Baker Hughes Inc. (BHI) – Long $56.33 average

Halliburton

Share Price:	$ 38.12	Revenue:	31,739	P/E:	9.5
Market Cap:	32,305	EBITDA:	7,008	P/TBV:	2.4
Enterprise Value:	38,119	EBIT:	4,942	EV/EBIT:	7.7
Cash:	2,029	Net Income:	3,392	Net Debt/EBITDA:	0.8
Debt:	7,816	FCF:	1,668	EBIT/Interest:	12.9

Baker Hughes

Share Price:	$ 56.33	Revenue:	23,776	P/E:	18.7
Market Cap:	24,368	EBITDA:	4,108	P/TBV:	2.2
Enterprise Value:	27,572	EBIT:	2,326	EV/EBIT:	11.9
Cash:	1,209	Net Income:	1,304	Net Debt/EBITDA:	0.8
Debt:	4,413	FCF:	936	EBIT/Interest:	9.9

<u>Background</u>

Baker Hughes Inc., with revenue of $22.4 billion in 2013, is the world's third largest integrated oilfield services company, after Schlumberger Ltd. (SLB) and Halliburton Co. (HAL). Baker Hughes was formed in 1987 with the merger of Baker International and Hughes Tool Company, both founded over 100 years ago. It operates in over 80 countries, with 52% of its revenues and 56% of EBIT generated in North America.

<u>Halliburton/Baker Hughes Merger</u>

On November 18th 2014, Halliburton announced the proposed acquisition of Baker Hughes for $34.6 billion. Baker Hughes stockholders will receive 1.12 HAL shares + $19 cash per share (76% stock/24% cash). The cash portion will be financed with cash on hand and fully committed debt financing. Baker Hughes stockholders will own 36% of the combined company. The deal is expected to close in 2H 2015. If the deal is not completed, Baker Hughes will receive a $3.5 billion breakup fee (~$8/share).

<u>Thesis</u>

1. **The merger of the two largest North American players will create a global No. 2 player with strong competitive positioning against French-based Schlumberger.**

The merger will cement the combined company's dominant position in North America, which at 39% will be double that of Schlumberger's market share in North America. More importantly, the combined company will become a much stronger competitor to Schlumberger in international markets.

Halliburton and Baker Hughes had higher combined revenue of $52 billion in 2013 versus Schlumberger at $45 billion. Both HAL and BHI, however, are underpenetrated internationally, with roughly half their revenues from international operations, versus Schlumberger with over two-thirds. By merging with a major competitor, the combined company will increase its global clout and gain stronger pricing power, giving it a better position to increase its international market share.

The two companies also have significant complementary product lines which fill gaps in each other's portfolio to create a truly comprehensive oilfield services company. For example, Baker Hughes is a strong player in the artificial lift market (a technology used to boost production in aging wells) which is expected to double from $15 billion to $26 billion globally in the next five years as wells begin to mature.[1] The post-merger company will have the depth and breadth to become a viable competitor to Schlumberger, which currently is the only company that can "deliver everything everywhere", according to research company Spears & Associates[2].

In addition, projected annual cost synergies are nearly $2 billion (~4% of combined revenues), realizable by the end of the second year following closing, versus total integration cost of $500 million. Aside from corporate overhead and R&D costs, the companies are likely to achieve operational efficiencies due to significant overlap in key product segments and geographies. For example, the pressure pumping business, which constitutes ~29% of combined revenues, carry significant logistics and raw materials costs[3], which provide ample opportunity for economies of scale post-merger. Overall, the acquisition is expected to be accretive to Halliburton's cash flows by the end of the first year post-merger and to earnings per share by the end of the second year.

2. **Baker Hughes is trading at a ~15% discount to Halliburton at the merger ratio; furthermore, there is an $8/share break-up fee, or 14% of BHI's market cap, if the merger does not go through.**

The current spread of ~15% is attractive relative to our evaluation of the merger's successful completion. Halliburton has demonstrated significant determination in getting the deal completed - it has agreed to divest businesses that currently generate up to $7.5 billion in annual revenues if required to do so by regulators. It has also agreed to pay a $3.5 billion break-up fee, equivalent to $8/BHI share, if the deal fails to get regulatory approval. Halliburton has secured up to $8.6 billion of bridge financing for the cash portion of the deal.

As with all large merger transactions, there is a degree of uncertainty as to eventual completion. The current spread reflects investors' uncertainty about antitrust issues and possible negative impact from low oil prices. We believe, however, that the current discount provides an attractive entry to the combined company, and the breakup fee provides a significant buffer on the downside in case the merger is not completed.

3. **Both Baker Hughes and the combined company are financially secure, with an ability to withstand significant short term adversities.**

Baker Hughes has a strong capital structure. As of September 30, 2014, it had $4.4 billion of debt, with substantially all issues maturing in 2018 and beyond. It also had $1.2 billion of cash on hand and $2.5 billion of untapped revolving credit available. Leverage is low, with total debt/capital at 19%, and net debt/EBIT less than 1.4x. Interest coverage is strong with EBIT/interest expense at 10x.

Similarly, preliminary pro forma financials as of September 30, 2014 indicate financial security for the combined company. Long-term debt will total ~$20.3 billion or ~36% of total capital, with no material maturity prior to 2018. Cash on hand is projected to total approximately $3.0 billion, and interest coverage remains strong, with last 9 months EBIT/interest expense of ~8.8x.

We believe that both Baker Hughes and the combined company will have a strong liquidity profile and are well positioned to weather significant short term adversity, with a low risk of financial failure.

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[1] http://washpost.bloomberg.com/Story?docId=1376-NF97176KLVRP01-2AGNFLV8EO251GGRGQ240CSOLC
[2] http://washpost.bloomberg.com/Story?docId=1376-NF97176KLVRP01-2AGNFLV8EO251GGRGQ240CSOLC
[3] http://www.forbes.com/sites/greatspeculations/2014/11/18/why-halliburton-is-buying-baker-hughes/

4. **Recent oil price decline has caused substantial decline in share price. Currently trading at historically low valuations.**

By purchasing Baker Hughes at its current spread to Halliburton, we are effectively buying Halliburton at $33.33/share. This implies a valuation of 9.5x pro forma earnings and 1.2x pro forma book value. On both earnings and book value multiples, the stock is trading at the low end of historical valuations.

On the other hand, we believe there will be significant upside to both earnings and valuation as the uncertainties related to the merger and oil price environment abate. We believe that the merger creates a stronger company that not only will have strong financials to weather the volatility in oil prices, but also puts it in a superior competitive position to gain market share in the future, especially in a low oil price environment.