Cactus, Inc. (NYSE: WHD)
Q2 2020 Earnings Call Transcript
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Call Participants

EXECUTIVES

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Joel Bender
Senior Vice President, COO and Director
Steven Bender
Vice President, Operations
David Isaac
Vice President of Administration and General Counsel
John Fitzgerald
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ANALYSTS

Sean Meakim
JPMorgan Securities LLC
Ian Macpherson
Piper Sandler & Co
George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
Tommy Moll
Stephens, Inc.
Jacob Lundberg
Credit Suisse Securities (USA) LLC
Connor Lynagh
Morgan Stanley & Co, LLC
Kurt Hallead
RBC Capital Markets LLC
Blake Gendron
Wolfe Research
Stephen Gengaro
Stifel Financial Corp
Chase Mulvehill
Bank of America Merrill Lynch

Presentation

Operator
Good morning, and welcome to the Cactus Q1 2020 Earnings Call. My name is Joanna, and I will be facilitating the audio portion of today's interactive broadcast. All lines have been placed on mute to prevent any background noise. For those of you on the stream, please take note of the options available in your event console. [Operator instructions]

At this time, I would like to turn the show over to Mr. John Fitzgerald, Director of Corporate Development and IR. Sir, please go ahead.

John Fitzgerald
Director of Corporate Development and Investor Relations
Thank you, and good morning everyone. We appreciate your participation in today's call. The speakers on today's call will be Scott Bender, our Chief Executive Officer and Steve Tadlock, our Chief Financial Officer. Also joining us today are Joel Bender, Senior Vice President and Chief Operating Officer, Steven Bender, Vice President of Operations, and David Isaac, our General Counsel and Vice President of Administration.

Yesterday, we issued our earnings release, which is available on our website. Please note that any comments we make on today's call regarding projections or our expectations for future events are forward-looking statements covered by the Private Securities Litigation Reform Act.

Forward-looking statements are subject to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to review our earnings release and the risk factors discussed in our filings with the SEC. Any forward-looking statements we make today are only as of today's date, and we undertake no obligation to publicly update or review any forward-looking statements.

In addition, during today's call, we will reference certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are included in our earnings release. With that, I will turn the call over to Scott.

Scott Bender
President, CEO & Director
Thanks, John; good morning everyone. Last quarter, we were among the first to set realistic expectations for our industry. Since then, oil prices have rapidly recovered to approximately $40 per barrel, completion activity looks to have troughed, and we appear to be approaching a bottom in the U.S. rig count that is marginally higher than previously forecasted. Nonetheless, we remain committed to further streamlining our existing operations as we expect activity to remain below the levels needed to support the current industry capacity.

The second quarter was better than expected for Cactus. Although drilling and completion activity in the U.S. fell by more than half, we demonstrated the variable cost nature of this business through industry leading margins and significant free cash flow generation.

In summary:

- 2nd quarter revenues were $67 million;
- Adjusted EBITDA was over $22 million;
- Adjusted EBITDA margins were approximately 34%;
- Our cash balance increased by $40 million to $271 million; and
- We paid a quarterly dividend of $0.09 per share.

I'll now turn the call over to Steve Tadlock, our CFO, who will review our financial results. Following his remarks, I'll provide some thoughts on our outlook for the near-term before opening the lines for Q&A. Steve?

Steve Tadlock
Vice President, CFO and Treasurer
Thanks, Scott. In Q2, revenues of $67 million were 57% lower than the prior quarter. Product revenues at $41 million were 53% lower sequentially, as the U.S. onshore rig count fell by more than 50% quarter-over-quarter. Product gross margins increased to 36% of revenues, up 100 basis points on a sequential basis, in part due to $3.1 million in tariff-related benefits received during the quarter.

Rental revenues were $12 million, down 68% from the first quarter. The decrease was attributable to significantly lower industry completion activity. Although gross margins declined on a sequential basis, we were able to maintain positive margins through the achievement of cost reductions in both direct and branch expenditures.

Field service and other revenues in Q2 were $14 million, down 54% from the first quarter. This represented just under 27% of combined product and rental-related revenues during the quarter, slightly ahead of expectations. We expect this to represent approximately 26% of Product and Rental Revenue during the third quarter. Gross margins decreased 440 basis points sequentially, largely due to lower revenues, which were offset by lower payroll expenses, better labor utilization, and a rationalization of our field service vehicle fleet.

SG&A was down $5 million sequentially to $8.7 million during the quarter. The decrease was primarily attributable to lower payroll related expenses, despite a sequential increase in non-cash stock-based compensation expense. We expect SG&A to be between $8 and $9 million in Q3 2020, with stock-based compensation expense flat at slightly over $2 million.

We recorded just under $1 million of severance expense in Q2 2020.

Second quarter Adjusted EBITDA was $22 million, down from $54 million during the first quarter. Adjusted EBITDA for the quarter represented 34% of revenues. Adjustments during the second quarter of 2020 included $900 thousand in severance expenses and $2 million in stock-based compensation.

Depreciation expense was $10.5 million during the period, down from $11 million during the first quarter.

Our public, or Class A ownership, was relatively stable in Q2 and was 63% at the end of the quarter. This should result in an effective tax rate of approximately 19% in Q3 2020, assuming no changes in our public ownership percentage.

GAAP Net income was $9.1 million in Q2 2020. Internally, we prefer to look at adjusted Net Income and earnings per share, which were $7.4 million and $0.10, respectively, compared to $31 million and $0.41 per share in Q1 2020. We estimate that the tax rate for adjusted EPS will remain at 26%.

During the second quarter we paid out $6.8 million resulting from our quarterly dividend of $0.09 per share. The board has also approved a dividend of $0.09 per share to be paid in September of this year.

Net of the dividend and associated distribution payments, our cash position increased by an impressive $40 million during the quarter to almost $271 million at June 30th, highlighting the strong free cash flow generation of the company. For the quarter, operating cash flow was $57.4 million, and our net capex spend was $8.2 million.

As disclosed in our release, Cactus recognized $7.5 million in refunds during the quarter associated with tariff exclusions granted in March of this year. The refunds reduced inventory values by $4.0 million and cost of revenue by $3.5 million during the second quarter. There remains over $6 million in additional potential refunds not yet recorded as of June 30th. These will be recognized as a reduction to Cost of Goods Sold if and when received, with the amounts substantially allocated to Product costs.

Early in the 3rd quarter we made our annual TRA payment and associated distribution of approximately $23 million. We expect this payment and associated distribution to be substantially lower in 2021 as such disbursements vary directly with imputed tax liability. The recent payment reflects our strong 2019 results and the associated tax savings arising from our corporate structure.

The capital requirements for the business remain modest, as evidenced by us reducing our net capex guidance for 2020 to be between $20 and $25 million.

That covers the financial review and I will now turn you back to Scott.

Scott Bender
President, CEO and Director
Thank you, Steve.

We have often highlighted two key factors in Cactus' success have been its variable cost nature and its modest capital requirements. This was validated during the second quarter as we reduced payroll-related expenses by approximately $85 million on an annualized basis and reduced the midpoint of our 2020 capital expenditure guidance to 60% below 2019 levels. The $85 million in annualized payroll cost savings was achieved through reductions made by the end of May, requiring less than $2 million in total associated cash severance charges during the first half of 2020.

Looking to our Products business, we received favorable news as the USTR granted exclusions on specific goods that we manufacture internationally. This produced a favorable impact on Product gross profit during the second quarter. As Steve mentioned, we are optimistic that we will receive a little over $6mm in additional refunds in the coming quarters, though the timing and final amount remains uncertain. These exclusions are currently set to run through early August of this year, though we have applied for extensions and are currently awaiting a response. Such extensions, if granted, portend well for future margins. Notwithstanding the foregoing, our strong financial position is allowing us to leverage lower costs throughout our supply chain. This should support incrementals looking further out.

With regards to market share, we believe the quarter played out largely in line with our previously communicated expectations for volatility given the magnitude of the week-to-week declines in April and May and our specific customer profile. Now that the rig count is exhibiting signs of stabilization, we are confident that we will emerge with higher market share during the second half of 2020 than both our June and pre-downturn levels, a view supported both by our mid-July market share reaching an all-time high and positive indications from long-term and recently acquired customers.

As witnessed during prior downturns, customers cannot afford to ignore efficiency gains as further service pricing concessions become scarce and untenable.

Assuming the U.S. onshore rig count is relatively flat from current levels in the near-term, the average Q3 rig count will be down approximately one-third sequentially. We currently expect Cactus' rigs followed to be down in the 20% range sequentially, outperforming the broader market.

From a financial perspective, we expect the percentage reduction in our Q3 product revenues to be slightly less than percentage reduction in our rigs followed during the 3rd quarter with some modest level of production-related activity increases, and with EBITDA margins in the range of 30%.

On the Rental side of the business, revenues declined to a similar degree as onshore completion activity during the 2nd quarter as operators ceased activity given limited ability to move barrels to market. In addition, desperation pricing mirrored levels witnessed in early 2016.

We continue to maintain discipline in evaluating business opportunities, recognizing the value our equipment and services bring to customers. This discipline was key to our ability to maintain EBITDA margins just below 70% during the second quarter. Looking to Q3, we expect a low-double-digits revenue decline quarter-over-quarter given the lower starting point, with margins in the 60 percent range.

Regarding Field Service, revenues in this segment continue to be driven by both our Product and Rental activity and expect to see EBITDA margins in the mid-20% range for the coming quarter.

We were very pleased to record total Adj. EBITDA margins of nearly 34% during the quarter. If you recall, we were able to maintain Adj. EBITDA margins above 20% during the prior downturn while private, and we believe that we will achieve similar results despite our public company costs.

As noted earlier, we have reduced our capital expenditure guidance to $20 to $25 million for 2020. Given expected levels of activity, we foresee continued annualized levels of spending below $10 million for at least the back half of 2020 and into 2021.

I'd like to close by highlighting a few items before opening the line to questions:

Internationally, we continue to believe that our strategy to expand into targeted markets will bear fruit in 2021 as we develop viable business opportunities outside of the U.S. Not surprisingly, however, travel restrictions have impeded our momentum.

Regarding M&A, we continue to believe that consolidation within our industry where we have visibility to tangible synergies makes the most sense.

Regarding capital allocation, we set our dividend level with our industry's cyclicality and our ability to flex costs in mind. We remain confident we will emerge as one of the few oilfield service companies who maintain their dividend level through this downturn.

As I remind you regularly, management are long-term investors in this business and highly aligned with our shareholders. Given the almost 75% reduction in activity levels since last year, our continued success in generating cash and returns has never been more important.

In summary, Cactus is well positioned to navigate this challenging market environment. With that, I will turn it back over to the Operator so that we may begin Q&A. Operator?

Question and Answer

Operator
Thank you, sir. [Operator Instructions] We have our first question from the line of Sean Meakim from JPMorgan. Your line is open.

Sean C Meakim
JPMorgan Securities LLC
Thank you.

Scott Bender
President, CEO and Director
Hey, Sean.

Sean C Meakim
JPMorgan Securities LLC
Hey. Good morning.

Scott Bender
President, CEO and Director
How are you?

Sean C Meakim
JPMorgan Securities LLC
So, Scott – I'm doing great. Thank you. Well done on managing the quarter. And you're right, this really highlights the variable nature of your costs and it's highly differentiated in the sector. The tariff revelation is quite constructive for margins going forward. As you said in the past, maybe half of your cost of goods sold are from China and the tariff is maybe 25% of those costs — is the blended impact on COGS, something like 10% to 15%? I'm assuming you're going to give me some caveats to tamp that down, but I would love to hear some elaboration on that.

Scott Bender
President, CEO and Director
Okay. Steve, you want to take that?

Stephen Tadlock
Vice President, CFO and Treasurer
Yeah. Yeah. Yeah. I think everything you said is correct except for the last part. First of all, these exclusions weren't on all of our products, but they were on a significant number of our products. So as we look at what the margin impact would have been for the quarter, because it did happen in March, so you've got a full quarter's impact. You're probably looking at something like 3% on the product margins on an absolute basis impact once you factor in that, you know, that 50% is coming from China and all the other caveats you mentioned.

I think something Scott mentioned on the phone call is important. I think Joel has been working with suppliers very hard, and obviously, in this environment, everybody suffers and things tend to roll downhill. So, we've been able to get concessions there. And so, regardless of the tariff extension outcome, we feel pretty confident that as we get some of these cost benefits in our inventory and they roll through the system, we'll be able to maintain something in the low 30s range on the product margins.

Sean C Meakim
JPMorgan Securities LLC
Got it. Yeah, thank you for that. That clarification is really helpful. And then, on market share. It sounds like there's some volatility just given the unprecedented speed of which rigs were getting dropped, but you sound pretty encouraged by how you came out of the quarter and then where you stand today in terms of

market share. So, now you're executing a similar playbook to the last downturn. Could you just talk about some of those puts and takes and what the implication is looking forward, in terms of market share?

Scott Bender
President, CEO and Director
Wow, Sean. I wish I could answer your question directly. I can tell you I feel very confident. The team feels very confident. This is such a volatile market, though. I think you're going to see – I mean I'm confident you're going to see record market share at this company by the end of the year. I really want to leave it at that.

Part of the problem that we've had is that, as you know, we have some very high-profile customers that went into this downturn with very large rig counts and they dropped rigs extremely rapidly, which increased the volatility in our month-to-month market share. That volatility has now subsided to a large degree and we're beginning to see the benefits of adding new customers, as well as some of those customers returning to work.

So, we have the best financed customers, I think, in the industry, the most financially responsible customers, and our adoption rate is going up. So, yeah, I feel very confident. I wish I could give you more detail, but you know I can't.

Sean C Meakim
JPMorgan Securities LLC
Understood. Thanks, Scott.

Operator
Your next question is from the line of Ian Macpherson of Simmons. Your line is open.

Ian Macpherson
Piper Sandler & Co
Thanks. Good morning and congrats on the quarter. Scott, you mentioned just briefly that with regard to the M&A opportunity landscape in front of you anything that is logical and accretive. I inferred from last quarter's call that M&A was not a hot plate issue, but obviously we've seen some stabilization in the US market and have a better sense of what the dimensions of it are looking forward and just curious what types of extensions or bolt-ons for Cactus could make sense conceptually given the redefinition of the US market over the course of this year.

Scott Bender
President, CEO and Director
So, let me be clear right now. We have nothing on the horizon in terms of M&A. There clearly are a lot more opportunities that are surfacing. But I think that because of the cautious nature of this team, we now believe that the best M&A opportunities will appear within our own industry. It's the business we know. In fact, I think we know it better than anybody else. I hate to sound like somebody else who makes public announcements, but I think it's true. We have more experience in this business. We understand it. There aren't surprises and we want M&A opportunities where, as I mentioned, we see tangible synergy benefits. And the best place to look is within our own industry for that reason.

Ian Macpherson
Piper Sandler & Co
Does that entail a US onshore focus or anything broader than that potentially?

Scott Bender
President, CEO and Director
I would say both. We just, quite frankly, want it to be related to frac rentals and wellheads.

Ian Macpherson
Piper Sandler & Co
Understood. Thanks very much. I'll pass it over. Appreciate it.

Operator
Your next question comes from the line of George O'Leary from TPH & Co. Your line is open.

Scott Bender
President, CEO and Director
Hey, George.

George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
Good morning, guys.

Scott Bender
President, CEO and Director
How are you?

George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
I'm doing well. How are you?

Scott Bender
President, CEO and Director
I'm doing great. Thanks.

George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
Just curious if you could frame what percentage of your rental revenues arer kind of the newer generation of technology that you rolled out last year and what percentage are older technologies? And just curious if there's any – if you can't frame the exact numbers, has that mix shifted as we've progressed through this soft period and start to bounce off the bottom?

Scott Bender
President, CEO and Director
It's about 15%, George. Right now, the headwinds that we face or that the customers who appreciated our technologies the most really cut back on their completion activity. And as a result, we've been unable to move that number up. Having said that, I think that collectively this group feels extremely good that that same group that will ultimately have the money to start completing wells in the latter part of this year and certainly in 2021, and for that reason, I'm optimistic that that adoption rate as a percentage of our total rental revenue is going to increase.

George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
Okay. Very interesting and very helpful. Thank you, Scott. And then just one more for me. You said July market share is already at a record. So, apologies for taking a stab at a previously asked question. Could you frame what the July market share of rigs followed was? And then is that level in July what you're targeting by the end of the year, what you think is feasible by the end of the year?

Scott Bender
President, CEO and Director
That's a nice try, George. I sort of purposely didn't tell you what that percentage was, but you can look at the chart. You know what it means, broadly speaking, I guess, when I tell you that we hit a record. I think that we can move up from that record additionally by the end of the year. I feel good about that.

George O'Leary
Tudor, Pickering, Holt & Co Securities, Inc
I figured that was the case, but I'd take a shot.

Scott Bender

President, CEO and Director
All right. Sorry, George.

Operator
Speakers, your next question comes from the line of Tommy Moll from Stephens. Your line is open.

Scott Bender
President, CEO and Director
Hey, Tommy.

Tommy Moll
Stephens, Inc.
Good morning, Scott, and thanks for taking my questions.

Scott Bender
President, CEO and Director
How are you doing?

Tommy Moll
Stephens, Inc.
Doing fine. Thank you. So we haven't talked about your Asia supply chain much today. But I wonder if you could give us an update on the extent to which there may be any interruptions for product coming out of China. And then on a related point, the priority level for alternative sources of supply in the future you've commented on that before, and any update you'd be willing to share would be helpful.

Scott Bender
President, CEO and Director
Yes. I'll let Joel talk about China. But I can tell you that as we discussed in the last call, we're moving with increased, I think, focus on diversifying our supply chain out of that area. But, Joel, you want to talk about China?

Joel Bender
Senior Vice President, COO and Director
China has really returned to base capacity and production. I'm not really seeing any kind of distribution issues with the suppliers there, in fact there's lots of capacity right now. I think the only issue that we see right now just relates to vessel availability. So it might take us two weeks longer to get product in than it did before because you typically deliver to the port and it used to be they'd load you same week now it may take you two weeks to get it in. But again, in terms of production, there's just been no disruption in production from there.

And going to the other point, in terms of alternate venues for product, we are actively, as Scott said, working on that. And I think you'll see that produce some sort of fruit in 2021. Lots of good options right now, couple of different locations for that, but that is our focus right now between now and the end of the year.

Tommy Moll
Stephens, Inc.
Great. Thank you both. That context is all helpful. And shifting to a different topic now on your cost save initiatives. You took $85 million annualized out pretty quickly, which as you indicated earlier, Scott, again underscores the variable nature of your cost structure. Maybe I'm getting a little bit ahead of things here, but as we think about a potential recovery, should we think about all of that $85 million as variable on the way back up? Or having gone through this process, have you seen opportunities or have you already moved on opportunities to take the fixed cost out as well, which would then have positive implications for your incrementals and recovery?

Scott Bender
President, CEO and Director

Okay. I'm going to answer that question in two parts. The first is if we took $85 million out going down and we return to pre-COVID, we would not have to add $85 million going up. That's the first part of the answer. Okay, even though that was payroll related, so that $85 million does not include the non-payroll-related costs that we've attacked with vengeance. So I hope that answers the first part.

The second part has to do with fixed costs. We just don't have a whole lot of fixed costs in this business. We don't have multiple layers of management. In fact, it's about the flattest organization I think you'll see. In terms of facilities, our average lease duration is in the neighborhood of three years. So, we have a lot of flexibility in terms of managing our long-term facility costs in that regard, should we need to. But I think the point is we never invested in a large fixed cost platform and as a result, there's just not that many opportunities for us to reduce. We don't - I mean certainly there are some and we've attacked those, but it's not going to be – they're not going to be write-downs. I'm going to go off – I'm off script already, which is not unusual. Taking write-downs, for example, to reduce your fixed cost, well, I guess that reduce your fixed cost. We'd never put ourselves in a position to have to take the write-downs. So, I think you need to look at this in a little different way.

Tommy Moll
Stephens, Inc.
Very helpful, Scott. And maybe we'll schedule a podcast for a more fulsome discussion on write-downs and fixed cost.

Scott Bender
President, CEO and Director
You want to be on that podcast?

Tommy Moll
Stephens, Inc.
I'd love to lead it. Thank you. I'll turn it back.

Operator
Your next question comes from the line of Jacob Lundberg from Credit Suisse. Your line is open.

Jacob Lundberg
Credit Suisse Securities (USA) LLC
Good morning, guys.

Scott Bender
President, CEO and Director
Good morning.

Jacob Lundberg
Credit Suisse Securities (USA) LLC
Just wanted to go back to the discussion on some of your new innovations within the rental segment. I'm curious if during the downturn, you've seen any change in the way your customers are thinking about some of those products. So I understand some negative customer mix took down the numbers temporarily in 2Q. But in terms of your conversations with customers, any changes in the way those operators are thinking about, thinking broadly just the application of innovative technologies in their business, but obviously specifically as it relates to your business and do you think coming out of this, there could be greater appetite for stuff like that as the focus goes from immediate cash preservation towards thinking about driving better efficiencies?

Scott Bender
President, CEO and Director
Yeah. So we saw very little appetite for any additional cost on the frac site during the quarter. Interestingly enough, over the last, I'd say, couple two, three weeks as some of our larger accounts are beginning to talk about going back to work, we're seeing renewed interest in the innovation part of our rental fleet.

The other item, of course, that's so significant is stage costs have gone down a lot, which means that the value of reducing NPT is not quite as great. And so the payback on an innovation, which we've always thought, was extremely high. This naturally becomes slightly less compelling in an environment like today's environment.

So the best thing that happens for us, frankly, and probably the industry, pressure pumping pricing stabilizes, begins to move up, and the customer mix that begins to frac is a customer mix that supports safety and innovation. So, I feel much better about the future. This quarter though, there was just no interest in spending money.

Jacob Lundberg
Credit Suisse Securities (USA) LLC
Okay. That makes sense. And then just a question, I guess, again on the on the rental segment. I was kind of curious on the top line guide for 3Q. I would have expected with perhaps a little bit of rebound completion activity in 3Q, maybe your revenues would have been flat to modestly up. I'm just curious if you could help me understand what seems like a disconnect but maybe you guys have a different view on 3Q completions?

Scott Bender
President, CEO and Director
I think the first part of the quarter was pretty good. And then it deteriorated in the last couple of months. Probably, the most honest answer is we're conservative.

Jacob Lundberg
Credit Suisse Securities (USA) LLC
All right. Fair enough.

Scott Bender
President, CEO and Director
I think there's some upside.

Jacob Lundberg
Credit Suisse Securities (USA) LLC
Makes sense. All right. Thanks a lot. Appreciate it, guys.

Scott Bender
President, CEO and Director
Sure.

Operator
Your next question comes from the line of Connor Lynagh from Morgan Stanley. Your line is open.

Connor Lynagh
Morgan Stanley & Co, LLC
Yeah. Thanks.

Scott Bender
President, CEO and Director
Connor, how are you?

Connor Lynagh
Morgan Stanley & Co, LLC
I just wondering if – good. How are you doing?

Scott Bender
President, CEO and Director
Great.

Connor Lynagh
Morgan Stanley & Co, LLC
I was wondering if I could follow up on Jake's question there; more on the rig side of things. I think you guys gave one of the more realistic assessments last quarter on where things were heading. I think you've addressed the completions there. But on the drilling side of things, I think you guys have highlighted you get a little bit more visibility than some of the other contractors. So, what's your thinking on people's appetite to put some rigs back to work later this year or early 2021? Where do you think the customers are at these days?

Scott Bender
President, CEO and Director
I see an appetite in, believe it or not, the Eagle Ford. I see an appetite in the Delaware. I see sort of no indication of any increased appetite in the Mid-Con. I see a waning appetite in the Northeast. We had really hoped that gas prices in the Northeast would be constructive; I'm not seeing that so much. Maybe a little bit of optimism on the Bakken. But I would say primarily South Texas and the Delaware.

Connor Lynagh
Morgan Stanley & Co, LLC
Got it. That makes sense. Any order of magnitude you'd have us think about as we move later this year? I mean, are we talking low double digits, are we talking single digits? What's your thinking there?

Scott Bender
President, CEO and Director
I would say probably low double digits by the end of the year.

Connor Lynagh
Morgan Stanley & Co, LLC
Got it. All right. I wanted to pivot maybe.

Scott Bender
President, CEO and Director
Let me...

Connor Lynagh
Morgan Stanley & Co, LLC
Go ahead, sorry.

Scott Bender
President, CEO and Director
Let me just caveat that by saying I mean that really is off the top of my head. I'm trying to think about customer by customer, and I think I said earlier, we're blessed with some customers that are capable of adding rigs financially, some of them are, some of them aren't. But I think it's fair to say low double digits.

What I really think will happen – you didn't ask this question, but I'm going to answer it anyway. Our production tree business, which is historically in the 26% or so range, 27% range of products, really fell off the face of the map because of completion activity. You're going to see much better results from our production tree segment. We're already seeing some light there. And as frac activity in general picks up, I think you'll see production – our production trees pick up disproportionately faster than our wellhead product segment.

Connor Lynagh
Morgan Stanley & Co, LLC
Got it. And that's the best kind of question where I get you talking about something I didn't even ask. The one high-level question I had here is you've had some of your large competitors, I mean, probably for the better part of the past 12 to 18 months here. But there's a serious mandate to generate returns. And I think it's clear to many that you've taken a lot of share and the returns of some of those larger players are

a lot lower than they used to be. Have you seen any shift in behavior there as we've gone into the downturn, these organizations have done another round of cost cutting - do you have a lot more opportunities or is it too early to tell?

Scott Bender
President, CEO and Director
You know how much I love all my competitors. I don't want to make any disparaging remarks about them. This business doesn't really probably move the needle as much with our competitors. I think they have a lot of other problems besides their surface wellhead business. The short answer is I haven't really seen any indication of any change in their behavior.

Connor Lynagh
Morgan Stanley & Co, LLC
That's fair. Thanks.

Operator
Speakers, your next question comes from the line of Kurt Hallead of RBC. Your line is open.

Kurt Hallead
RBC Capital Markets LLC
Hey. Good morning, everybody.

Scott Bender
President, CEO and Director
Good morning.

Stephen Tadlock
Vice President, CFO and Treasurer
Good morning.

Kurt Hallead
RBC Capital Markets LLC
Hey, Scott. I just wanted to clarify – see if I can clarify one thing. When you talked about the prospect of increased activity in South Texas and the Delaware, was that specific to completion activity or drilling activity or some combination of both?

Scott Bender
President, CEO and Director
Yeah, I was really talk – when I responded, I was only thinking about drilling.

Kurt Hallead
RBC Capital Markets LLC
Okay. Great. I appreciate that. In the context of completion-related activity, can you give us your perspective on how you may see things evolving? It seems like there's going to be a pick-up of activity here in the third quarter. And then I'm getting a little bit of a mixed read on the prospects for sustainability of that dynamic into the fourth quarter. So maybe pushing a little bit beyond your comfort zone about quarter-to-quarter dynamics, but I know you're really tied in close to your customer base, so really appreciate your perspective.

Scott Bender
President, CEO and Director
Yeah. I think that our view is that the improvement in completion activity will be in West Texas to a far greater degree than any other basin. And I don't really have good visibility beyond the next 90 days in that regard. So we have – we know that a couple of our customers are going to be adding some crews. But they're not talking about the continued adding of crews. Having said that, our customers have built a lot of DUCs. Sooner or later, they're going to have to address those. I think that the industry is probably going

to maintain a higher level of DUCs than they have in the past, but I feel pretty good about 2021 in that regard. Maybe I'm probably not as optimistic that you're going to see a large increase from Q3 to Q4 though.

Kurt Hallead
RBC Capital Markets LLC
Okay. That's great color. And then I think, at least from my perspective, be curious to get a read from you as to – or a refresher if you will, as to what is driving the market share gains on the wellhead side of the business. Has there been any recent developments or new developments or improved elements of technology, efficiencies? I just wonder if you can give us a little more color on what you think is ultimately driving that share dynamic?

Scott Bender
President, CEO and Director
Yeah. I think it's a combination of customers and customer mix, the right customers adding rigs. I think it's – it's so hard for anybody outside the business to appreciate it, but it's outstanding execution. As everybody cuts back, it's not going to surprise you to learn that service levels also suffer and we made the decision because we were financially capable of maintaining our core group of field service and branch operating people. And I think our level of execution has – in my opinion, has never been better than it is today. And so as our competitors perhaps begin to maybe pay less attention to that aspect of the business, I think we're seeing the benefits of that.

Kurt Hallead
RBC Capital Markets LLC
Okay. Appreciate that. And if I may slip one in for Stephen, just wanted also to clarify on this, in terms of the margins for the products business, that low 30% margin would be exclusive of any tariff refunds in the back half of the year?

Stephen Tadlock
Vice President, CFO and Treasurer
Yes.

Scott Bender
President, CEO and Director
Yes.

Kurt Hallead
RBC Capital Markets LLC
Okay. Thank you for clarifying. Thanks.

Operator
Your next question comes from the line of Blake Gendron from Wolfe Research. Your line is open.

Blake Gendron
Wolfe Research
Hey. Thanks. Good morning. Thanks for taking my questions here. The first on product, so it sounds like trees fell off a cliff, so products revenue underperformed the rig count quarter-over-quarter on average. I wouldn't assume the pricing improved in the quarter, but still revenue in products per rig followed increased slightly. So is it just an efficiency thing where the rigs that were left were drilling far more wells and is this a trend you see continuing that may not be fully appreciated in the way we think about this business for a lower growth rig count moving forward?

Scott Bender
President, CEO and Director
Well, Blake, there's a delay between rigs added and revenue realized, okay? So we went into the downturn with a very, very high rig count and you saw the benefit of that, I think, during the quarter, as I

said, because of the lag. That's one point. I think the next point is our product mix has become more favorable in that the areas with the lowest cost wellheads fell off the most and areas like the Delaware held up the best, and the average wellhead is a good deal more expensive in the Delaware than it is, for example, in the Bakken or in South Texas. So, it's a combination of product mix as well as, as I said, the lag time between rigs being added and revenue being generated.

Blake Gendron
Wolfe Research
Totally fair. Shifting gears to international. I know we have some time obviously to nail this down. As we move forward here right now with logistical constraints, it's tough to get traction here. But how do you think about the international expansion and I guess specifically the Middle East as one that investors anticipate you eventually getting back to just because you're very familiar in your prior businesses in that part of the world. What would the ideal commercial structure look like? Would you basically stand up your own operation in that part of the world? Would you try to go through a commercial partner? Appreciating some of your comments about overhead and keeping fixed costs low. Just trying to understand, I guess, what the optimal strategy is and then how you think about roughly margin accretion versus the US business as it stands today if we were to see a little bit more expansion internationally.

Scott Bender
President, CEO and Director
Well, I think I might have some competitors on the line, which always gives me a little bit of concern. So I'm not going to – I'm going to have to be a little bit vague in my response. I would say you're going to see a combination of the two. But one thing we will never do and that is subject our technology to the whims of others to distribute it outside of our control. So, no matter what structure we adopt, be it a stand-up facility, be it a JV or a partnership, we're going to maintain control, so we can control the technology.

In terms of margins, it's just a fact that margins internationally – I know that some of our larger competitors take a different view. My experience, as I've said many times before, is margins are lower internationally. I think that maybe the industry doesn't appreciate the fact that while international has held up extremely well this year simply because it's project-oriented and the orders were booked last year. Margins internationally are going to take a beating in 2021, as particularly the NOCs negotiate their 2021 purchases.

So margins are going to be even worse than what we had anticipated. But nonetheless, we are staying the course. We're going to continue to pursue this. And I still feel like 2021, you're going to see some results of that. So general, margins worse than I had anticipated, worse than maybe some people have disclosed to you. And we're not the only company, obviously, that's turning its attention internationally, which is just going to increase competition along all service lines, not just wellhead.

Blake Gendron
Wolfe Research
Totally fair. Is that lower – that's lower margin than the US business, just to be clear, or just lower than international has been in recent history?

Scott Bender
President, CEO and Director
Lower than the US. Lower than it has been.

Blake Gendron
Wolfe Research
Got you. And just one quick follow-up. Any opportunity you think on the unconventional gas side as it relates to your rental products or is it just not of scale yet in the Middle East?

Scott Bender
President, CEO and Director
Yes, there is opportunity there.

Blake Gendron
Wolfe Research
Great. Thank you very much.

Operator
Your next question comes from the line of Mr. Gengaro of Stifel. Your line is open.

Stephen Gengaro
Stifel Financial Corp
Thanks. Good morning, gentlemen. Just a quick follow-up for me. When you talk about market share gains going forward, is it a function of more work by existing customers, new customers, or a combination of those two?

Scott Bender
President, CEO and Director
Combination.

Stephen Gengaro
Stifel Financial Corp
Okay. Thanks. And just one other follow-up on the working capital front as we look at the second half of the year. Any guidance, the benefit you might get from working capital either based on the dynamics of DSOs and payables or in aggregate?

Scott Bender
President, CEO and Director
Sure.

Stephen Tadlock
Vice President, CFO and Treasurer
Yeah. I would say on the AR side, we had a great quarter in terms of collections. Obviously, days slipped some. But we think we'll continue to see some harvesting in AR; and certainly in inventory we would expect some. I think looking at the overall picture, we think we will remain free cash flow positive through the remainder of the year with the cash balance roughly flat after paying out dividends and taking into account the recent TRA payment.

Stephen Gengaro
Stifel Financial Corp
Great. Thank you.

Scott Bender
President, CEO and Director
Yes. Let me just add to that even though you didn't ask the question. This team has done a really remarkable job on AR. I mean I'm very optimistic that we're going to emerge from this thing with very little impact from customer payment problems.

Stephen Gengaro
Stifel Financial Corp
Okay. Thank you.

Operator
Your next question comes from the line of Chase Mulvehill from Bank of America. Your line is open.

Scott Bender
President, CEO and Director

Hey, Chase.

Chase Mulvehill
Bank of America Merrill Lynch
Hey. Good morning, gentlemen.

Scott Bender
President, CEO and Director
How are you doing?

Chase Mulvehill
Bank of America Merrill Lynch
Hey, Scott. I'm doing well. It's finally sunny here in Houston, so it's nice to look out the window and see some sun rather than rain.

Scott Bender
President, CEO and Director
It's not going to last, Chase.

Chase Mulvehill
Bank of America Merrill Lynch
I know, it's Houston, right?

Scott Bender
President, CEO and Director
Yeah, exactly.

Chase Mulvehill
Bank of America Merrill Lynch
I guess, I wanted to come back to the market share question. And doing a calculation what the rig count expectations probably are for 3Q for the industry and your comment about rigs followed down around 20%. If I'm doing the math right, that implies that you'd have about 35% share in the third quarter. Can you confirm that number? And then, also on the share gains, this has been asked a lot but I guess maybe I didn't hear if you've actually had success penetrating the majors yet?

Scott Bender
President, CEO and Director
I think that's the third question I've gotten about market share. Chase, you're a pretty good mathematician, buddy. Let me just say that, okay?

Chase Mulvehill
Bank of America Merrill Lynch
All right.

Scott Bender
President, CEO and Director
The next question really, you asked about the majors and I'm not going to comment on that except to say that if you think about the people who are going to be drilling wells to the second half of the year and into next year, and I feel good about the customers with whom we do business and their ability to drill wells financially.

Chase Mulvehill
Bank of America Merrill Lynch
Okay. All right. I'll take that as a yes.

Scott Bender
President, CEO and Director
Don't. Chase, I didn't say yes.

Chase Mulvehill
Bank of America Merrill Lynch
You didn't say no. All right. I guess a lot of other things have been covered here, but just wanted to talk about CapEx and longer-term CapEx. Obviously, the back half is mostly maintenance. Maintenance, I think, you've said is below $10 million on an annual basis. As we look over the next couple of years and you think about building out internationally, how should we think about the moving pieces for CapEx? How much growth do you think that you need to spend over the next couple of years as you push internationally?

Scott Bender
President, CEO and Director
I wish I could tell you it was an immense amount of money. It's not going to be. I think I've said in the last call or the call before, do not concern yourself with international CapEx. We're going to do it in a manner that's going to be very conservative because that's just the way we operate. You're not going to see us announce a $10 million facility in Kazakhstan or someplace like that or anywhere.

Chase Mulvehill
Bank of America Merrill Lynch
Okay.

Scott Bender
President, CEO and Director
We're just not going to do that.

Chase Mulvehill
Bank of America Merrill Lynch
Okay. And then on the rental side, is there anything – I mean, I imagine you probably don't need to spend on the rental side anytime in the near term. But over the next couple of years, do you foresee any big bumps in growth for rental?

Scott Bender
President, CEO and Director
Not for legacy equipment. Obviously, we've got plenty of that. Got a couple of very interesting products that I'm not going to discuss on the completion side that we have not introduced, but we intend to introduce. But it's still not going to be a significant amount of money.

Chase Mulvehill
Bank of America Merrill Lynch
Okay. Understood.

Scott Bender
President, CEO and Director
But it will be incremental CapEx to be sure. I stand by, I think, our earlier statement that 2021 looks like a $10 million CapEx year.

Chase Mulvehill
Bank of America Merrill Lynch
Got it. Okay. I'll turn it back over. Appreciate the color.

Operator
Thank you. Speakers, there are no more questions at this time. You may continue.

John Fitzgerald
Director of Corporate Development and Investor Relations
Thanks everyone for joining the call.

Scott Bender
President, CEO and Director

Thanks, everybody. Stay safe. Looking forward to seeing everybody again when we can all get together. Stay well.

Operator
Thank you, speakers. Once again, ladies and gentlemen, this concludes today's conference call. Thank you all for joining. You may now disconnect.