Baker Hughes Third Quarter 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 Third Quarter 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 third quarter with strong growth in Turbomachinery and Oilfield Equipment orders, and continued margin improvement in our Oilfield Services business. Overall, we are very pleased with our continued execution as a team, and we are firmly on the right path financially, operationally, and strategically.

Before I turn it over to Brian for more details on our financials and outlook, I would like to take some time to discuss what we view as an exciting new beginning for Baker Hughes.

During the third quarter, GE sold down a portion of its stake in our company through a secondary offering and concurrent buyback, taking its ownership percentage from just over 50% to just below 37%. This most recent transaction is another major step in our separation from GE.

As you know, GE announced their intention to exit their stake in our company over a year and half ago and we have been working on this process since that time. At the end of July 2019, we finalized our separation agreements which included a number of transitional services. These are intended to ensure continuity of operations during the separation period for IT systems and other critical infrastructure.

As you have seen in the weeks following the sell-down, we changed our company name, stock ticker, and branding. In addition, GE's representation on our board went from 5 seats to 1. These are important, highly visible steps we have taken that outline the direction of the company going forward.

While less visible, an equally important near-term impact is the acceleration of our separation efforts, as we work quickly to minimize our time in transition and to be fully operational on our own systems as soon as possible. I want to emphasize that these separation efforts are largely focused on back-office functions such as IT, HR, and treasury systems, and other supporting infrastructure. The commercial and operational front-end of our business is largely unaffected by the separation.

Although our name change, ownership, and board structure are the most visible aspects of this new beginning for Baker Hughes, we are also entering a new chapter as we move into the next stage of our corporate development and prepare for the energy transition we see unfolding over the next decade.

Two years after the formation of our company, we have executed on our integration and synergy targets and are in the early stages of evaluating the optimal portfolio for Baker Hughes, not only in the current environment but into the future. In the coming decades we forecast natural gas to be the key transition fuel for a lower carbon future as oil demand growth slows and demand for renewable energy sources accelerates.

While it is clear that renewables will grow as a share of overall energy supply, renewable sources will not be able to fulfill global energy demand given currently available technology and its small footprint today. These dynamics create the opportunity for natural gas to take a more prominent role over the coming years. Our view is that natural gas demand will grow at more than twice the pace of oil, and LNG demand growth will be higher still at an annual rate of 4-5%. This creates tremendous opportunity for our businesses, and we will position the company to capture the high value, higher technology opportunities along the gas value chain.

In this environment, our strategic goals are simple.

First, we will improve margins in our Oilfield Services and Oilfield Equipment businesses.

In OFS, we have executed over the last two years on some of the more straightforward synergy areas such as right-sizing our footprint and facility consolidation to help improve margins. Moving forward, we are increasingly focused on the next stage of margin improvement, which we expect to be driven by supply chain efficiencies, increases in asset utilization, and lower product costs through better procurement and standardization.

In OFE, we expect margin improvement as growing volumes from backlog conversion should drive cost absorption, and allow us to capitalize on the significant cost out initiatives we have implemented in recent years.

Second, we will leverage some of our unique core competencies in TPS and Digital Solutions to further expand our offerings in the industrial and chemical end markets. We see the opportunity to grow more in the gas value chain with our Turbomachinery segment, grow in the downstream space with our Digital Solutions segment, and grow our industrial and chemicals presence across our portfolio.

As an example, we have utilized our expertise in gas turbine technology to develop and launch the NovaLT family. This new class of turbine builds on TPS's deep domain experience in the rotating equipment space. This product line targets the industrial markets and lower-megawatt applications where we had not previously competed such as distributed power, e-frac, and pulp and paper. In our Digital Solutions business, we have leveraged our strengths in inspection

technology to enter the automotive and consumer electronics space with limited incremental investment.

For our third strategic goal, we will work to continue to improve our Digital offering to help facilitate better, safer, and more reliable operations for our customers through our recent joint venture with C3.ai, which we have branded BHC3. In addition, we will be able to apply C3's offering internally to improve our own operational and execution capabilities. By integrating our strong suite of digital offerings and capabilities, oil and gas industry expertise, and C3's unique AI solutions, we will accelerate the overall digital transformation of this industry.

As we focus on these initiatives and work to complete the separation from GE, we are also fully aware that we will be executing against a somewhat challenging macro backdrop.

On the demand side, global crude oil demand growth appears to be slowing due to a number of factors, most notably trade tensions, which are beginning to manifest into slower growth and weaker manufacturing data in some of the major economies around the world. Recent PMI data has shown slowing momentum for bellwether economies, with the most recent data for the United States, China and the Eurozone signaling softening demand.

On the supply side, we agree with the view that OPEC may have to consider additional cuts as non-OPEC, non-US production appears poised for solid growth in 2020 as new offshore developments come online. In the US, production growth is likely to decelerate, but should remain resilient despite the expectation of E&P capex cuts next year. Weighing these factors together, we expect an adequately supplied market under most economic scenarios, resulting in a range-bound oil price environment for 2020 and potentially beyond.

Despite this macro backdrop, we still feel good about the potential for revenue and margin growth across our portfolio in 2020. We believe the geographical and business mix in our OFS segment should still be conducive to modest growth next year, while our long cycle business segments should produce solid revenue growth as we execute current backlog and anticipate continued firm order activity.

More specifically, within our OFS segment we are preparing for a North America market that is likely to see another reduction in E&P spending in 2020 as operators exercise capital restraint and seek to improve their free cash flow.

Although it is still early, we agree with some estimates suggesting that Lower 48 Drilling & Completion spending could decline in the high-single digit or even low-double digit range in 2020 on a year-over-year basis due to a combination of weaker pricing and lower activity levels.

Internationally, we expect growth to moderate compared to 2019, but still believe that drilling and completion spend can grow in the mid-single digit range or higher in 2020 depending on a number of macro factors. International revenue growth for Baker Hughes has significantly outpaced market trends over the last two years as we sought to re-capture share and re-gain critical scale in select regions. Our core focus going forward will be on improving margins, therefore I would expect our top line to be more representative of overall international market trends.

Overall, I am generally pleased with the continued performance and execution of our OFS team, the operational improvements they have made, and some of their recent contract wins. In the third quarter, OFS had a number of important wins in the Middle East across multiple product lines, including Artificial Lift, Completions and international Pressure Pumping.

We also continue to see progress in our partnership with ADNOC, delivering strong execution as we help to build out ADNOC Drilling's capabilities. In North America, we won an important artificial lift contract with a key customer in the Permian, building on our strong relationships and execution capabilities in this important basin.

In our OFE segment, we continue to see demand for around 300 trees in 2019, which is roughly flat versus 2018. We also see an opportunity for additional orders in the flexible pipe market in 2019, following a subdued 2018.

We were extremely pleased with our orders performance in the third quarter in OFE as we secured some important wins with Inpex GS4, Vår Energi's Balder field, and with Apache in the North Sea. Overall, we remain constructive on the opportunity for order growth in the OFE segment in 2019.

In our TPS segment, order growth remains solid compared to 2018 driven by continued strength in LNG and resilient order activity in our non-LNG businesses. Looking more closely at the LNG market, the project cadence is playing out largely as we expected. So far this cycle, 80 out of the 100 MTPA we outlined earlier this year has reached FID, which includes the recent FIDs of Venture Global's Calcasieu Pass and Novatek's Arctic-2. Today, our technology drives almost 400 million tons of LNG production capacity, and in this most recent cycle, our technology has been selected for each of the projects that have reached a successful FID. As we look to the remainder of the year and into 2020, we believe there are several large LNG projects still to come and we are well positioned to win many of them.

Although the year got off to a slow start for the non-LNG portion of TPS, I am very pleased with the progression of non-LNG equipment order intake over the last six months. We have been successful in securing awards across a wide range of applications such as electric frac, FPSOs, and pipelines, while still being selective in the less profitable markets of refining and petrochemical. During the quarter we were awarded two FPSO contracts offshore Brazil and offshore India, as well as a number of awards in the onshore/offshore production and pipeline businesses.

Lastly, in our Digital Solutions segment, the broad, diversified nature of our portfolio, and growth in oil and gas and other end markets has helped to partially offset weakness in the Power market. Going forward, we generally expect these trends to continue.

On the commercial side, only weeks after forming the BHC3 joint venture, the team launched its first artificial intelligence software application, BHC3 Reliability. We are extremely excited about this partnership, and the potential it brings to our industry.

That is a short summary of how we see the market today. Overall, we believe that Baker Hughes is well positioned to navigate a potentially choppy macro backdrop. This is enabled by our combination of long-cycle businesses in TPS and OFE, more stable end markets within Digital Solutions, and a differentiated OFS portfolio that is focused on high technology drilling and completion applications and production-related offerings such as upstream chemicals and artificial lift.

I am confident that we have the right team in place to execute our strategy and position Baker Hughes to generate strong free cash flow, improve margins and drive 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 $7.8 billion, up 35% year-over-year and up 19% sequentially. This is the highest orders quarter we have seen since the second quarter of 2015.

The year-over-year growth was driven by strong orders in Oilfield Equipment and Turbomachinery. We delivered solid growth across both equipment and services, with equipment orders up 89% and services orders up 1%. Sequentially, the increase was driven by Oilfield Equipment and Turbomachinery.

Remaining Performance Obligation was $22.2 billion, up 8% sequentially. Equipment RPO ended at $7.4 billion, up 32% sequentially and services RPO ended at $14.9 billion, down 1% sequentially. Our total company book-to-bill ratio in the quarter was 1.3 and our equipment book-to-bill in the quarter was 1.8.

Revenue for the quarter was $5.9 billion, down 2% sequentially. The sequential decrease was driven by Turbomachinery and Digital Solutions, offset by revenue growth in Oilfield Services and Oilfield Equipment. Year-over-year, revenue was up 4% driven by Oilfield Equipment and Oilfield Services, offset by declines in Turbomachinery and Digital Solutions.

Operating income for the quarter was $297 million, which is up 10% sequentially and 5% year-over-year. Adjusted operating income was $422 million, which excludes $125 million of restructuring, separation, and other charges. Separation charges in the quarter were $54 million. Adjusted operating income was up 17% sequentially and up 12% year-over-year. Our adjusted operating income rate for the quarter was 7.2%, up 120 basis points sequentially and up 50 basis points year-over-year.

Corporate costs were $109 million in the quarter. We expect the corporate line to remain at a similar level for the fourth quarter as we continue our separation efforts. We are investing in systems and processes that enable us to fully separate, such as IT, HR, and other back office infrastructure. As we have ramped up the buildout of these systems and not yet transitioned from GE, we are beginning to incur modest additional costs in line with the framework we communicated last November.

Depreciation and amortization was $355 million, down 1% sequentially and up 1% year-over-year. We expect depreciation and amortization to remain at this level in the fourth quarter.

Tax expense for the quarter was $107 million. For the fourth quarter, we estimate that our effective tax rate, excluding the impact of one-time separation and restructuring expenses, should be in the mid to high thirties.

GAAP earnings per share were 11 cents, up 12 cents sequentially and up 7 cents year-over-year. Adjusted earnings per share were 21 cents, up 1 cent sequentially and up 2 cents year-over-year.

Free cash flow in the quarter was $161 million, which was below our expectations. The shortfall was driven primarily by collections and inventory management in OFS. We still expect to see a free cash flow profile in the fourth quarter similar to what we generated in the fourth quarter of 2018, excluding the $300 million progress payment from ADNOC Drilling we received last year.

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 is navigating a challenging North American environment, while working to improve our execution globally. As Lorenzo highlighted, we are entering a new phase of cost-out and productivity initiatives in OFS, focused on supply chain optimization, improving asset utilization, and driving down product cost. Our goal from these various initiatives is not only to improve margins, but also improve the overall cash flow efficiency of our OFS business.

The OFS team executed a strong third quarter with revenue of $3.3 billion, which was up 3% sequentially. North American revenue was $1.2 billion, down 3% sequentially. International revenue was $2.2 billion, up 6% sequentially, driven by strong product sales and growth in the Middle East, Asia Pacific, Europe, and Latin America. We saw strong execution in our Artificial Lift, Completions and international Pressure Pumping product lines.

Operating income in the quarter was $274 million, up 18% sequentially. Margins grew 110 basis points, driven primarily by continued cost-out and stronger-than-planned product sales.

As we look ahead to the fourth quarter, we expect overall OFS revenue to be slightly down sequentially. We expect North America revenues to decline due to further deterioration in drilling and completion activity in the US land market. Internationally, we expect revenue to be roughly flat as year-end product sales should be offset by seasonal weakness in some Eastern Hemisphere markets. In addition, we do not expect product sales related to some international contracts to repeat at the same level as the third quarter. Against this revenue scenario, we would expect margins to be roughly flat to slightly down versus the third quarter.

Looking beyond the fourth quarter and into 2020, we believe there are a number of cross-currents that will impact our OFS business. As Lorenzo highlighted earlier, our focus is shifting primarily to margin and free cash flow improvement for this business. As a result, we expect our international revenue growth profile to more closely track international D&C spending trends after significantly outperforming over the last two years. We believe mid-single digit international growth is a reasonable expectation. This anticipates execution on the visible work that we have contracted, but also risk adjusts for a number of factors, including the potential for additional OPEC cuts and weakness in certain markets like Argentina.

In North America, we are preparing for US D&C spend that could be down high-single digits to low double digits. Similar to the third quarter, we would expect our top line to outperform market trends given our production-weighted mix with almost 40% of our OFS revenue driven by upstream chemicals and artificial lift.

Under this revenue outlook, we expect modest margin improvement in 2020 aided by our cost-out and productivity actions, and our long-term goal remains margin parity with peers.

Next, on **Oilfield Equipment**.

Orders in the quarter were $1 billion, up 86% year-over-year driven by strong growth in both equipment and service orders. Equipment orders were up 122% year-over-year, driven by subsea production systems and flexibles, and services orders were up 31%. Equipment book-to-bill in OFE was 1.7 for the quarter. Overall, we continue to believe that order activity for subsea trees and flexibles are returning to a more normalized level.

We booked several key awards in the quarter, including 16 trees for Var Energi's Balder project, 7 trees for Inpex in Australia, and 6 trees for Apache in the North Sea. Importantly, the Balder project represents our first subsea tree award on the Norwegian Continental Shelf since 2008.

Revenue was $728 million, up 15% year-over-year. This increase was primarily driven by better Subsea Production Systems volumes and Subsea Services activity, partially offset by lower revenues in Flexibles.

Operating profit was $14 million, up $8 million year-over-year, driven by increased volume in SPS and Subsea Services. Although operating income was higher year-over-year, sequential margin performance in OFE was below our expectations primarily due to weaker results from our Surface Pressure Control business.

Looking into the fourth quarter, we expect modest revenue growth and sequential margin improvement driven by similar mix dynamics to what we saw in the third quarter.

Following 23% orders growth in 2018 and what should be solid orders growth in 2019, we believe that OFE should see 2020 revenue growth in the high single digit range as we convert backlog into revenue. We expect volume growth combined with our cost-out actions and improving mix from Flexibles to drive solid margin improvement in OFE in 2020.

Moving to **Turbomachinery**.

Orders in the quarter were $2.8 billion, up 79% year-over-year.

Equipment orders were up over 200% year-over-year. The growth was driven by very strong orders in LNG and onshore/offshore production. TPS equipment book-to-bill in the quarter was 4.9, supported by the large award for Venture Global's Calcasieu Pass, as well as two FPSO orders. After a slower start in 2019, we have seen non-LNG equipment awards begin to normalize to quarterly levels that we saw in 2018, supported primarily by orders within our onshore/offshore production and pipeline segments.Service orders in the quarter were down 13% year-over-year mainly driven by fewer upgrades and installations.

Revenue for the quarter was $1.2 billion, down 14% versus the prior year and down 15% sequentially. TPS revenues this quarter were impacted by supply chain issues with a key supplier and some other equipment delivery delays.

Operating income for Turbomachinery was $161 million, up 22% year-over-year, driven by higher services mix. Operating margin was 13.5%, up 390 basis points year-over-year and up 380 basis points sequentially.

For the fourth quarter we expect TPS to see modest year-over-year growth in both revenues and margins versus the fourth quarter of 2018. Given our strong orders year-to-date and visibility for other awards the rest of the year, we continue to expect strong order growth for the full year 2019, driven by LNG awards.

Looking ahead to 2020, we expect high-teens revenue growth based on our 2018 and 2019 order intake, and for margins to continue to expand. For orders, the outlook for 2020 runs a fairly wide range depending on the exact timing of when orders are booked between late this year and early next year.

Finally, on **Digital Solutions**.

Orders for the quarter were $616 million, down 2% year-over-year. Growth in our Bently Nevada and Measurement & Sensing businesses was partially offset by declines in Controls and Pipeline and Process Solutions. Regionally, we saw strong orders growth in North America and Europe.

Revenue for the quarter was $609 million, down 7% year-over-year. Growth in Measurement & Sensing was offset by declines in Controls and Pipeline and Process Solutions.

Operating income for the quarter was $82 million, down 23% year-over-year driven by lower volume and negative mix.

In the fourth quarter, we expect revenue in Digital Solutions to be down mid-single digits year-over-year and for slightly lower margins year-over-year as weakness in the power markets remain a drag on operations.

Looking ahead to 2020, we expect revenue growth in the low-single digits and modestly higher margins.

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

Jud Bailey *Baker Hughes – VP of Investor Relations*

Thanks. With that, let’s open the call for questions.