

National Oilwell Varco

Ticker: NOV

Business Description

National Oilwell Varco, Inc. is a provider in the design, manufacture and sale of equipment and components used in oil and gas drilling, completion and production operations, and the provision of oilfield services to the upstream oil gas industry (Morningstar). NOV is the largest US based oil and gas equipment provider. Their four operating segments by sales are: Rig Systems (43%), Rig Aftermarket (13%), Wellbore Technologies (24%), and Completion & Production Solutions (20%). As you can see, NOV derives much of its sales and relating operating profits from rig system sales.

Thesis

National Oilwell Varco along with other E&P companies have taken a hit as the price of oil plummeted. Over the past 2 years their stock has dropped over 60%, revenue has been cut in half, net income has turned negative, and dividend was slashed from 46 cents to 5 cents. As an investor you may see this as the perfect buying opportunity if you expect NOV rebound alongside the price of oil. It makes sense to think that since oil caused this price decline then it will also bring NOV back to life when it rebounds in 2017. However, I do not believe this is the case as there are too many red flags and strings attached to NOV. First let's talk about the positives. NOV has a D/E ratio of just .2 which is extremely low when compared to their competitors. They should not have any issues paying down their long term debt. They also have a significant amount of cash on hand and positive free cash flow. Lastly, NOV is very cheap based on different valuation ratios when compared to its peers. Now for my concerns. NOV has had zero organic growth over the past two years, acquired 11+ companies over the past 20 months, has 89% of its largest revenue segment tied up in long term offshore activities ([see risks for more detail](#)), and has cut its dividend by 89%. I believe that these four points will create massive headwinds for NOV going forward. In my opinion, NOV's management knows they are stuck in a rut and the only way to get out is to acquire other companies. I do not like nor agree with this. I fail to see how acquiring these small cap E&P companies will have any impact on their \$12.6 billion market cap. Yes, NOV is able to acquire these companies using their cash on hand and revolving credit facilities but will they be able to capitalize off

these distressed energy companies? There are also rumors that NOV is potentially gearing up for a multi-billion-dollar M&A deal. There is too much uncertainty surrounding their core business model and the dynamics of the oil market. I would possibly hold onto NOV and even DCA **if** they did not have so much exposure to offshore drilling and paid at least an industry average sized dividend. I do not like the risk/reward of NOV and am not willing to take any chances when there are better large cap E&P companies to invest in.

Valuations

- P/E – 16.6 – Expensive when compared to its 5YR average of 13.5
- P/S – 1.3 – Undervalued compared to the industry average of 1.8
- P/B – .8 – Undervalued compared to the industry average of 1.8
- P/Cash Flow – 7.1 – Undervalued when compared to the industry average of 13.4

Source: Morningstar

Income Statement

- Revenue – \$9.9 billion (TTM) – Increased YOY to \$22.8 billion 2013 and has declined ever since.
- Net Income – (\$1.7) billion (TTM) – Increased YOY similar to revenue and plateaued in 2014 at \$2.5 billion then went negative in 2015.

Balance Sheet

- Cash – \$2 billion (2015) – There should be no immediate cash flow problems. Cash flow is positive and annual dividends will cost NOV less than \$100 million or 5 cents a share.
 - NOV reduced its dividend by 89% in April 2016. This reduction will increase their net cash flow by approximately \$615 per year (WSJ).
- Long-Term Debt – Increased by \$600 million from 2014 to 2015.
 - NOV has a very conservative capital structure of 17.1% debt and 83.1% equity. NOV has a lower D/E ratio than Baker Hughes, Schlumbergers, Halliburton, Cameron

International, and FMC Technologies, all of which are its main competitors. Even so, NOV's stock has had the largest decline in price.

- Goodwill/Intangibles – Increasing due to acquisitions. The excess in purchase price over the fair value is allocated to this item.

Source: Morningstar

Cash Flow Summary

NOV's free cash flow has been volatile over the past 5 years ranging from just \$37 million to \$1.9 billion. The TTM has left NOV with \$1.3 billion in FCF which is very favorable for a E&P company given the current market environment. This can be broken down into \$1.8 billion CFO, (\$436) million CFI, and (\$2.2) billion CFF. NOV's CFF and FCF should increase in the future due to the massive reduction in their dividend assuming all else stays the same. Their cap ex has been relatively stable over the past few years and the TTM shows it at (\$380) million.

Ratios

- Gross Profit Margin – Has decreased YOY and now sits at 18.39% which is lower than the industry average and highly undesirable.
- Dividend Payout Ratio – Since NOV has negative net income for the time being there is no dividend payout ratio, but in 2015 it was at 55.6%.
- Return on Assets – (6.2%)
- Return on Equity – (9.2%)

Source: Morningstar, TheStreet

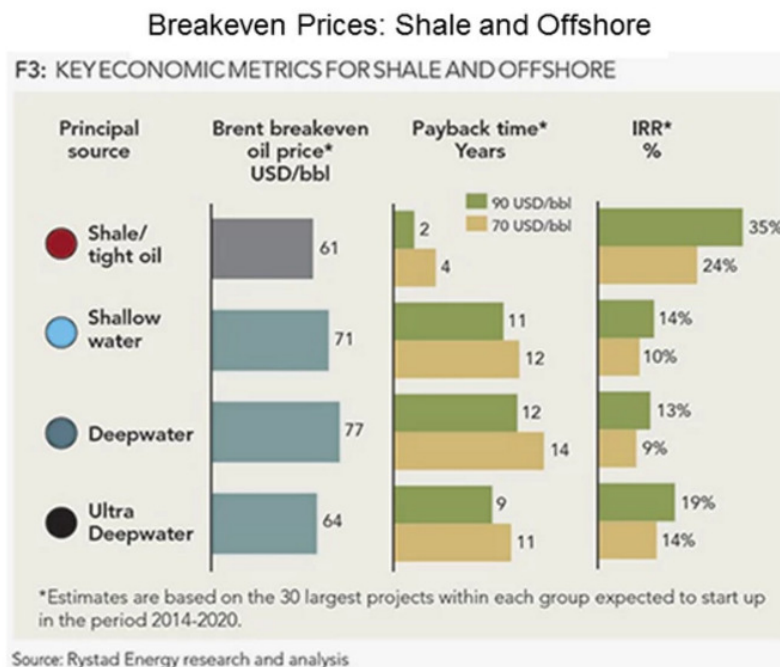
Recent Events

- Signed a contract with GE to collaborate on a Floating Production Storage and Offloading Vessel project. The project is aimed towards using new technology to reduce costs and increase efficiency.
- Seven acquisitions totaling \$84 million in 2015
- Four acquisitions during Q3'16

Source: Value Line, Morningstar

Risks

- Backlog risks: unpredictable timing and receipt of payments from customers
- Cyclical nature of commodity prices affects the demand for NOV's products and services
- Cyclical nature of the economy "..."
- Ability to finance future projects
- Rise of renewable energy sources
- Failure of acquisitions and subsequent write downs
- 89% of NOV's Rig Systems segment backlog is for offshore drilling. This could be a huge problem for the stock. The chart from Market Realist below highlights why.



You can see from this chart that shale/tight oil is the most favorable among oil E&P companies. Its breakeven price is the lowest, payback time is the shortest, and IRR is the highest. Deepwater and ultra deep-water on the other hand is the worst according to this chart. With 89% of NOV's main revenue stream averaging a payback period of 9-14 years with oil priced at \$70-\$90 per barrel, we can see why investors have fled from NOV's stock. As the demand for oil increased, so did the prices. At \$100+ per barrel offshore E&P was profitable and I suspect that NOV attempted to take advantage of this trend by investing heavily in it. This would explain why 89% of their Rig Systems backlog is currently in offshore drilling. However, the recent plunge in oil prices has left some of these projects unprofitable, deferred, or shut down indefinitely. We should continue to see a reduction in backlog due to write downs. Together the offshore Rig Systems and Rig Aftermarket segments represent 60%-75% of NOV's revenue and 81% of their operating profit. In order for E&P to become profitable in its offshore drilling segment, oil must trade in the range of \$60 - \$70 a barrel. To conclude, a large part of NOV's operations and revenue is tied to offshore drilling which could take potentially take years to recover if at all. Onshore drilling will be first to recover, leaving NOV as one of the last companies to benefit from the rebound in oil prices.

Source: CBI's 2015 10-K, Market Realist

Models & Analyst Price Targets

- Value Line - \$35 - \$55
- Yahoo Finance Analyst Coverage Average - \$32.37
- Financial Times 31 Analyst Average - \$31

Closing Summary

I recommend we sell our entire position of NOV. There are entirely too many risks associated with holding NOV and I believe that it will take years to recoup our losses through dividends and capital gains. There are other E&P companies with a much brighter outlook on the future with or without the rapid recovery of the price of oil and natural gas.

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