STIFEL

**Oilfield Services & Equipment**

**INITIATION OF COVERAGE**

**September 10, 2018**

# Why the Big Pause? Balancing Long-Term Value with Near-Term Headwinds. Initiating Coverage of Oilfield Svcs and Equipment

## Summary

We are launching coverage of 21 companies in the the Oilfield Services & Equipment sector. Despite short-term headwinds due to transitory Permian takeaway constraints, we believe the risk/reward in several names in our universe is very compelling. We project strong growth to restart in U.S. land activity by mid-2019 and believe international activity is in the early stages of a recovery.

## Key Points

- **Crude Outlook Supports Higher Activity**: Stifel's WTI crude oil price forecasts of $67.25, $63.50 and $60.00 in 2018-20, respectively, are supportive of rising worldwide drilling activity. We expect the U.S. rig count to increase about 18%, 8% and 14% in 2018-20, respectively, following 84% growth in 2017. Internationally, we are forecasting annual growth in the mid- to high-single digits in 2018-20.
- **The Permian Pause:** We are expecting takeaway constraints in the Permian basin to lead to a temporary pause in growth, not a material decline in activity. Based on detailed work by Stifel's E&P team, it appears that if completion activity plateaus, production will not overwhelm takeaway capacity. As pipeline capacity begins to come on line in 1Q19, Permian completion activity should rise with more significant growth in 2H 2019. In our view, many of the stocks in our universe are reflecting a material decline in the Permian, not a pause.
- **Short-Term Pressure Pumping Headwinds Should Abate by Mid-2019:** The anticipated pause in Permian completion activity over the next few quarters combined with new pressure pumping capacity additions will likely lead to utilization and pricing softness for U.S. pressure pumpers. We do not expect a dramatic decline in frac pricing, but we do believe spot pricing will fall. As additional Permian takeaway capacity comes on line in 2019, we predict a fairly rapid rebound in demand and solid earnings growth for frac operators in 2020.
- **Frac Sand Outlook:** Demand for sand continues to rise sharply and we are anticipating continued growth over the next several years. However, significant supply growth from in-basin mines have a meaningful delivered cost advantage. While we believe there is a market for high-quality NWS and some operators will shun in-basin sand, the in-basin mines will likely lead to sand price weakness over at least the next several quarters.
- **International Recovery Appears to be on the Horizon:** Following four years of weakness, there have been a few positive signs, including a modest uptick in rig activity, that indicate a rebound internationally is on the horizon. We expect gradual improvement and do not expect meaningful pricing and margin growth internationally until 2H 2019/2020.
- **Oil Service Stocks Have Underperformed E&Ps and Many Names Look "Cheap":** The OSX (Oil Service Index) has underperformed the XOP (Exploration & Production ETF) in 2016, 2017 and thus far in 2018. In addition, despite strong crude oil prices, the OSX has underperformed the S&P 500 in 2017 and year-to-date 2018. In addition, on average, names in our universe are down 33% from 52-week highs, including 26% for the three large caps, 41% for pure-play pressure pumpers and 50% for frac sand companies. On average, names are trading at a 30% discount to median forward EV/EBITDA multiples based on our 2020 forecasts and many sit near the bottom of the historical range, particularly pressure pumpers and frac sand companies.
- **Dealing with the Big Pause:** Over the next few quarters, we believe Permian takeaway constraints will create volatility and keep many stocks in our universe range-bound until visibility improves. In our view, many of our names offer very compelling value for long-term investors but lack positive catalysts in the short term. As it pertains to pressure pumping companies and frac sand providers, we suggest being selective and very valuation sensitive in the near term. Outside of these groups, we are focused on names with solid return on capital profiles, strong growth opportunities, robust free cash flow expectations and potential positive catalysts.
- **Our Favorite Stocks Near-Term:** Our favorite large cap names are **Tenaris** (TS, Buy, $31.22, Select List), **Baker Hughes, a GE company** (BHGE, Buy, $31.42, Select List). On the smaller cap side, we prefer **Solaris** (SOI, Buy, $15.29), **DMC Global** (BOOM, Buy, $36.95) and **Oil States** (OIS, Buy, $30.40). We also are recommending **National Oilwell** (NOV, Buy, $44.24) and **Civeo** (CVEO, Buy, $3.47).
- **Compelling Risk/Reward Plays:** While there are clearly some short-term headwinds, several names appear to offer a compelling risk/reward for value-oriented investors. These include **Halliburton** (HAL, Buy, $36.80) among large caps and small- to mid-caps **Keane Group** (FRAC, Buy, $10.67), **Liberty** (LBRT, Buy, $16.38), **ProPetro** (PUMP, Buy, $15.01), and **TETRA** (TTI, Buy, $4.24).

**Stephen Gengaro** | (973) 549-4055 | gengaros@stifel.com
**Stifel Equity Trading Desk** | (800) 424-8870

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## Exhibit 1: Valuation Summary

| | Ticker | Rating | Mkt. Cap ($ Mil.) | Price 09/08/18 | Target Price | Upside to TP | Price/EPS 2019E | Price/EPS 2020E | EV/EBITDA 2019E | EV/EBITDA 2020E |
|---|---|---|---|---|---|---|---|---|---|---|
| **Large-Cap Oil Service** | | | | | | | | | | |
| Baker Hughes, a GE Company Class A | BHGE | Buy | 34,531 | 31.42 | $40.00 | 27.3% | 20.9x | 13.1x | 9.7x | 9.2x |
| Halliburton Company | HAL | Buy | 32,380 | 36.80 | 45.00 | 22.3% | 17.2x | 10.7x | 8.9x | 6.7x |
| Schlumberger NV | SLB | Hold | 82,632 | 59.70 | 69.00 | 15.6% | 23.0x | 16.1x | 11.5x | 9.3x |
| ***Average*** | | | | | | | **20.4x** | **13.3x** | **10.0x** | **8.4x** |
| **Oilfield Equipment** | | | | | | | | | | |
| National Oilwell Varco, Inc. | NOV | Buy | 16,927 | 44.24 | 54.00 | 22.1% | 44.0x | 20.1x | 14.8x | 10.1x |
| Tenaris S.A. Sponsored ADR | TS | Buy | 18,428 | 31.22 | 41.00 | 31.3% | 16.9x | 12.5x | 9.7x | 7.6x |
| ***Average*** | | | | | | | **30.4x** | **16.3x** | **12.3x** | **8.9x** |
| **Small/Mid Cap** | | | | | | | | | | |
| Core Laboratories NV | CLB | Hold | 4,813 | 108.87 | 117.00 | 7.5% | 36.3x | 27.6x | 26.6x | 21.0x |
| DMC Global Inc. | BOOM | Buy | 550 | 36.95 | 53.00 | 43.4% | 13.9x | 10.6x | 7.9x | 6.2x |
| Oil States International, Inc. | OIS | Buy | 1,824 | 30.40 | 40.00 | 31.6% | 43.3x | 20.3x | 11.4x | 8.6x |
| Pioneer Energy Services Corp. | PES | Hold | 231 | 2.95 | 3.00 | 1.7% | NM | 57.7x | 6.0x | 4.9x |
| Superior Energy Services, Inc. | SPN | Hold | 1,259 | 8.15 | 9.00 | 10.4% | NM | 55.4x | 5.1x | 4.4x |
| TETRA Technologies, Inc. | TTI | Buy | 533 | 4.24 | 6.50 | 53.3% | 27.7x | 14.1x | 6.9x | 5.9x |
| Weatherford International plc | WFT | Hold | 2,293 | 2.30 | 3.00 | 30.4% | NM | NM | 9.9x | 8.1x |
| ***Average*** | | | | | | | **30.3x** | **30.9x** | **10.5x** | **8.4x** |
| **Pressure Pumpers** | | | | | | | | | | |
| FTS International, Inc. | FTSI | Hold | 1,038 | 9.50 | 12.00 | 26.3% | 4.6x | 3.7x | 4.2x | 3.4x |
| Keane Group, Inc. | FRAC | Buy | 1,170 | 10.67 | 16.00 | 50.0% | 13.4x | 8.2x | 3.7x | 3.1x |
| Liberty Oilfield Services Inc. Class A | LBRT | Buy | 1,936 | 16.38 | 21.00 | 28.2% | 7.4x | 6.1x | 4.0x | 3.5x |
| ProPetro Holding Corp. | PUMP | Buy | 1,254 | 15.01 | 18.00 | 19.9% | 6.8x | 6.1x | 3.8x | 3.4x |
| RPC, Inc. | RES | Hold | 2,855 | 13.29 | 15.00 | 12.9% | 16.5x | 12.6x | 7.1x | 5.9x |
| ***Average*** | | | | | | | **9.8x** | **7.3x** | **4.6x** | **3.9x** |
| **Frac Sand** | | | | | | | | | | |
| Smart Sand, Inc. | SND | Hold | 194 | 4.67 | 5.50 | 17.8% | 4.4x | 4.7x | 3.4x | 3.5x |
| Solaris Oilfield Infrastructure, Inc. Class A | SOI | Buy | 719 | 15.29 | 20.00 | 30.8% | 5.5x | 4.9x | 3.7x | 3.4x |
| U.S. Silica Holdings, Inc. | SLCA | Buy | 1,504 | 19.41 | 26.00 | 34.0% | 7.0x | 7.2x | 4.7x | 4.8x |
| ***Average*** | | | | | | | **5.6x** | **5.6x** | **3.9x** | **3.9x** |
| **Others** | | | | | | | | | | |
| Civeo Corp | CVEO | Buy | 583 | 3.47 | 5.00 | 44.1% | NM | NM | 9.3x | 7.8x |

*Source: Company reports, FactSet and Stifel estimates.*

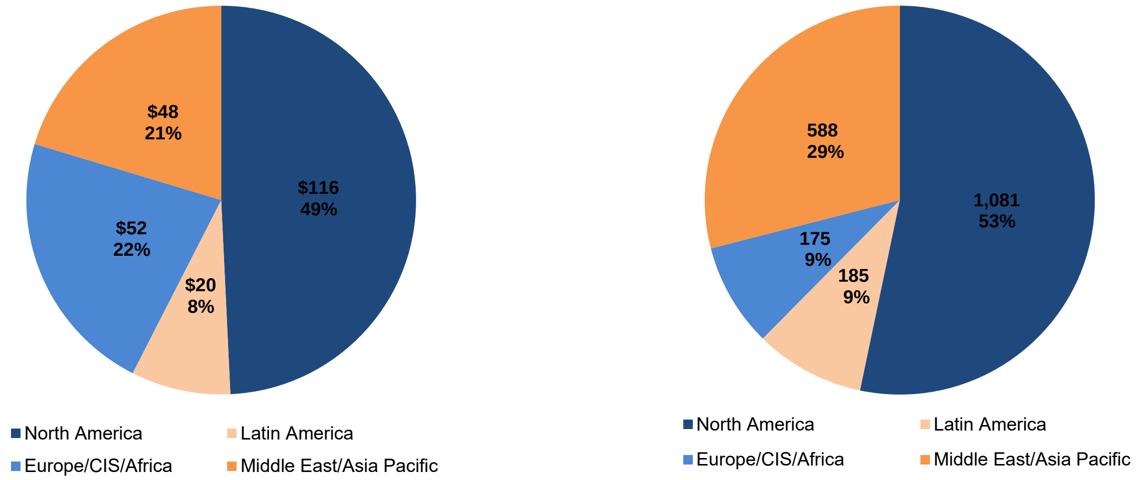
## Overview

The Global Oilfield Services and Equipment market includes a wide array of products and services ranging from commodity products like simple tubulars to highly engineered, advanced technologies used to access hydrocarbons buried deep below the Earth's surface. We estimate the worldwide Oilfield Services and Equipment market currently stands at approximately $250 billion, well off its 2014 peak of close to $450 billion. In general, the primary driver of the market is the upstream capital spending budgets of oil and gas companies, ranging from major National Oil Companies (NOCs, e.g. Saudi Aramco, Petrobras) to global integrated major oil companies (IOCs, e.g. ExxonMobil, BP) to small "mom-and-pop" operators in the U.S. land market.

From a geographic perspective, historically the rule of thumb was that roughly 75% of the market was driven by international activity and 25% by the U.S. market. This has shifted, at least in the near term, owing to the improved economics of U.S. oil production and the increasing role of the United States in world oil markets. In fact, over the past two years the U.S. rig count has more than doubled from the bottom (404 rigs in May 2016) to more than 1,000 rigs while the international rig count has been essentially flat. Looking ahead, we expect the U.S. rig count to continue to rise in 2019-20 (albeit at a slower pace) and it appears we are finally beginning to see improvements in the international rig count after several years of anemic activity.

We believe the first step to evaluating an oil service company is to clearly understand the primary markets it has exposure to and the key drivers of those markets. Spears & Associates estimates that North America accounted for 49% of the $230 billion of global oilfield spending in 2017 versus 36% in 2016 and well above the historical norm of around 25%. As highlighted in **Exhibit 2**, Latin America is estimated to be about 9% of the global oilfield market and the Eastern Hemisphere 42-43%. While there are signs that international activity is gradually improving, we expect the U.S. land market to be the fastest growing segment over the next one-to-two years.

**Exhibit 2: 2017 Global Oilfield Spending by Region (Dollars in Billions) and 2017 Rig Count by Region**

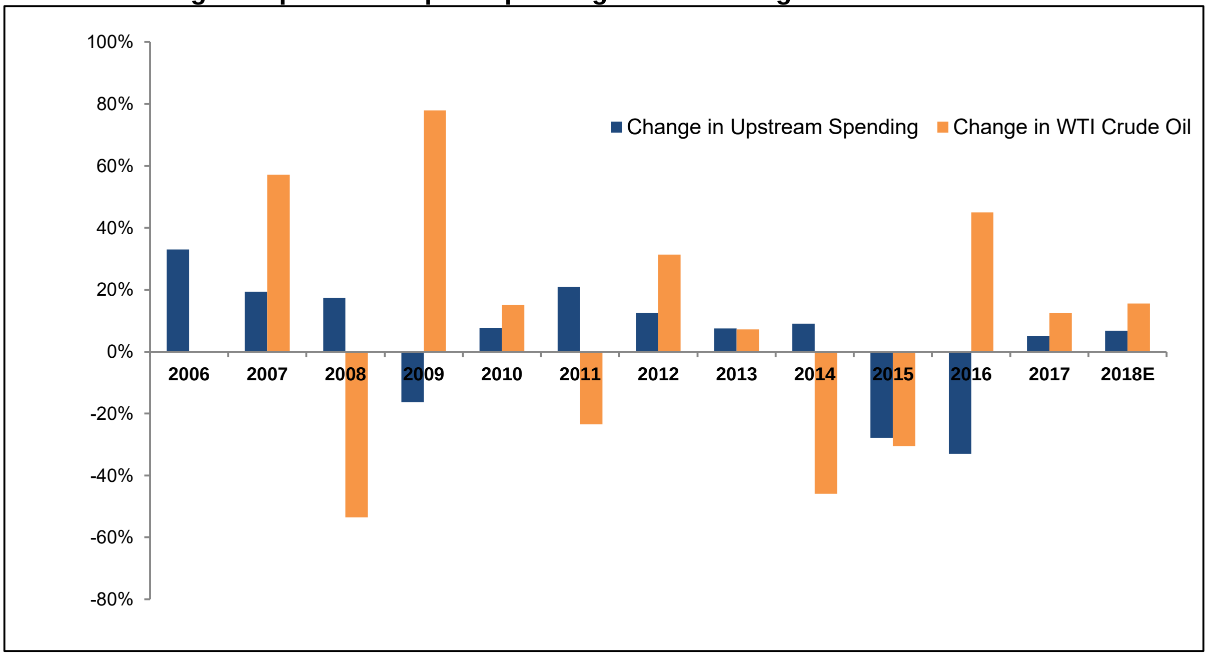



*Source: Spears & Associates (left) and Baker Hughes, a GE company (right)*

## It's a Cyclical Business and Crude Matters

The global oilfield services market is unquestionably a cyclical business with sharp swings in activity driven by several macro factors. As shown in **Exhibit 3**, industry spending tends to follow fluctuations in crude oil prices, and over the last 10+ years, the smallest percentage change in global oilfield spending was roughly 5% in 2017. This rather small change was the net effect of a very sharp rise in U.S. land revenue growth offset by anemic international land markets and weak offshore activity. While 2018 is shaping up to be a strong year in the U.S. land markets and possibly a transitional year internationally, it might be a bit optimistic to declare 2019 as the year of a synchronized global oilfield recovery, but we do expect higher activity in most areas around the globe.

**Exhibit 3: Change in Upstream Capital Spending versus Change in WTI Crude Oil Price**

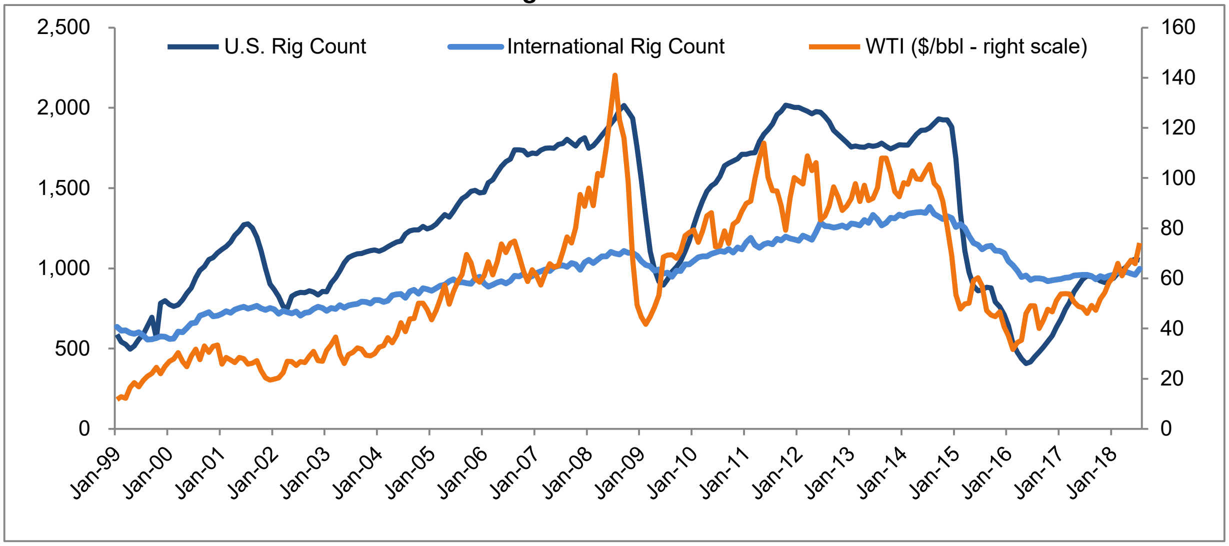



*Source: Spears & Associates, FactSet and Stifel estimates*

Crude oil prices have a significant impact on worldwide drilling and completion activity, and on oil service stocks. In the short term, fluctuations in crude oil prices tend to create volatility in stock prices and potentially create short-term trading opportunities. Importantly, near-term oil price swings are common given the abundance of noise from both expected data (weekly crude inventory data, monthly oil reports, etc.) and unexpected news (geopolitical events, rumblings from OPEC, weather, etc.).

Our investment thesis is largely driven by our expectation for crude oil prices over the next 12-24 months coupled with our view on whether the crude futures curve is too bearish, bullish or reasonable. We believe WTI crude oil prices will remain in the mid- to high-$60s per barrel level over the next several quarters and normalize to $60 longer term. In our view, this backdrop supports strong activity levels in the U.S. land market and rising drilling in intentional land markets. **Exhibit 4** highlights WTI crude oil prices relative to the U.S. rig count and the international rig count.

**Exhibit 4: WTI Crude Oil Prices versus Rig Count**




*Source: FactSet and Baker Hughes, a GE company*

As noted above, we continue to be fairly bullish on WTI crude oil prices and expect prices to remain in a range that supports rising drilling activity, particularly in the U.S. land market. Furthermore, it appears international activity will gradually rise over the next several quarters supported by increased confidence in oil prices over the next few years. We currently expect the U.S. count to rise roughly 18% in 2018 fueled by a 31% increase in the Permian and a 19% increase in the overall oil rig count. In 2019, we are forecasting an 8% rise in the U.S. rig count owing to a pause in the Permian followed by low- to mid-teens growth in 2020. Internationally, after several anemic years, we expect around a 5% increase in 2018 and likely 6-9% growth in 2019-20, respectively. Our rig count assumptions are summarized in **Exhibit 5**.

**Exhibit 5: Rig Count Assumptions**

| | | | | Average | | | | Percentage Change | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018E | 2019E | 2020E | 2017 | 2018E | 2019E | 2020E |
| **United States** | **1,861** | **979** | **509** | **875** | **1,020** | **1,100** | **1,250** | **71.9%** | **16.6%** | **7.8%** | **13.6%** |
| U.S. Horizontal | 1,275 | 744 | 400 | 737 | 867 | 957 | 1,088 | 83.9% | 17.7% | 10.4% | 13.6% |
| *% U.S. Horizontal* | *68.5%* | *76.0%* | *78.7%* | *84.2%* | *85.0%* | *87.0%* | *87.0%* | | | | |
| Permian Basin | 538 | 277 | 182 | 355 | 465 | 490 | 575 | 95.1% | 31.0% | 5.4% | 17.3% |
| *% Permian* | *28.9%* | *28.3%* | *35.8%* | *40.6%* | *45.6%* | *44.5%* | *46.0%* | | | | |
| U.S. Oil | 1,527 | 750 | 408 | 703 | 836 | 891 | 1,025 | 72.3% | 18.9% | 6.5% | 15.0% |
| *% U.S. Oil* | *82.0%* | *76.6%* | *80.2%* | *80.4%* | *82.0%* | *81.0%* | *82.0%* | | | | |
| U.S. Gas | 335 | 229 | 101 | 171 | 184 | 209 | 225 | 70.0% | 7.2% | 13.8% | 7.7% |
| *% U.S. Gas* | *18.0%* | *23.4%* | *19.8%* | *19.6%* | *18.0%* | *19.0%* | *18.0%* | | | | |
| **Canada** | **380** | **192** | **131** | **206** | **205** | **225** | **250** | 58.1% | -0.8% | 9.9% | 11.1% |
| **International** | **1,337** | **1,169** | **955** | **948** | **991** | **1,055** | **1,140** | -0.7% | 4.5% | 6.5% | 8.1% |

*Source: Baker Hughes, a GE company and Stifel estimates*

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