baker Hughes – VP of Investor Relations*

Thank you.

Good morning everyone, and welcome to the Baker Hughes Company fourth quarter and full year 2019 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.

We delivered a solid fourth quarter with strong orders in our Turbomachinery and Oilfield Equipment segments, solid operating performance from our TPS business, strong free cash flow, and better execution in our Digital Solutions business. These positives were partially offset by weaker than expected margin performance from our OFS business.

For the full year 2019, we achieved a number of key milestones, including 20% year-over-year order growth in TPS, almost 300 basis points of margin improvement in TPS, 12% order growth in OFE, and free cash flow of $1.2 billion. In addition, we accelerated our separation efforts from GE, launched our new company brand, and positioned ourselves to compete more effectively in a changing marketplace. I cannot thank our employees enough for their hard work and dedication to achieve our goals throughout the year.

As we look into 2020, we see a macro environment that is slowly improving, as well as a range of opportunities to further strengthen Baker Hughes on both a near-term and long-term basis. In the near-term, we continue to identify and execute on opportunities to improve our day-to-day operations and cash flow efficiency in 2020. Looking out on a longer-term basis, we see a number of attractive growth opportunities for our company, and we remain focused on positioning Baker Hughes for the upcoming Energy Transition and the digital transformation of the industry.

This balance between near-term and long-term objectives can be found in each of the strategic goals that I highlighted on our last earnings call. To remind you, these goals are:

One - margin improvement in our Oilfield Services and Oilfield Equipment businesses;

Two - evolving our portfolio, specifically leveraging some of our unique core competencies, to expand our offerings in the industrial and chemical end-markets, as well as improving our position for the Energy Transition;

And three - continuing to expand our Digital offerings to drive greater efficiency as well as safer and more reliable operations for our customers, together with our AI partner C3.

Over the last several months, we have spoken at length about our first goal of execution and operational improvement, which remains an important focus for Baker Hughes in 2020. However, today I would like to spend some time providing insight on how we are thinking about our goal of portfolio evolution and positioning for the Energy Transition. As you know, Energy Transition is an important topic that has gained a significant amount of momentum in the industry and the investment community over the last six to twelve months.

As we have stated previously, Baker Hughes is firmly committed to playing a leading role in a lower carbon future. One year ago we made our own commitment to achieve net-zero carbon emissions by 2050, and our corporate strategy remains clearly focused on being the leading energy technology company to help facilitate the Energy Transition.

As we look ahead to the next two decades, there are various published forecasts on the long-term demand outlook for hydrocarbons, and the expected growth rate for renewable energy sources. Within these forecasts, there are a wide range of predictions for growth or peak demand for the different types of hydrocarbons in the coming decades. Our view remains that in almost any scenario, natural gas will be the key transition fuel, and perhaps even a destination fuel, for a lower carbon future. As a result, we believe that natural gas demand will grow at more than twice the pace of oil over the next 10 years and that LNG demand growth will be higher still at an annual rate of 4 to 5%.

Against this market backdrop, we believe that Baker Hughes is uniquely positioned to provide technologies and solutions that help our customers lower their carbon footprint. While there is strong recognition of our world-class LNG franchise, our broad portfolio also offers a wide range of products that help customers lower their carbon footprint today and that are directly tied to the continued growth in renewable energy sources.

Some examples of these products are well known, like our LM9000 aeroderivative gas turbine, which can reduce NOx emissions by 40% and overall CO_2 equivalent emissions by up to 25% compared to alternative turbines in its class. However, there are broader, system-level uses where our TPS equipment has the opportunity to be deployed in carbon reduction applications.

For example, our core technologies in compression have the capability to help deliver carbon capture, utilization, and storage (CCUS), and we are actively marketing these solutions to customers today.

In one application, we reconfigured our NovaLT gas turbine generator technology to operate 100 percent on hydrogen, and we continue to explore opportunities in the hydrogen value chain, in both transportation and production.

As another example, our turbomachinery equipment can be used to help deliver mechanical storage of energy for use in peak demand for renewables, enabling customers to store and deliver renewable-sourced energy to the grid efficiently and effectively.

In addition, we see three new technology areas emerging as part of the Energy Transition, for which our Digital Solutions segment is uniquely positioned.

The first is emissions monitoring, where our products such as Lumen and Avitas are directly applicable. Lumen is a suite of methane monitoring and inspection solutions, and Avitas offers smart inspection and monitoring service solutions in both land and aerial applications.

The second area is emissions reduction, where our Flare.IQ flare management system allows downstream operators to reduce flaring emissions by 90%.

The third area is condition monitoring for renewables, specifically in wind turbine applications. Our Bently Nevada business within Digital Solutions has monitoring devices, which ensure detectability of the most costly and critical drive-train failure modes, deployed on more than 32,000 wind turbines globally – a tremendous installed base we have built over the last decade.

While these technologies combined represent a small percentage of Baker Hughes' overall revenue today, they are products and services that we believe have great growth potential and also provide a strong platform for future product introductions and carbon-based initiatives with customers.

As we execute on these near-term and long-term strategic initiatives, we are also mindful of the ever-changing macro backdrop across the energy markets. On this note, we generally believe that macro fundamentals have slightly improved over the last few months as dynamics on both the demand and supply side have become more positive. With that said, our incrementally positive view of the macro environment is tempered by growing geopolitical risk, most notably in the Middle East.

On the demand side, the outlook for oil and gas has modestly improved with the recent Phase 1 trade deal, the slight improvement in PMIs for key economies, and continued positive economic data out of the US. We believe that these variables should be supportive of a firm oil demand outlook in 2020 and one in which our customers will continue to execute their budget plans and advance important projects.

On the supply side, the outlook has also firmed with another recent round of OPEC production cuts and more signs of slowing US production growth. Importantly, we believe the continuation of solid demand growth, combined with the growing commitment to E&P capital discipline, helps support a more constructive macro outlook. Further, we believe the continuation of these trends could begin to reduce excess crude inventory by later this year or into 2021 and support multiple years of growth internationally.

Although the macro environment appears to be improving, our overall outlook for our OFS and OFE segments remain largely unchanged from the framework we outlined on our third quarter earnings call.

For our OFS segment, we now believe that North America D&C spend in 2020 is trending towards a low double-digit decline rate versus 2019. This view is based on early E&P budget announcements and the lower exit rate in the fourth quarter of 2019. We continue to believe that our differentiated OFS portfolio will provide somewhat of a buffer to the challenges in the North American market.

Internationally, our expectations remain mid-single digit growth, but with a slight bias to the upside driven primarily by an improving pipeline of opportunities.

In the OFE segment, our outlook is for the subsea tree market to remain stable around 300 trees in 2020. We expect to maintain our position in the subsea market driven by strong execution for customers and continued traction with our Subsea Connect strategy.

For TPS, while we do not expect the exceptionally strong year for LNG FIDs in 2019 to repeat in 2020, our outlook for this segment remains constructive as we execute the largest backlog in the company's history and expect continued growth in services and non-LNG equipment awards.

For the LNG portion of our TPS segment, our outlook remains constructive. Despite some softness in near-term spot prices, conversations with our customers have not changed materially. If spot price weakness persists, we would expect this to shift the balance for future FIDs towards more economically advantaged brownfield projects in the 2021 to 2025 timeframe.

We were pleased to see around 90 MTPA of LNG FIDs between the fourth quarter of 2018 and the end of 2019. While just short of the 100 MTPA we thought the industry could FID in this period, we believe that FID activity in 2020 should remain solid and at least in line with the average annual FID levels witnessed in the prior cycle between 2011 and 2015.

In our Digital Solutions segment, we continue to believe global GDP growth is the most relevant metric by which to forecast this business given the variety of end-markets it serves. The oil and gas market drives approximately 50% of DS revenue, with 20% coming from the power market, and the balance from a number of industries including aerospace, automation, consumer electronics, and other industrials.

With over 90% of DS revenue coming from hardware and associated software solutions across a range of brands such as Bently Nevada, Nexus Controls, Druck, Panametrics, and Reuter-Stokes, this is a mature, stable business with best in class measurement, sensing, and inspection technology.

In summary, we delivered a solid fourth quarter and full year 2019. We are clearly focused on executing our strategy and generating strong free cash flow, improving margins, and driving returns.

With that, let me turn the call over to Brian.

Brian Worrell *Baker Hughes – CFO*

Thanks, Lorenzo. I will begin with the total company results and then move into the segment details.

Orders for the quarter were $6.9 billion, up 1% year-over-year and down 11% sequentially.
The year-over-year growth was driven by strong orders in Oilfield Equipment.
Sequentially, the decrease was driven by Turbomachinery which booked a very large LNG order in the third quarter.

Remaining Performance Obligation was $22.9 billion, up 3% sequentially. Equipment RPO ended at $8.1 billion, up 10% sequentially and services RPO ended at $14.8 billion.

Our total company book-to-bill ratio in the quarter was 1.1 and our equipment book-to-bill in the quarter was 1.2.

Revenue for the quarter was $6.3 billion, up 8% sequentially, driven by Turbomachinery, Digital Solutions and Oilfield Equipment, offset by Oilfield Services.

Year-over-year, revenue was up 1% driven by OFS and OFE, offset by declines in TPS and DS.
Operating income for the quarter was $331 million, which is up 11% sequentially and down 13% year-over-year.

Adjusted operating income was $546 million, which excludes $216 million of restructuring, separation, and other charges. We incurred $135 million of new restructuring charges in our OFS business during the quarter as we continue to work through a new phase of cost-out and productivity initiatives. These are primarily focused on supply chain optimization, improving asset utilization, and driving down product and service delivery costs. Separation and merger related charges in the quarter were $57 million.

Adjusted operating income was up 30% sequentially and up 10% year-over-year. Our adjusted operating income rate for the quarter was 8.6%, up 140 basis points sequentially and up 70 basis points year-over-year.

Corporate costs were $118 million in the quarter, which is modestly higher than third quarter levels and our initial expectations a few months ago. We expect the corporate line to increase slightly from this level in 2020 as we continue to accelerate our separation efforts. I will go into more detail on these costs in a moment.

Depreciation and amortization was $354 million, down sequentially and flat year-over-year. We expect depreciation and amortization to remain around this level in the first quarter of 2020.

Tax expense for the quarter was $212 million, which was higher than expected driven by the geographic mix of earnings and certain year-end provisions.

GAAP earnings per share were 7 cents, down 3 cents sequentially and down 21 cents year-over-year.

Adjusted earnings per share were 27 cents, up 6 cents sequentially and up 1 cent year-over-year.

Free cash flow in the quarter was $1.1 billion, which was above our expectations. We delivered $639 million from working capital, driven by strong collections and inventory management in OFS, as well as progress collections in TPS and OFE. Overall, we are very pleased with the cash performance in the fourth quarter as OFS saw improvements after the shortfall in the third quarter.

We continue to see improvement in our working capital processes and are focused on optimizing our cash operations to ensure we deliver on our free cash flow conversion target.
When I look at the total year 2019, I am pleased with our financial results, which reflect our consistent execution on the priorities we set out at the beginning of the year.

Orders for the full year were up 13% in 2019, driven by 20% order growth in TPS and 12% order growth in OFE. TPS book-to-bill was 1.4 in the year, and OFE book-to-bill was 1.2.

Full year revenue was up 4%. Our OFS and OFE businesses were both up 11%, offset by declines in TPS and DS.

Despite a challenging macro environment for the broader energy market, we were able to grow total company adjusted operating income margins by 60 basis points. We drove margins higher in three of our four segments, with improvements of 270-basis points in TPS, 190-basis points in OFE and 40 basis points in OFS, offset by a 120-basis point decline in DS.

Overall, the results for each of our product companies are in line with the framework we outlined at the beginning of the year.

Corporate costs for the year were $433 million. As I mentioned, we expect to incur an additional $50 to $60 million of corporate costs in 2020 related to the ramp up in separation efforts. We have a significant number of transition services agreements in place with GE across a range of functions including IT, HR, Treasury, and other infrastructure to ensure we maintain the continuity of our business operations. Importantly, we expect these incremental costs to recede in 2021 as we roll-off the transition services agreements and utilize our own systems.

In conjunction with the separation activities, we are also taking the opportunity to upgrade our systems and sunset some aging processes and infrastructure to ensure Baker Hughes is best positioned to drive further efficiencies in our operations which should lead to higher margins.

We generated $1.2 billion of free cash flow in 2019. We were very pleased with our cash performance in the year and continue to improve our working capital metrics.

We invested $976 million in net capital expenditures in 2019 and we expect to see similar net capex levels in 2020.

Included in our 2019 free cash flow results are $307 million of restructuring, separation and merger related cash outflows. As we have outlined, we expect restructuring-related outflows to decline in 2020, offset by an increase in separation related cash outflows.

Given the strong level of free cash flow generated in 2019, we ended the year with $3.2 billion of cash on hand and net debt of $3.4 billion after returning $1 billion of cash to shareholders through buybacks and dividends. We continue to see our balance sheet as a key strength and differentiator in this cyclical industry.

Now I will walk through the segment results in more detail and give you our thoughts on the outlook going forward.

In **Oilfield Services**, the team continues to navigate a challenging environment in North America, while driving strong growth internationally.

OFS revenue in the quarter was $3.3 billion, which was down 2% sequentially. North American revenue was down 11% sequentially driven by declining rig count and weaker completions in US Land, as well as a double-digit sequential decline in our Gulf of Mexico operations. International revenue was up 4% sequentially, driven by continued growth in the Middle East, Asia Pacific, and Latin America.

Operating income in the quarter was $235 million, down 14% sequentially and margins declined 110 basis points. OFS margins were below our expectations primarily due to weaker North American results and lower product sales than originally planned. Despite coming in slightly below our expectations, we believe the margin headwinds in the fourth quarter are largely transitory and our expectations for 2020 are unchanged.

As we look at 2020 for our OFS segment, we expect international spending to increase in the mid-single digit range with most of the growth coming from a number of offshore markets and regional strength in the Middle East, North Sea, and parts of Latin America. Given our focus on execution and improving margins, I would expect our international OFS business to generally track in line with industry trends.

In North America, we expect US D&C spend to decline low double digits versus 2019 as domestic E&Ps continue to restrain spending to generate more free cash flow. Similar to 2019, we would expect revenue for our North American OFS business to outperform industry spending trends given our production-weighted mix.

For margins, we expect to deliver year-over-year growth driven primarily by our cost out and productivity enhancement actions. I will also reiterate that over time, our goal remains to close the margin gap with peers.

As we look ahead to the first quarter, we expect North America to get off to a relatively slow start and expect typical seasonal trends in key Eastern Hemisphere markets like the North Sea and Russia. As a result, we expect total OFS revenue to experience a modest sequential decline and for margins to decline slightly but still remain well above year-ago margin levels.

Next, I will cover **Oilfield Equipment**.

Orders in the quarter were $1.1 billion, up 6% year-over-year driven by growth in both equipment and service orders. Equipment book-to-bill in OFE was 1.7.

We booked several key awards in the quarter totaling 22 trees, which brings our 2019 total to 73 trees. With this level of awards, we maintained a similar position in the market as in 2018.

Revenue was $765 million, up 5% year-over-year. This increase was primarily driven by better Subsea Services activity and Subsea Production Systems volumes, partially offset by lower revenues in Flexibles.

Operating income was $16 million, up 28% year-over-year, driven by increased volume in SPS. Operating margins were up 20 basis points sequentially and up 40 basis points year-over-year.

As we look at our OFE segment in 2020, we believe that offshore market fundamentals should support another solid year of orders with subsea tree awards expected to remain relatively consistent with 2019. For 2020, we believe that OFE should see revenue growth in the high-single digit range following two years of strong orders growth.

We expect volume growth in SPS and improving mix from Flexibles to drive solid margin improvement in OFE in 2020.

For the first quarter, we expect the trend of year-over-year revenue growth to continue as we execute on the positive momentum from our SPS and Flexibles product lines. Based on our anticipated project conversion schedule, we expect OFE revenues to increase in the mid-single digit range on a year-over-year basis along with modest margin improvement.

Moving to **Turbomachinery**.

Orders in the quarter were $1.9 billion, down 10% year-over-year.

Equipment orders were down 16% year-over-year, and equipment book-to-bill was 1.5. During the quarter we booked an award for the liquefaction equipment on Total's Mozambique Area 1 LNG project and we had some important wins in Onshore/Offshore Production, including two FPSO awards in Latin America.

Service orders in the quarter were down 4% year-over-year mainly driven by lower contractual services, offset by higher transactional services and upgrades.

Revenue for the quarter was $1.6 billion, down 8% versus the prior year. For the quarter, services revenue was down 2% versus the prior year and equipment revenue was down 18% driven primarily by business dispositions.

Operating income for TPS was $305 million, up 19% year-over-year, driven by higher services mix and cost productivity. Operating margin was 18.7%, up 430 basis points year-over-year and up 520 basis points sequentially.

Overall, TPS results for the quarter came in slightly above our expectations with a much stronger margin rate offsetting revenue that was below our expectations.

While the supply chain issues that impacted the third quarter lingered into the fourth quarter, the primary driver behind the lower than expected revenue was slower conversion of our equipment backlog than we anticipated. Rod and the team have done a very good job of managing costs and execution as they work to deliver on the largest LNG equipment backlog in TPS's history.

The 2020 outlook we provided for TPS last quarter remains largely similar. Given the consecutive years of strong order growth in 2018 and 2019, we expect year-over-year revenue growth of roughly 20% and for margins to continue to expand. I would note, however, that our current expectation for revenue conversion is weighted more towards the second half of the year based on project timing. For orders, we still believe that TPS could be flat to down low-double digits compared to 2019 levels. As you know, timing on large projects can vary, which drives a wide range of scenarios.

As we think about the first quarter, we expect TPS revenues to be roughly flat with first quarter 2019 levels given the equipment conversion schedules that I previously mentioned. On the margin front, we expect to show solid improvement on a year-over-year basis.

Finally, on **Digital Solutions**, orders for the quarter were $645 million, down 4% year-over-year. Growth in our Controls and Inspection businesses was partially offset by declines in Measurement & Sensing and Pipeline & Process Solutions. Regionally, we saw strong orders growth in Asia and the Middle East offset by declines in the other regions.

Revenue for the quarter was $659 million, down 5% year-over-year primarily due to the sale of the Digital APM product line. Excluding the impact of this disposition, revenue was down slightly with growth in Bently Nevada, Inspection, and Measurement & Sensing offset by declines in Controls and Pipeline & Process Solutions.

Operating income for the quarter was $109 million, down 5% year-over-year driven by lower volume. Despite the decline in year-over-year revenue, we delivered on productivity and cost out to hold the margin rate flat versus the fourth quarter of 2018.

Looking ahead to the full year 2020 for DS, we continue to expect revenue growth in the low-single digits and modestly higher margins. This outlook takes into account a GDP-plus growth rate but anticipates that DS is likely to see some continued softness in the power business. Revenue growth will also be impacted as we pivot our software strategy with the sale of the Digital APM offering and work closely with our AI partner C3 on new opportunities.

For the first quarter, we expect revenue to decline in the mid-single digits year-over-year and for margins to decline modestly due to the non-repeat of a large project in the first quarter of 2019.

In closing, we delivered a strong fourth quarter, finishing out a solid 2019 for Baker Hughes. As we look forward to 2020, we are clearly focused on executing our strategy and generating strong free cash flow, improving margins, and driving returns.

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

Jud Bailey *Baker Hughes – VP of Investor Relations*

Thanks, let’s open the call for questions.