National Energy Services Reunited
First Quarter Earnings Call
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Presenters
Christopher L. Boone -- Chief Financial Officer
Sherif Foda -- Chairman of the Board and Chief Executive Officer

Q&A Participants
David Anderson -- Barclays
Sean Meakim -- JPMorgan
George O'Leary -- Tudor Pickering Holt
Greg Colman -- National Bank Financial
Andres Menocal -- Evercore ISI
Blake Gendron -- Wolfe Research
Igor Levi -- BTIG
Jeff Fetterly -- Peters & Company

Operator
Greetings, and welcome to the National Energy Services Reunited First Quarter Earnings Call. At this time all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press *0 on your telephone keypad. As a reminder, this conference is being recorded.
It is now my pleasure to introduce your host, Chris Boone, Chief Financial Officer.
Thank you, sir, you may begin.

Christopher L. Boone
Good day, and welcome to NESR's First Quarter 2020 Earnings Call. With me today, is Sherif Foda, Chairman and Chief Executive Officer of NESR. On today's call, we will comment on our first quarter results and overall performance. After our prepared remarks, we will open up the call to questions. Before we begin, I'd like to remind our participants that some of the statements we'll be making today are forward-looking. These matters involve risks and uncertainties that could cause our results to differ materially from those projected in these statements. I therefore refer you to our latest earnings release filed earlier today and other SEC filings. Our comments today may also include non-GAAP financial measures. Additional details on reconciliations to the most directly comparable GAAP financial measures can be found in our press release, which is on our website. Finally, feel free to contact us after the call, with any additional questions you may have. Our Investor Relations contact information is available on our website. Now, I'll hand the call over to Sherif.

Sherif Foda

Thanks, Chris. Ladies and gentlemen, thank you for participating in this conference call.

We are very excited to report on our outstanding results this quarter….. It is the largest quarter ever in the history of the company; we grew 31% year over year and 8% sequentially. This is in contrast to a usual seasonal decline from Q4 to Q1 …more so… given it was achieved under the shadow of both a worldwide pandemic crisis and a once in a generation oil price environment. I will touch in details both the challenges and our actions related to COVID-19… as well as the reality of the new oil price environment… but before that I want to acknowledge the exceptional effort all our employees have put in to support our customers and differentiate ourselves in these challenging times.

Their resilience…., hard work and extended stays in the different countries and at our worksites is the reason we are considered the trusted partners by our customers. Its an outstanding team effort and I am very thankful to be blessed with such an enterprising group of individuals in our company across all the levels. I have spent a fair bit of my career in the field and in normal days things are challenging enough but to do that under the limitations of this pandemic adds a layer of complexity which only the best can handle. Our teams on the ground have come out with flying colors and the results are there to speak for themselves…..

So how did we enable our organization to go and gain market share,….. deliver growth… and exceed our customers expectations in such trying circumstances and how are we going to go ahead with this? I will take a few minutes to explain our approach….

…. we prepared early and appointed a Crisis Management Team or CMT which comprised of all my direct reports and key operations personnel and below it… each country had its Emergency Response Teams or ERT activated…. This CMT has been meeting daily and reviews the status of our readiness across all aspects of our operations as well as addresses any upcoming or potential issues we could face in due course. So we are not only focused on what is happening today but also simultaneously planning for things 2 weeks,…. one month, two months down the road and also for any eventuality including if the borders between the countries are completely shutdown. This covers everything from Logistics,…. Suppliers sustainability and how they are handling their own operations, Customer engagement, minimum inventories for spares and chemicals, liaising with our customers and local authorities for their elevated and continuously evolving processes, navigating through each country regulations on handling quarantine procedures while ensuring the health,.. safety and wellbeing of our employees and everything else which could…. and would get affected.

Lastly we always need to ensure that we go the extra mile to confirm our people on the ground are well taken care off… and the CMT set out a series of initiatives to not only take care of our employees at their worksites but also for their families….. One of these initiatives was to offer financial help in the form of pre-payment of salaries to the families of employees who are either out of their home countries or at the wellsite for extended periods, and send money to their country of origin. At those difficult times, we strongly believe it is our duties to support all our employees and their families, they are making the difference to our customers and maintain our business continuity intact.

Our Customers recognize these efforts and have in turn depended on us more and more to cover for any disruptions of their activity on account of some of our competitor's inability to manage through the challenges.

In summary, Not only are we coping with our existing normal work scope but are actually taking on more work in this period because we have been able to plan better than others and have managed our equipment, supplies and inventories as well as our field staff. It is a testament to the culture of performance and customer first that we have built in NESR. And all this reflects in the 8% growth sequentially when the overall customer activity has been flattish and I will expand on an example later in my comments.

Now let me segue into what is happening on the Macro front. I won't belabor on the dynamics of OPEC, Russia and US Land as everybody knows it or has an opinion on it but the key point of relevance to oilfield services which I want to make is that international low cost per bbl markets are always more resilient in the downturns and this especially applies to MEA and Russia. From day one and the reason we formed NESR was to focus in MEA and our clients, and that is the exact reason we opted not to change our mantra. Now we are going to see why we held the line on our core foundational principle. There is inherent stability in the region and our main clients are National companies who have larger objectives than to respond to short term oil price gyrations.

They are focused about their country's well being, maximizing the returns for the country as a whole, employment and social effects of the industry. Yes, as priorities change they will move between Oil and Gas as per their long term directions and Yes, they also have to work within the parameters of the Oil price environment reality but this also provides us an opportunity to innovate on our delivery and the solutions we provide both commercially and technically.

GCC as a whole remains active and had no slow down in Q1. Things will change obviously with the OPEC Cut in May but I see it both as a challenge but also as an opportunity to strengthen the business. In my opinion, going forward, most of the delays will come from new projects: seismic, exploration cancellation, offshore new frontier, and additional downstream mega developments. We pride ourselves on being close to our customers, we understand them… and have the pulse of the region and the way we will execute our strategy is by being agile to react and adapt. Our relatively small size also helps us in readjusting to any changes.

Outside of GCC, North Africa and Iraq both are affected by these oil prices as it is driven by several international and local independent companies and this is further compounded by the effect of Coronavirus in an already security and structurally challenged environment. Drilling new wells will be the most affected especially the large LSTK projects but the production activities won't get affected by the same scale. On a marginal basis they still have a very low cost of production per barrel so these fields are going to continue to produce and they will maintain production and workover activities rather than drilling new wells.

Outside of the larger MENA region, Africa has seen a significant drop and project cancellations… and West Africa will be heavily affected and I don't see any new Deepwater or offshore projects being sanctioned in the near future. Our limited exposure is to Chad only where most clients declared force majeure but in the overall scheme of things is insignificant to NESR.

As in any downturn, Pricing is going to be a topic of issue eventually if not already with our customers and we have to ensure that we adjust to the market realities in the most optimum way. Similarly, we are working to get the appropriate savings from our supply chain and align our partners and suppliers to the new reality. All this is happening in parallel but overall, our endeavor is to reduce the total cost of operations and share those savings to our customers.

Last quarter, I talked about how we initiated and started executing our Unconventional fleet operations in the Jaffurah Basin in Saudi Arabia. We broke all records and did all this in a very short period of time. All with a very innovative capex light business model with our main partner: NexTier. I am very pleased to report that we have further consolidated our position and we have extended our workscope for the Unconventionals fracturing in Jafurah. We have brought significant innovations, making it similar to USL efficiency to this very complex MEA operation.

It is a clear testament to our execution capabilities and ability to project manage one of the largest oilfield services projects. Our Customers are very wise and truly believe in leveraging the best of the world and the open source methodology to create differential outcomes for themselves. And if a local company does it even though it may not have the same pedigree or history as its larger counterparts, even better and more commendable as that ties into their improving In Country capabilities objective.

I would like to remind everybody that we did all this with truly innovative business model and not just buy a fleet and hence this project has been accretive from day one. We did this by capitalizing on merging our knowledge, experience and expertise with our partners mainly NexTier for which this structure is also accretive. If you look at this structure in light of today's environment – it makes even more sense than it already did. So I am very pleased with how this has panned out for us and our partners and most importantly our customer.

And to further build on this we have already shipped a second fleet from NEXTIER to the region with plans to deploy it before year end. We have been in active discussions with our Customers to put the framework in place to repeat the same performance in other fields.

Also, as we mentioned in previous quarters, we made significant investments in our new countries of operations like Kuwait and to a smaller extent Bahrain where we are pretty small but have delivered stellar performance. In Kuwait we are conducting our Cementing contract at full tilt and our activity is more than 3 times our exit rig assignment in Q4 of 2019. In Iraq we have started operations on our large integrated services contract with a super major which is a commendable effort on the part of the team given the logistical challenges in the coronavirus world.. In Indonesia we have expanded our offerings by conducting our first Cementing and WL operations outside of Geothermal wells. We also conducted a small Prop Fracturing operations to one of the client.

Another great milestone and very close to my heart, was the groundbreaking of our Technology R&D center in Saudi with the presence of the President of the university KFUPM and all Aramco senior management. The center called NORI which in Arabic means My Light and is setup with our technology partners to lead the way and develop… and deploy custom fit solutions for our Customers in the region. Today we have more than 15 technology agreements in place and NORI is going to be front and center of our technology strategy once we inaugurate it in early 2021.

Also, as most of you have seen the announcement of the signing of the agreement to acquire SAPESCO, one of the largest Service companies in Egypt and the oldest Oilfield Services in the region. I spoke about it in details in the last quarterly conference call so as an update we are presently working through the modalities of closing the transaction given several regulatory delays. With this acquisition NESR will have a large footprint in Egypt and their operations in Saudi Arabia, Egypt and Kuwait are directly accretive with no or minimal overlap. This transaction is also accretive from a cost perspective as we will leverage the human capital and back-office capabilities which SAPESCO has invested a lot in.

Chris will delve into details about the numbers but briefly before I pass this to Chris I want to speak about our approach to Capex in this brave new world. Typically, because of how our growth mobilizations have worked out we have front loaded our Capex to ensure readiness of these projects. But going forward we have already cut the second wave of Capex as we believe with our better utilization as well as the drop in activity with US Land, will present us with opportunities to innovatively arrange with partners or procure the required assets at significant discounts with which we can cover the growth. We are already working on 4 such deals and consequently we have cut 30% of our Capex for the Year.

And on that note, I will pass the call over to Chris, to talk about the financials in detail. Chris?

Christopher L. Boone
Thank you, Sherif. First quarter revenues were $199 million, an increase of 31% over the prior year quarter and 8% over the fourth quarter. The sequential growth was driven primarily by the new unconventional product line in Saudi Arabia. This, coupled with most of our other new contracts now being active, puts NESR in the strong position going into the second quarter. Adjusted EBITDA was $51 million for the first quarter of 2020, increasing 25% over the prior year quarter. EBITDA adjustments of $1.7 million for the quarter are primarily for transaction and integration planning costs associated with our pending acquisition of SAPESCO in Egypt.

Despite increased costs related to COVID-19, we considered all these costs as normal operations and made no adjustments to EBITDA for them. Moving to our segments.

Our Production segment revenue for the first quarter was $133 million dollars, growing 45% over the same period last year and 10% over Q4 of 2019. The sequential growth is primarily related to unconventional completion activity in Saudi Arabia. This was partially offset by lower activity in Iraq and North Africa from the initial impact of the global oil price environment as well as shutdowns and security challenges.

Adjusted EBITDA margins for the production group of 31% were down sequentially from 33%. Margins were impacted by the higher proportion of pass-through revenue associated with unconventional activity and the impacted markets. The company has taken actions to reduce costs in these impacted markets to align operating costs with current business levels. Separately, our Drilling and Evaluation segment revenue for the first quarter was $66 million dollars, growing 11% over the same quarter last year and 3% sequentially. The sequential growth is primarily related to drilling services in Oman and Kuwait and wireline and well testing activities in Saudi Arabia. Adjusted EBITDA margins improved to 22% in the first quarter compared to 21% in the prior quarter, due to a more favorable mix of revenue. Depreciation and amortization increased to $29.2 million in the first quarter compared to $28.4 million in the prior quarter. The majority of this increase was due to additions from capital spending. We expect D&A to increase by approximately $2 million in Q2 2020, and an additional $1 million in Q3 from equipment additions. These estimates do not include any additional depreciation and amortization related to the SAPESCO transaction.

Interest expense in the first quarter was $4.5 million, up slightly from $4.3 million in the prior quarter. The effective tax rate for the first quarter of 2020 was 18.2%, a decrease from the fourth quarter 2019 rate of 37%. Based on current full year projections, we expect the effective tax rate to stay at or below 20% due to the benefit of certain legal entity restructurings and other tax efficiency initiatives. This resulted in reported net income of $11.4 million or $0.13 per diluted share and adjusted net income of $13 million or $0.15 per diluted share. Turning to cash flows. Cash flows from operations for the first quarter were $9.9 million. Operating cash flow decreased from the fourth quarter, primarily due to an increase in total receivables, which include unbilled revenue and retention of $34 million. Absent this short-term increase in receivables, free cash flow would have been $20 million in the quarter. Approximately half this increase in receivables was due to the sequential increase in revenue. However, we did experience some slowing of collections in March from COVID-19 restrictions in the region, which were earlier and more stringent than in the U.S.

This impacted field ticket approval, invoice processing and customer approvals. In addition, the processing of the retention release payment of approximately $20 million was delayed but should be paid in the second quarter. DSO, however, only increased sequentially by approximately seven days to 114 days. While the collection cycle will continue to be impacted in Q2, there was an improvement in invoice processing in April in most areas. It is also important to remember that most of our customers are NOCs and large IOCs that have always paid, even if the process is a bit slower today.

In the second quarter, we expect to see strong free cash flow as collections mostly normalize and put us back on our cash generation plans. Capex for the three months ended March 31, 2019 was $24 million. In the wake of COVID-19 and its impact on oil prices and energy demand, we have reduced our original 2020 cash capex budget of $100 million by approximately 30%. Net debt increased to $336 million in March 31, 2020, compared to $310 million as of December 31st, 2019. Net debt increased quarter-over-quarter to fund accounts receivable growth and capital expenditures. Overall debt balances remained relatively flat sequentially. As of March 31st, 2020, our net debt to adjusted EBITDA ratio was 1.7, down from 1.8 last quarter and should reduce to our target level of approximately 1.5 in future quarters. Also, we remained in full compliance with our credit facility financial covenants in Q1 2020. The SAPESCO transaction is still expected to close during the second quarter. Currently, we finalized the audit of the financials, are awaiting final regulatory clearances, which have been delayed to ongoing COVID-19 restrictions. We believe we have sufficient liquidity to fund the transaction with existing cash and credit facilities, and the transaction will be overall accretive to that (INAUDIBLE). Finally, in response to current market conditions, we've been taking steps to maintain our financial strength and margin profile.

For smaller markets that have experienced activity declines, we are rightsizing our organizations as well as redeploying assets to our growth markets, which will improve our asset efficiency metrics. In all markets, we are aggressively negotiating and receiving discounts with both global and local suppliers on capex, products such as chemicals, spare parts and services such as equipment rentals. Also, as part of our working capital management, we are aligning supplier payment terms with our customer payment cycle. We have also recently implemented new ERP tools to enhance the visibility of available spare parts across all countries to help reduce inventory levels and enhance cash flow. In conclusion, we are pleased with the investments we've made in capex, new product line and new country entries that will allow NESR the opportunity to grow and gain market shares in this difficult global market.
With this, I'd like to pass back to Sherif for his final comments.

Sherif Foda
Thanks, Chris. So to conclude, going forward, we plan to navigate and be ahead of the curve to ensure we continue to capture the growth, mainly market share gains by demonstrating readiness with our customers and executing flawlessly when others are struggling or trying to keep their head above water.

We are an execution machine, and we strongly believe we can continue on our growth path with appropriate adjustments. And I go back to our original thesis, Middle East is going to be the last man standing when it comes to oilfield services. And we are in a great position to leverage our execution capabilities, in-country knowledge, and deep customer relationships to capture the opportunities which the market presents to us.

On that note, I would like to pass it on to the operator for your questions. Donna?

Questions and Answers

Operator
Thank you. The floor is now open for questions. If you would like to ask a question, please press *1 on your telephone keypad at this time. A confirmation tone will indicate your line is in the question queue. You may press *2 if you like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handsets before pressing the star keys. Once again that's *1 to register a question at this time. Our first question is coming from David Anderson of Barclays. Please go ahead.

David Anderson
Hey, good morning Sherif on Juffarah basin. I think it might be the only basin in the world that's actually adding frac crews right now. I was just wondering maybe if you could talk a little bit about the success you've had there.. I think you originally had a long-term contract and now you have what you call the extended scope, work scope for Jafurah, so I don't know if there's a difference in that. But maybe you could just kind of talk about what the differences is here? I mean, I think most of us as we've been looking at unconventional plays, particularly pressure pumping, it's hard to differentiate from one player to the other. So, how do you differentiate in that part of the world and how are you able to succeed there?

Sherif Foda
So, thanks, David. In summary, Jafurah Basin today, as all of you have seen, is the development of huge 200 tcf, $110 billion dollars project announced by the Kingdom. As we understand, the plan was always to have two frac fleets operating there for the foreseeable future, and then it gets increased once the drilling rigs, they put more rigs on the pads and have the development go to the second phase, which is they announced in 2024, 2025. So today, what's happening is us on a pad and our competitor on a pad or they take a pad and they split it into two. And they see who performed better in delivering the number of stages and finishing properly with the best safety record, etc..

Obviously, they are always moving between oil and gas,. They are moving between conventional and unconventional gas periodically as per the business model. So, with the OPEC cuts, the expectation, some of these projects will get some delays. So, the key for us is to be, as I explained, the stronger performer.

So, any delays or cancellation doesn't come from us, it comes from others., I think the whole innovative business model we put in place is to go and pick the best crew from NEX. . And I did this personally with my dear friend, Robert Drummond. And we went and checked the best crew in the Permian, the people will be able to manage that operation. We checked every piece of equipment. We brought some innovative technology that did not exist in the Middle East, but exist in the US land, but nobody thought of bringing this over to the region.

We brought all this, we did the investment properly and the crew today is involved with 12 personnel from NexTier and around 100 people from us. And that's how you meld the whole organization together and make sure that the people see that efficiency as they see in the US Land from a best-in-class crew, which, in my opinion, NexTier is, and to get all this local knowledge of Saudi Arabia that we do have, I would say, the strongest crew, and we put this together and passed the benefits to the client. And that's why the clients were extremely impressed, and we had couple of visits of the VP, of the Chief, of the unconventional, and they were very, very impressed. And that's why, obviously, they didn't take it lightly that we become the contractor for something like that, that is extremely complex. that's the reason we shipped a second frac fleet. Obviously, after agreement, verbal agreement with our customer that, that frac fleet will be sent and will be made to work.So, our plan is to have the two frac fleets running. The second frac fleet will not be working for Jafurah. It will be working for other fields.

David Anderson

Okay. So, when you think about how Jafurah gets developed over the years, and you said there's a timeline out to '24, '25 right now, what's the limitations on it right now? I know there's like a processing. I think there's some processing that they're building there, which has nothing to do with you. But you obviously have a lot of wells that have to be in front of you to have an efficient field. So, is it part drilling? Is it part processing? I don't know if you can share with us kind of how that--

Sherif Foda

--Yeah, there are no delays. I would say, there are no delays at all. I mean, they have the plan as is. You have the natural delays, right? So, what the natural delay is, because of what happened the restriction, the Middle East were actually one of the first to completely shut down borders and flights and everything. So, a lot of this is just going to get six-month natural delays. On top of it, it's compounded by the oil price and what's happening. Obviously, Saudi was producing almost 12.3 million barrels in April. So, there was a lot of associated gas, right, that comes with this production. Now are you going to add more rigs at the same pace in the current environment, that's yet to be seen. They will decide on that. And that's why I think that was very important for us to be, again, ready because then if there are any delays, and the delays will come from number of pads ready by the current rig count. So, they have the same rig count on those in Jafurah Basin, but will they add more rigs in the current environment or they delay it a bit?

That's yet to be seen and obviously, I am sure some of the downstream projects going to get some delays naturally, because of what's happening.

David Anderson

Look, Sherif, that was my final question. I just want to ask you, it's kind of more of a general take on Aramco. We saw a couple of months back, Aramco comes out and talks about lowering their upstream--sorry, not their upstream, but their overall capex budget by 25%, 30%. What's changed in the field from your standpoint? Is that just a shift from kind of gas to more rigorous work on the oil? Is it more of a downstream? Maybe can you just kind of help us understand a little bit without getting into details, I don't want to put you much in a bad spot. But just kind of a general standpoint, what are the changes that are going on in Aramco? And where do we see that budget cut?

Sherif Foda
Yeah. I think one of the big, I would say, misunderstanding, people always take the budget cut from what they were planning to, right, not from the previous year. So yes, obviously, if you go to the $35 million or to $40 billion, people see a huge cut. But if you take it from year-to-year, to be able to come back to your question about activities, what was the spend in 2019? And what will be the spend in 2020? then you get a much modest, less--cut. It's not as 30%, 40% as people say because that's from the budget. So, if you go from $29 billion to go to the $25 billion or the $20 even billion, you're talking now about 15% or 25 % What you see today, again, you will have four months of natural delays because of the COVID-19. So, a lot of this will come from the mega projects just being late.

You have all this mega development. You get all this gas processing, all this $5 billion, $6 billion, $7 billion dollars, that's already gets delayed by four, five months. And some of it, they might postpone it as well. So you're going to get a big shift from that. And then, you get your upstream budget, and the upstream budget today from the field, not much changes. But obviously, it will happen. You will see changes, and the changes will come, in my past experience, it comes on two fronts. The projects that are, you want to call it, nice to have or exploration, gets postponed for a year and the projects that are new offshore, complicated gets postponed. And then you will get--what you will get is a price discount.

So, they will ask everybody for the price discount. And overall, all this gives you the activity or the budget drop. So, the upstream activity will not drop as much as people think. Remember, Saudi always maintain their MSCT, which is--and they always do it, and they proved to the whole world for all these people that are skeptical that they cannot produce 10 million, they did produce 12.3 million barrels. they will always maintain the most reliable producer. So, they are always looking at the long term, and they will maintain the activity for that.

David Anderson
Thank you.

Operator
Our next question is coming from Sean Meakim, of JPMorgan. Please go ahead.

Sean Meakim
Thank you. Thanks Sherif. I appreciate all those details there's a lot that you own there, especially in Saudi. So, with the 30% cut to capex, it doesn't necessarily sound like you're dialing

back your growth plans. So if anything, maybe you're being opportunistic in terms of how you pay for the equipment or how you get it, can you maybe just give us a consolidated view of the top line opportunity set for NESR in terms of 2020 on a medium-term basis? Are there any risks to the 20% CAGR?

Sherif Foda
No, I think so far I would say, obviously, there's always risk, right? So, would you get the second wave of Coronavirus, will you get another shutdown? So for our plans, we are going ahead, as I explained. And you can see that we spent already our $24 million dollar capex in Q1. So, we front loaded, we added all our capex. What we see today, we have a lot of opportunities with our partners to get equipment for the second growth or the second half of the year at much bigger discount or a different business model like we did with the frac. And therefore, we are going to get the same amount of equipment, but we are going to spend 30% less. So today, our target, if we had spent $107 million dollars in 2019, we will not spend more than $75 million in 2020 but we're going to get the same amount of equipment. We have the same growth plans.

Sean Meakim
Got it. Well, I think that, that capital efficiency should certainly resonate even in this environment. Could you maybe just talk about which markets seem most prone to delays or kind of slow playing activity versus those that should be more resilient? Just any risk of certain markets which you can see volumes decline in ‘20 or ‘21?

Sherif Foda
Okay. 2020, I would say, as I said in the previous call in the remarks, North Africa and Iraq will definitely see an impact. We see it already, , We saw it in Q1. I think it's going to get worse for sure in Q2.you have to separate Iraq between two: You have Kurdistan and you have Basra.You have the south and the north. So, Kurdistan, this is like we had planned. They're going to go to zero.Because this is majority independent operator. They need the cash flow. At this oil price, they won't drill. So, they're just going to wait until the next wave. Then you go to the IOCs that have the big contracts with BOC, and they're going to drill it? So, what will they do? Today, if you are the big super major, you will not drill new wells.

You would just stop, and that's exactly what they're doing. And that's why I said, the biggest drop you would see is drilling new wells. And that's why the effect on us is so much less. I'm not saying that we are like, so much better. It's just because we are not into these projects.

We can say that we are lucky.? We are not an LSTK company. We are not into drilling new wells in Iraq because it's all lump sum. So, these projects are going to get slashed by 70%, at least.Then, how do they make their money? They make their money because they have producing fields. And the producing fields, you get the fee per barrel. That's the contract structure in Iraq. So, if you are in Rumaila, for example, you get your fee per barrel and you're producing 1.4 million barrels. And it's the lowest cost producing, so maybe the government would tell you, “Okay cut for the OPEC, your quota is cut maybe 100, 150, and you keep the rest.” So how you keep the rest is you keep your workover and rigless activity intact, and that's where we get involved.

If I give you some more color on North Africa, you have Algeria and you have Libya. Tunisia and Morocco are very small. I mean, it's insignificant. So, Libya is having a shutdown already before the virus just because of the war. And they are not producing, and almost the whole east is shut down. They don't export anything. So, I think it's compounded now with what's happening. So, you're going to get more delays, and I don't see the country picking up in the second half. Algeria, they announced already a budget cut of 50%. And again, you have the national oil company and you have the internationals. So, the internationals, in my opinion, will not do any work, will make a minimal program as much as they can. And the NOC, with the OPEC cut they have, they will just maintain the budget and they will cancel all new projects. So today, you see, for example, in Algeria, all exploration is zero.If they had some offshore activity, they would not do it there. So that's why the activity gets shrunk so much, but the effect on us is so much less than the others, because we are not involved on those new projects or nice-to-have or exploration or seismic, etc. So, we still get affected, obviously, but not at the same scale.

Sean Meakim
Well, Sherif.

Operator
Our next question is coming from George O'Leary of Tudor Pickering Holt. Please go ahead.

George O'Leary
Morning Sherif, morning guys.

Sherif Foda
Good morning.

George O'Leary
I just wanted to kind of expand on the last question and a comment you made earlier in the prepared remarks. You talked about the opportunity to strengthen the business in a downturn, and my read on that is playing a little bit of offense while a lot of other folks are just kind of in defense mode, which screams one, intriguing, and two, smart in this type of environment. So, you talked about it a little bit with respect to maybe opportunistically adding some equipment at cheaper than previously anticipated costs, but and I realize you have a big transaction that's still ongoing. But could you describe the M&A landscape, and just broadly, that kind of opportunity go on offense while everybody is going on defense? Is there anything in the M&A landscape that has cropped up as a part of that?

Sherif Foda
Sure. So, I would say, three main angles to the answer. The number one is organically continue to secure market share because we are ready, and others are not. They are struggling, we are

not. So, there is a great line here of, , I'm ready, I can deliver. The customer trust us, and we are getting more work because we can deliver. And that's exactly what happened in Q1, and that's why you see this growth from Q4 to Q1, and we are expecting to keep doing the same. And what does this do, number one is we gain market share, gain their trust and get more complicated projects, and that compensates for the countries that are going down significantly. And that's, again, the key is to be agile and be able to send equipment from Country A to Country B, despite the pandemic, you have restrictions. And all this is what's the agility of the organization to move when everybody else is struggling. And that's what we did. So, we are moving equipment from one country to another because we know that this country will not need a lot of the stuff in the future.

So that's the corner, if you like, or the anchor, and that's what we keep doing. The second part, almost similar, is today, I have a very good agreement, for example, on the frac with my partners. So why don't we expand more on this agreement to make it with other stuff?. Why don't we make it with some coil equipment? Why don't we do it with some wireline equipment? And if I get the proper contract, and we have a nice framework, we go with this equipment and attack. And we did this attack already on the second frac fleet that we send it on spec and it's already sailed and arriving. And now we are discussing deploying in which field. So, this gives you another market share gain, without spending any of the capex because you have the expertise and you have the equipment. The third part of the growth is, as you rightly mentioned, is the M&A. So obviously, a lot of people now are knocking the door."Come, we need to join you. We have amazing stuff." So, to be quite frank, we have not much interest in anything in the US except to buy equipment at $0.10 on the dollar. And for the landscape of MENA, if somebody comes with accretive and solid company like SAPESCO then yes, but not with the numbers that they asked for before, which was in the nine, 10 X times EBITDA multiple. Now they are coming down because they see that the market is not as rosy as before, plus that they see that even if the market is not as resilient, not everybody is resilient. We are differentiated today. Not everybody is coping. So, a lot of the local companies are completely shut down. They cannot even go to a well site because they didn't have any plans. They don't have, obviously, that expertise of crisis management, etc. They do not operate at all. So, some of these guys or their owners say, "Sherif, why don't we join you?" Right? And now we are talking about, "Yes, you can join, but this evaluation, you have to significantly come down." So yes, it presents an opportunity. This obviously takes time, but it's the third part of the growth strategy.

George O'Leary
That was very helpful color, Sherif. And then secondarily, just as you talk about market share opportunities and just kind of core organic growth, there's a lot of it feels like kind of myopic apathy going around now, where everyone is focused on the very near term. But if you think about the next 24, 18, 24, 36 months, kind of a longer-term timeframe, which geo markets do you think offer you the greatest organic growth opportunities, over that time frame?

Sherif Foda

It will be the same, GCC. GCC will definitely be the biggest. And I believe you're going to get a very big upturn coming. I'm a strong believer with the, I would say, the destruction of all the deep water projects in West Africa, etc. And then, once the oil demand goes back to normal, the Middle East is going to be the biggest provider of that additional oil. Definitely, Saudi is going to be the clear winner. They have the capacity, and there will be a lot of projects going. And that's why we are strengthening our core to a certain degree, and now getting that trusted partner status and being able to do a project like Jafurah give us the credibility and give them the trust that they can rely on us on giving us big projects. And that's exactly what we want, which is our path to the 10% market share of MENA and get into a $2 billion revenue.

George O'Leary
Thanks very much Sherif, I'll turn it back over.

Operator
Thank you. Our next question is coming from Greg Colman, of National Bank Financial. Please go ahead.

Greg Colman
Thanks a lot, Sherif for all the color on the call, it sounds like things are going really well. I wanted to dive into sort of normal--this is not a normal year, and I want to talk about normal Middle Eastern seasonality. In past years, and following some of your competitors in the region, we tend to see a sort of escalation over the course of the year as spending and the move through the budget rises from Q1 to Q2 through into Q3 and Q4. However, this is not a normal year. We have borders closing, we have commodity issues. Should we expect the normal seasonality to trump any of the near-term hiccups? Or are pricing discussions, logistical issues, sort of hiccups here and there going to sort of more flatten the activity for NESR over the course of the year, and we should be a little more cautious as to the quarter-over-quarter growth rates going into subsequent quarters?

Sherif Foda
Yes, the latter. Yes, you're absolutely correct, Greg. This is not a normal year. I think Q2, you will see the activity will start dropping. So far, we are in a good shape. But definitely, people will start dropping because you get the effect of the OPEC cut.I mean, there is a lot of countries, if it's not for the employment, they could cut 70% of the rig count, and they would produce the OPEC quota. They don't even need to drill wells. I mean these fields are very prolific, and they can produce without doing anything. So, because of employment, because of the business, because of, again, it's a national oil company with the government.

So, to strictly answer your question, definitely, you will not see that seasonality of Q1 to Q4. You would see more moderate Q1 to Q4. The difference we will have is what happens in Q3, Q4 of the demand. If the demand picks up then some of these drops, if you like, that we expect maybe might not happen, and you get another strong Q3, Q4, right? But overall, I agree with you. It will be more of a flattish approach because some of the growth of the market share will be in a very competitive environment and with some of the pricing you have to give away, and some of the drop of some of the other countries that I think are going to slash more and more of their budget plus some of the super majors that are in the Middle East, If they announce another budget cut, I'm sure they are going to cut their operation, , all these guys for sure they're going to cut some of that activity.

Greg Colman
Got it. That makes sense. That's pretty consistent with what we were looking for. And then I had some technical issues earlier, so apologies if you already addressed this. But you were talking about border closings. You were talking about moving people. You have, obviously, your crew in place to deal with challenges regarding the pandemic. Can you talk to us about the percentage of your capacity which has fallen off as a result of the challenges with moving either people and logistics now? If pre-COVID, if, call it, whatever, Q4 or early Q1 was 100% capacity, what have you pulled back to now? And what are you going to be sitting at as we go through this period of more challenged border control and logistics?

Sherif Foda
So, I will answer you, but I mean the whole idea of the CMT and what we did is to maintain 100% capacity. And we maintain 100% capacity. So, it's shocking for some people, but the way you do it is you make sure that you negotiate with everybody. So obviously, we have a lot of local workforce.And that's the strength of the company. But then the people that are rotating ,we went and talked to them one by one. That's again, the beauty of being small. We get one by one and told them, “Okay, you want to go now, for example, to the field, you might stay four months. So, you agree to stay four months. If you are staying four months, the people you are replacing, you are not going to be able to come. And after that, we're going to manage your rotation schedules.” And then we did a lot of, if you want soft part, which is taking care of their families, sending money, etc. Obviously, the guys, they did not complain a lot because they cannot go home anyway. So, if they are not on the worksite and they go to a hotel, they cannot go home because the flights have shutdown. So, this but a lot of people did not prepare as well as that. So, they had a lot of gaps. So today, I am running all my equipment and fleet intact. And that's why we are capturing all this market share. That's why we grew 8% quarter-over-quarter. So if this last for another six months, yes, we'll have a problem for sure because the guys are not going to last forever. But I believe you can see the clients are already thinking about it, we are working with the clients in a couple of countries where they are saying, “Guys from next month, let's start to think about crew change.” And all the people that already took three months off will be expected to come back and they want to come back and stay three months on. So, I mean it sounds a bit case by case, but we are 95%, 100% in capacity.

Greg Colman
Got it. Thank you. That's it from me.

Sherif Foda
Thank you.

Operator
Our next question is coming from Andres Menocal, of Evercore ISI. Please go ahead.

Andres Menocal
Hey Sherif, hey Chris.

Sherif Foda
Hey, how are you.

Andres Menocal
I'm doing good. So just two questions from me today. The first one is, as we kind of think about the opportunity set that's expanding for you guys in the region, and I would say even outside of the region, is you're going to be one of the clearly surviving and thriving players through this downturn. My question is if just thinking outside of the cash you have on the balance sheet and liquidity, like if you need to get some kind of large form of deal done, can you kind of talk through what kind of strategic financing levers that you'd be able to pull? And what's at your disposal if you want to ramp things up, to take advantage of an opportunity?

Sherif Foda
Look, I mean I don't see anything when you say "Large." We are not doing anything large, right? I mean anything in the ME is always going to be bolt-on. So, we will be able to always finance with our cash because all the agreements will always be cash and share like we are doing with SAPESCO, always will be something similar. If something is going to be completely different scale, which there is not much really in the region at that different scale, yes, we can look at completely different. We have a lot of our core investors want to come on a much bigger scale into the story, especially now with such a price. So, there will be so many other avenues that we can capitalize on. Again, leverage, we want to maintain our leverage.
We are not going to exceed it. So, a lot of the banks are obviously offering us to raise more debt and being able to do that, but we are not going to do that. We want to maintain our covenant and our leverage, which we always said is in the 1.5 to two. So, our cost of capital is very small.

So we want to maintain it. And with enough cashflow, I mean, obviously, this quarter, you saw we took some because we had some retention issue with the customer, which we know it, right? I mean, this is our very good customer, very strong. And we know that the whole logistical issue of people not going to the office and not releasing this. I mean we can wait for this quarter, Q2, to release the retention. And then if it was, we would have had $20 million dollars of free cash flow, right? So, we have so much to do and so much activity to capture and a lot of business to do, which is the good thing, right? I mean, a lot of people don't have something to do, right?

Andres Menocal

So yes, that's it's definitely a high-class problem to have. Second question, and the last one for me, and this was alluded to earlier, but can you try to describe the process, the kind of philosophy as to how you arrived at the newly revised capex number? Like what was the thinking behind that? Obviously, a lot of that is due to the decline in oil and gas activity. And I don't want you to--I want to be sensitive to any customer commercial issues, but just kind of curious to see how much of that is due to lower activity versus what you think is going to be a new changing landscape for how you decide to spend in order to generate revenues?

Christopher L. Boone
This is Chris. So obviously, when you, again, look at cash capex, it's just paying off capex we've already purchased. But then looking forward, I think Sherif has already said, the whole point right now is to take a quick break in capex, understand the market, but especially where can we take advantage in the future of acquiring capex differently than we might have a month or two ago? We're looking at how can we--are there different creative ways--as we talked about. Can we find ways with other US people to partner, use their underutilized equipment or find it at a much lower price? So we're taking advantage of being able to move our equipment, where we have, as we said, some lower utilization in some markets, move that equipment, make sure we're at full utilization of all of our equipment everywhere, before we buy anything else. But then we'll reassess sometime in the second quarter what it looks like around the world, and we may then reactivate some of the capex plans.

Andres Menocal
Okay, understood. Thanks a lot for the color. Thanks, Sherif, thanks Chris.

Christopher L. Boone
Thank you.

Operator
Thank you. Our next question is coming from Blake Gendron, of Wolfe Research. Please go ahead.

Blake Gendron
Hey, good morning guys. Appreciate the helpful color on all the volume puts and takes here throughout the region. I wanted to focus on pricing a little bit. It sounds like your 15% to 20% growth bogey is still intact. You're offsetting maybe some of the pricing pressure with share gains, so on, volume. For modeling purposes, we basically build up your topline by your legacy activity and then your SAPESCO and then thirdly, the unconventional contract. So, focusing in on the legacy work, I'm just wondering if you've gotten the pricing call yet broadly? I know it's not homogenous across all of the region. But could you help quantify the magnitude of pricing and maybe the net impact on margin here moving forward? And then for specifically cost plus,

and I would consider the unconventional contract is cost plus. If we do see some pricing pressure in that contract specifically, do you have any pricing leverage, I guess, on the other inputs that you're passing through and maybe blunt the net impact of pricing there? Appreciate any color on that.

Sherif Foda
Thanks, Blake. So pricing is an issue that is going to come. Obviously, I'm not going to instigate it. So, the smart thing to do is to be the last man asked. So far, if you deliver very well, they ask you the last, and that's exactly our plan. Do I feel what will be the impact? In my history, usually, the impact will be in the 10%, Some stuff you can pass it through with your partners and suppliers. Some you cannot. So overall, it gets you around the 10% effect. Now, if you ask me about your other question on the cost plus. The Jafurah Basin or the frac is not a cost plus, Blake, it's a pure like the US, it's a per stage, very, very strong business. The thing we have in that contract is a lot of cost plus. Why? Because we do the camp, we do all the stuff, which is a huge cost-plus and that dilute your margins, correct? So you rightly said that the unconventional growth that we obviously had in Q1 created a big cost-plus to us in the production, and that's why you see the production percentage, and not as a dollar, but percentage, if it had dropped from the 32% to 30% because obviously, you had a lot of passthrough.

What we are doing without even the client asking, we--that's why we're maintaining our intact and the lowest impact on our bottom line is to ask for this discount ahead of the game. And we started this already in February. So, a lot of this is already to make sure that we can maintain our profitability intact despite the fact that we have a lot of increase of costs. By the way, we mentioned a lot on this call, but you have to see that we have a clean quarter. I mean a lot of people don't have that, right? We have nothing in our quarter because of COVID-19, and we did not. We took all the extra costs and measures and we absorbed it in our P&L and our structure. You have to remember, now all these camps have a single occupancy. It's a huge cost.
You have to put every person alone now in a room; before it was four. Yes, there is no more catering that is a huge mess hall, and everybody is not together because of social distancing. Everybody is alone, and you have to provide this alone. So, there is a huge increase of cost that we absorbed in our operation and still delivered the results.

Blake Gendron
That's totally fair. On the third piece of the model here, the SAPESCO deal, it sounds like it's going to close on schedule. Wondering what your outlook is for the Egyptian market specifically. And whether or not we should rejigger our assumptions for topline growth as a result of that contribution, that would be helpful.

Sherif Foda
Egyptian market gets affected like North Africa. Egyptian market is characterized by a lot of small independent, they also have IOCs. They have NOCs. It gets affected by the oil price. People will delay drilling, so it will get affected. And that's part of the negotiation we are talking

that the earn-outs that they have, the second earn-out has to be linked to that because I cannot pay you earn-out when the activity is going to go down, right? And we are in discussion on that. If you look at their business outside, it's going to be affected like us. And so far, it's intact. So, the Saudi, UAE, Kuwait, it's intact. Their business in Libya will be obviously impacted and will be completely affected like ours, and the Egyptian market will not be the same. We'll definitely get a decline year-on-year.

Blake Gendron
That's helpful. One more if I can sneak it in here. I know we're past the hour. D&E, typically, 1Q, I would have thought would have been seasonally weak especially on the margin, but it sounds like or it looks like rather, in the clean quarter that you drove margin improvement. Was it a mix tailwind there in the first quarter in D&E? Or are you starting to see some cost leverage potentially on the portfolio pull through the endeavoring?

Sherif Foda
It's a mix, Blake. It's a purely mix. So, you had more evaluation this quarter like the last. So, we had a very strong quarter. We replaced a lot of the guys in the testing segment. So, our testing did a phenomenal job as usual, and they replaced almost five competitors this quarter. So, the other guys could not deliver, and they had a lot of issues. Despite our cost increases, to be able to maintain all these crews, they did an absolutely phenomenal job, and that's why you see that. So, you get more evaluation, you get better results And going forward, I think the drilling, as I kept trying to say, you have to think exactly opposite of North America. People in North America, say, "Okay, now I have to do an activity, let me drill wells, but I'm not going to produce it." They do exactly the opposite in the middle east, right? So, they will stop a lot of the drilling, and that's why you're going to get some of that impact in the drilling segments. Obviously, we don't have direction drilling, we don't have this stuff. So, it doesn't really affect us.

Blake Gendron
Got it. Totally fair. Thanks a lot for the time guys.

Sherif Foda
Thanks.

Operator
Thank you, so it is*1 if you do have a question. Our next question is coming from Igor Levi, of BTIG. Please go ahead.

Igor Levi
Hi guys. So, you talked about being able to gain on frac work based on your performance. But in the release, you also talked about gaining additional jobs and your competitors had significant disruptions due to COVID-19 related logistical issues. So, could you elaborate a bit about the

second point? What were the circumstances where you were able to overcome these logistical issues that your competitors had? And then, what happens when they're able to return to work? Do they get that work right back? Or do you keep that market share?

Sherif Foda
So, it's a mix, I would say. But to make it a bit simplified, there is a lot of those market share gains, you do it as itis a call out business. So, the client calls you like and I give you the example of the testing. So, our testing crews are ready. Some of the other guys were not ready. Why they are not ready, because they did not plan their people, so their crew did not come. Maybe one of them had a couple of cases of the Corona. So, the customer shut down their crew, or they did not have spare parts, the border shut down, they did not ship the spare parts. Part of the working capital planning as well that we don't elaborate on, but we prepared ourselves to get six months of inventory of chemicals and spares into the countries before the shutdown. We took that risk and did that. So, we have chemicals and spares to keep us running for six months, even if the border is shutdown, right? Nobody does this, right, and especially some of the other small competitors. So, we replaced them.

Let's say, after three months, they are ready. Yes, for sure, you are not going to replace them forever. The customer will take that back. however, some other part of the market share gain could be permanent.

Igor Levi
Great, thank you. That's all from me.

Operator
Thank you. Our next question is coming from Jeff Fetterly, of Peters & Company. Please go ahead.

Jeff Fetterly
Good morning, guys. Just a couple of quick follow-up questions. On the frac side, the second crew that you're bringing into Saudi, you mentioned that crew will be working in Saudi?

Sherif Foda
Yes.

Jeff Fetterly
And what sort of visibility or contract structure do you have to support that crew going in?

Sherif Foda
We have, I would say, strong discussion with our customer. And let me just tell you this way; I know the customer pretty well. I trust them. So, I am confident that we will be able to put this crew to work. We obviously send the equipment without people because there are no people that can go. So, the fleet is purely frac equipment, etc. We have our own team, NESR team

physically in Saudi, Saudi people that will be able to operate that once it opens because, obviously, today, there is no people going between the US and Saudi.

Jeff Fetterly
And your comment earlier about broadening the scope of some of the partnerships that you have or are looking at. For this second frac crew, will you also have additional services, whether it's coiled tubing, wireline or other?

Sherif Foda
Yes. Always. You always do everything, yes.

Jeff Fetterly
But is that equipment coming from the US as part of the NexTier partnership? Or is that equipment that you have in-country or you're building yourself?

Sherif Foda
Some are brought to the country. I have some in-country, and I manage through the better utilization. We are increasing utilization by almost 12 points across the group now. Since we put the company together, obviously, at the beginning, let' put it this way, less aggressive in utilization number because people need to get to know each other and like each other. And after that, you start to become a bit more aggressive in demanding what time the fleet has to be out of the base and out of the maintenance and operating. So, with that improvement, we're already being able to gain a lot without adding more equipment. And you have to remember, we invested a lot. We did a lot of investment ahead of time. So, our vision was always to add and front-load our capex, and ensure that we are ready for the growth and capture it. And that's how we plan better than anyone else. And when the client said, "I need to do that," I said I'm ready, and "Are you serious," and they said, "Yes." And that's why I'm repeating a bit, but that's why I could replace four or five testing companies that are not able to deliver, I replace them. And the client was like surprised that you could do that during the pandemic event.

Jeff Fetterly
And a clarification on the capex side. So, if you end up spending $70 million or $75 million dollars in 2020, is your expectation that the revenue capacity of the business will be similar to what you previously expected when you had budgeted $100 million dollars of spend this year?

Sherif Foda
Yes.

Jeff Fetterly
Okay. And last thing, in terms of the sustainability and your contingency plans, you mentioned if this goes on for six months, you obviously won't be able to sustain it. But is this something--could you maintain your 100% capacity through the second quarter? Or if these

restrictions are in place through the second quarter, do you start to see some deterioration in your productive capacity?

Sherif Foda
I can sustain it in the whole second quarter. We already have agreements with every single person and expectation that the border does not open up, and we will still be able to maintain our capacity intact for the second quarter.

Jeff Fetterly
But the expectation is you'll start to see some improvement in accessibility or logistics in the third quarter?

Sherif Foda
Correct. From June, we should be able to see--after Ramadan, my expectation after Ramadan and the holidays, you would start to see ease of opening up borders for spares and some flights for movement of people.

Jeff Fetterly
Great, thank you for the color.

Operator
Thank you. This brings us to the end of our question-and-answer session. I would like to turn the floor back over to management for closing comments.

Sherif Foda
Thank you very much. I know that we took more of our time. So, I really appreciate your time, and we are very, very excited about the quarter and looking forward to further success in Q2 until the end of the year. Thank you very much.

Operator
Ladies and gentlemen thank you for your participation, you may disconnect your lines at this time and have a wonderful day.