DRIL-QUIP INC
Form 10-Q
July 29, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2016
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 001-13439

DRIL-QUIP, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	74-2162088
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6401 N. ELDRIDGE PARKWAY
HOUSTON, TEXAS
77041
(Address of principal executive offices) (Zip Code)
(713) 939-7711
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes ¨ No ý
As of July 27, 2016, the number of shares outstanding of the registrant's common stock, par value $0.01 per share, was 37,570,727.

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2016	December 31, 2015
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$491,729	$381,336
Trade receivables, net	251,075	319,780
Inventories, net	339,862	344,458
Deferred income taxes	26,645	24,613
Prepaids and other current assets	31,280	54,111
Total current assets	1,140,591	1,124,298
Property, plant and equipment, net	293,857	294,251
Deferred income taxes	1,685	—
Other assets	11,717	9,701
Total assets	$1,447,850	$1,428,250
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$20,311	$30,934
Accrued income taxes	26,894	14,052
Customer prepayments	8,433	18,388
Accrued compensation	14,524	17,957
Other accrued liabilities	16,298	19,484
Total current liabilities	86,460	100,815
Deferred income taxes	2,899	2,977
Total liabilities	89,359	103,792
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued)	—	—
Common stock:		
100,000,000 shares authorized at $0.01 par value, 37,563,379 and 37,951,223 shares issued and outstanding at June 30, 2016 and December 31, 2015	374	378
Additional paid-in capital	—	—
Retained earnings	1,480,733	1,425,344
Accumulated other comprehensive losses	(122,616)	(101,264)
Total stockholders' equity	1,358,491	1,324,458
Total liabilities and stockholders' equity	$1,447,850	$1,428,250

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DRIL-QUIP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
	(In thousands, except per share data)			
Revenues:				
Products	$116,048	$176,099	$251,242	$363,623
Services	26,391	39,177	57,758	77,655
Total revenues	142,439	215,276	309,000	441,278
Cost and expenses:				
Cost of sales:				
Products	65,407	98,349	142,329	204,356
Services	14,474	19,315	30,648	38,446
Total cost of sales	79,881	117,664	172,977	242,802
Selling, general and administrative	5,762	33,633	18,983	50,591
Engineering and product development	11,579	11,400	22,480	23,613
Total costs and expenses	97,222	162,697	214,440	317,006
Operating income	45,217	52,579	94,560	124,272
Interest income	541	165	1,023	214
Interest expense	(10)	(3)	(14)	(6)
Income before income taxes	45,748	52,741	95,569	124,480
Income tax provision	9,611	13,528	22,663	31,603
Net income	$36,137	$39,213	$72,906	$92,877
Earnings per common share:				
Basic	$0.96	$1.01	$1.94	$2.40
Diluted	$0.96	$1.01	$1.93	$2.39
Weighted average common shares outstanding:				
Basic	37,564	38,686	37,658	38,729
Diluted	37,713	38,888	37,779	38,912

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DRIL-QUIP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Net income	$36,137	$39,213	$72,906	$92,877
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(20,087)	21,841	(21,352)	(10,693)
Total comprehensive income	$16,050	$61,054	$51,554	$82,184

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DRIL-QUIP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six months ended June 30, 2016		2015	
	(In thousands)			
Operating activities				
Net income	$ 72,906		$ 92,877	
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization	15,500		15,139	
Stock-based compensation expense	6,254		6,482	
(Gain) loss on sale of equipment	(29	)	75	
Deferred income taxes	(3,828	)	(4,935	)
Changes in operating assets and liabilities:				
Trade receivables, net	64,200		70,508	
Inventories, net	763		3,348	
Prepaids and other assets	20,658		(2,958	)
Excess tax benefits of stock options and awards	(26	)	(57	)
Accounts payable and accrued expenses	(13,537	)	(67,468	)
Net cash provided by operating activities	162,861		113,011	
Investing activities				
Purchase of property, plant and equipment	(15,276	)	(11,204	)
Proceeds from sale of equipment	139		136	
Net cash used in investing activities	(15,137	)	(11,068	)
Financing activities				
Repurchase of common stock	(24,238	)	(19,943	)
Proceeds from exercise of stock options	508		1,952	
Excess tax benefits of stock options and awards	26		57	

Net cash used in financing activities	(23,704		)	(17,934		)
Effect of exchange rate changes on cash activities	(13,627		)	(41		)
Increase in cash and cash equivalents	110,393			83,968		
Cash and cash equivalents at beginning of period	381,336			298,705		
Cash and cash equivalents at end of period	$	491,729		$	382,673	

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DRIL-QUIP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Organization and Principles of Consolidation

Dril-Quip, Inc., a Delaware corporation (the “Company” or “Dril-Quip”), designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. The Company’s principal products consist of subsea and surface wellheads, subsea and surface production trees, subsea control systems and manifolds, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, liner hangers, wellhead connectors and diverters. Dril-Quip’s products are used by major integrated, large independent and foreign national oil and gas companies in offshore areas throughout the world. Dril-Quip also provides technical advisory assistance on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products. In addition, Dril-Quip’s customers may rent or purchase running tools from the Company for use in the installation and retrieval of the Company’s products.

The Company’s operations are organized into three geographic segments—Western Hemisphere (including North and South America; headquartered in Houston, Texas), Eastern Hemisphere (including Europe and Africa; headquartered in Aberdeen, Scotland) and Asia-Pacific (including the Pacific Rim, Southeast Asia, Australia, India and the Middle East; headquartered in Singapore). Each of these segments sells similar products and services and the Company has major manufacturing facilities in all three of its headquarter locations as well as Macae, Brazil.

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of June 30, 2016 and the results of operations and comprehensive income for the three and six months ended June 30, 2016 and 2015 and the cash flows for the six months ended June 30, 2016 and 2015. Certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. Management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate. The results of operations, comprehensive income and cash flows for the six months ended June 30, 2016 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

2. Significant Accounting Policies

Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Some of the Company’s more significant estimates are those affected by critical accounting policies for revenue recognition, inventories and contingent liabilities.

Revenue Recognition

Product revenues

The Company recognizes product revenues from two methods:

- product revenues recognized under the percentage-of-completion method; and
- product revenues from the sale of products that do not qualify for the percentage-of-completion method.

Revenues recognized under the percentage-of-completion method

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The Company uses the percentage-of-completion method on long-term project contracts that have the following characteristics:

- the contracts call for products which are designed to customer specifications;
- the structural designs are unique and require significant engineering and manufacturing efforts generally requiring more than one year in duration;
- the contracts contain specific terms as to milestones, progress billings and delivery dates; and
- product requirements cannot be filled directly from the Company's standard inventory.

For each project, the Company prepares a detailed analysis of estimated costs, profit margin, completion date and risk factors which include availability of material, production efficiencies and other factors that may impact the project. On a quarterly basis, management reviews the progress of each project, which may result in revisions of previous estimates, including revenue recognition. The Company calculates the percentage complete and applies the percentage to determine the revenues earned and the appropriate portion of total estimated costs. Losses, if any, are recorded in full in the period they become known. Historically, the Company's estimates of total costs and costs to complete have approximated actual costs incurred to complete the project.

Under the percentage-of-completion method, billings may not correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the Condensed Consolidated Balance Sheets. Likewise, revenue recognized may exceed customer billings in which case the amounts are reported in trade receivables. Unbilled revenues are expected to be billed and collected within one year. At June 30, 2016 and December 31, 2015, receivables included $62.5 million and $70.8 million of unbilled receivables, respectively. For the quarter ended June 30, 2016, there were 6 projects representing approximately 16% of the Company's total revenues and approximately 19% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 10 projects during the second quarter of 2015, which represented approximately 17% of the Company's total revenues and approximately 21% of its product revenues. For the six months ended June 30, 2016, there were 10 projects representing approximately 15% of the Company's total revenues and approximately 19% of its product revenues, compared to 13 projects that represented approximately 16% of the Company's total revenues and approximately 19% of its product revenues for the six months ended June 30, 2015, all of which were accounted for using percentage-of-completion accounting.

Revenues not recognized under the percentage-of-completion method

Revenues from the sale of inventory products, not accounted for under the percentage-of-completion method, are recorded at the time the manufacturing processes are complete and ownership is transferred to the customer.

Service revenues

The Company recognizes service revenues from three sources:

- technical advisory assistance;
- rental of running tools; and
- rework and reconditioning of customer-owned Dril-Quip products.

The Company does not install products for its customers, but it does provide technical advisory assistance. At the time of delivery of the product, the customer is not obligated to buy or rent the Company's running tools and the Company is not obligated to perform any subsequent services relating to installation. Technical advisory assistance service revenue is recorded at the time the service is rendered. Service revenues associated with the rental of running and installation tools are recorded as earned. Rework and reconditioning service revenues are recorded when the refurbishment process is complete.

The Company normally negotiates contracts for products, including those accounted for under the percentage-of-completion method, and services separately. For all product sales, it is the customer's decision as to the timing of the product installation as well as whether Dril-Quip running tools will be purchased or rented. Furthermore, the customer is under no obligation to utilize the Company's technical advisory assistance services. The customer may use a third party or their own personnel.

Fair Value of Financial Instruments

The Company’s financial instruments consist primarily of cash and cash equivalents, receivables and payables. The carrying values of these financial instruments approximate their respective fair values as they are short-term in nature.

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Earnings Per Share

Basic earnings per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share is computed considering the dilutive effect of stock options and awards using the treasury stock method.

In each relevant period, the net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the weighted average basic number of common shares outstanding and the weighted average diluted number of common shares outstanding for the purpose of calculating basic and diluted earnings per share:

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Weighted average common shares outstanding—basic	37,564	38,686	37,658	38,729
Dilutive effect of common stock options and awards	149	202	121	183
Weighted average common shares outstanding—diluted	37,713	38,888	37,779	38,912

3. New Accounting Standards

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-09 “Improvements to Employee Share-Based Payment Accounting (Topic 718).” The standard simplifies several aspects of accounting for share-based payment transactions, including the accounting for income taxes, forfeitures and statutory withholding requirements, as well as classification in the statement of cash flows. The standard is effective for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. The Company is evaluating the impact of the new standard on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02 “Leases (Topic 842).” The new standard requires lessees to recognize lease assets (right of use) and lease obligations (lease liability) for leases previously classified as operating leases under generally accepted accounting principles on the balance sheet for leases with terms in excess of 12 months. The standard is effective for annual periods beginning after December 15, 2018, including interim periods within those fiscal years. The Company is evaluating the impact of the new standard on its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17 “Income Taxes (Topic 740).” In an effort to reduce complexity, the requirement to separate deferred income tax liabilities and assets into current and noncurrent amounts will no longer be necessary. In the future, all deferred income taxes will be considered noncurrent and will continue to be offset into a single amount within each country. The standard is effective for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. The Company’s financial statements will be revised to reflect this amendment beginning in the first quarter of 2017.

In July 2015, the FASB issued ASU 2015-11 “Simplifying the Measurement of Inventory (Topic 330).” This standard states that inventory within the scope of this update should be measured at the lower of cost and net realizable value. Net realizable value is defined as the estimated selling price in the normal course of business, less reasonably predictable costs of completion, disposal, and transportation. The standard is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company is evaluating the impact of the new standard on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09 “Revenue from Contracts with Customers (Topic 606).” The amendment applies a new five-step revenue recognition model to be used in recognizing revenues associated with customer contracts. The amendment requires disclosure sufficient to enable readers of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures, significant judgments and changes in judgments and assets recognized from the costs to obtain or fulfill the contract. The standard’s effective date was originally for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. On April 1, 2015, the FASB voted to defer the effective date by one year to December 15, 2017 and interim periods within annual reporting periods beginning after December 15, 2017. The Company is evaluating the impact of the new standard on its consolidated financial

statements.

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4. Stock-Based Compensation and Stock Awards

The Company recognized approximately $3.1 million of stock-based compensation expense during the three months ended June 30, 2016 and 2015, which is included in the selling, general and administrative expense line on the Condensed Consolidated Statements of Income. For the six months ended June 30, 2016 and 2015, stock-based compensation expense totaled $6.3 million and $6.5 million, respectively. No stock-based compensation expense was capitalized during the three or six months ended June 30, 2016 or 2015.

5. Inventories, net

Inventories consist of the following:

	June 30, 2016	December 31, 2015
	(In thousands)	
Raw materials	$92,011	$101,311
Work in progress	86,444	104,102
Finished goods	203,459	178,292
	381,914	383,705
Less: allowance for obsolete and excess inventory	(42,052)	(39,247)
Net inventory	$339,862	$344,458

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6. Geographic Areas

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Revenues:				
Western Hemisphere				
Products	$62,786	$82,560	$141,386	$174,375
Services	16,783	21,498	33,776	43,807
Intercompany	10,505	14,770	21,216	24,755
Total	$90,074	$118,828	$196,378	$242,937
Eastern Hemisphere				
Products	$29,913	$60,818	$63,074	$140,239
Services	8,007	13,617	21,011	25,259
Intercompany	22	4,602	207	4,823
Total	$37,942	$79,037	$84,292	$170,321
Asia-Pacific				
Products	$23,349	$32,721	$46,782	$49,009
Services	1,601	4,062	2,971	8,589
Intercompany	236	1,208	516	2,389
Total	$25,186	$37,991	$50,269	$59,987
Summary				
Products	$116,048	$176,099	$251,242	$363,623
Services	26,391	39,177	57,758	77,655
Intercompany	10,763	20,580	21,939	31,967
Eliminations	(10,763)	(20,580)	(21,939)	(31,967)
Total	$142,439	$215,276	$309,000	$441,278
Income before income taxes:				
Western Hemisphere	$14,035	$27,016	$38,991	$59,964
Eastern Hemisphere	25,050	13,875	41,734	45,583
Asia-Pacific	5,110	9,064	11,223	12,489
Eliminations	1,553	2,786	3,621	6,444
Total	$45,748	$52,741	$95,569	$124,480

	June 30, 2016	December 31, 2015
	(In thousands)	
Total Long-Lived Assets:		
Western Hemisphere	$217,575	$208,408
Eastern Hemisphere	38,108	43,449
Asia-Pacific	54,503	55,021
Eliminations	(2,927)	(2,926)
Total	$307,259	$303,952
Total Assets:		
Western Hemisphere	$691,665	$677,460
Eastern Hemisphere	385,314	391,672
Asia-Pacific	393,128	372,823
Eliminations	(22,257)	(13,705)

Total	$1,447,850	$1,428,250

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7. Commitments and Contingencies

Brazilian Tax Issue

From 2002 to 2007, the Company's Brazilian subsidiary imported goods through the State of Espirito Santo in Brazil and subsequently transferred them to its facility in the State of Rio de Janeiro. During that period, the Company's Brazilian subsidiary paid taxes to the State of Espirito Santo on its imports. Upon the final sale of these goods, the Company's Brazilian subsidiary collected taxes from customers and remitted them to the State of Rio de Janeiro net of the taxes paid on importation of those goods to the State of Espirito Santo in accordance with the Company's understanding of Brazilian tax laws.

In August 2007, the State of Rio de Janeiro served the Company's Brazilian subsidiary with assessments to collect a state tax on the importation of goods through the State of Espirito Santo from 2002 to 2007 claiming that these taxes were due and payable to it under applicable law. The Company settled these assessments with payments to the State of Rio de Janeiro of $12.2 million in March 2010 and $3.9 million in December 2010. Approximately $7.8 million of these settlement payments were attributable to penalties, interest and amounts that had expired under the statute of limitations so that amount was recorded as an expense. The remainder of the settlement payments generated credits (recorded as a long-term prepaid tax) to be used to offset future state taxes on sales to customers in the State of Rio de Janeiro, which were subject to certification by the tax authorities. During the second quarter of 2015, the tax authorities certified approximately $8.3 million of those credits paid in 2010 and granted an additional $2.3 million in inflation-related credits. The additional amount of credits granted by the tax authorities increased long-term prepaid taxes and decreased selling, general and administrative expenses by $2.3 million.

In December 2010 and January 2011, the Company's Brazilian subsidiary was served with two additional assessments totaling approximately $13.0 million from the State of Rio de Janeiro to cancel the credits associated with the tax payments to the State of Espirito Santo ("Santo Credits") on the importation of goods from July 2005 to October 2007. The Santo Credits are not related to the credits described above. The Company has objected to these assessments on the grounds that they would represent double taxation on the importation of the same goods and that the Company is entitled to the credits under applicable Brazilian law. With regard to the December 2010 assessment, the Company's Brazilian subsidiary has filed an appeal with the relevant State of Rio de Janeiro judicial court to annul the tax assessment following a ruling against the Company by the tax administration's highest council. In connection with that appeal, the Company was required to deposit with the court approximately $3.1 million in December 2014 as the full amount of the assessment with penalties and interest. The Company intends to file a similar appeal in the judicial system with regard to the January 2011 assessment as a result of a ruling against the Company by the tax administration's highest council once that ruling is finalized. The Company believes that these credits are valid and that success in the judicial court process is probable. Based upon this analysis, the Company has not accrued any liability in conjunction with this matter.

Since 2007, the Company's Brazilian subsidiary has paid taxes on the importation of goods directly to the State of Rio de Janeiro and the Company does not expect any similar issues to exist for periods subsequent to 2007.

General

The Company operates its business and markets its products and services in most of the significant oil and gas producing areas in the world and is, therefore, subject to the risks customarily attendant to international operations and dependent on the condition of the oil and gas industry. Additionally, products of the Company are used in potentially hazardous drilling, completion, and production applications that can cause personal injury, product liability and environmental claims. Although exposure to such risk has not resulted in any significant problems in the past, there can be no assurance that ongoing and future developments will not adversely impact the Company.

The Company is also involved in a number of legal actions arising in the ordinary course of business. Although no assurance can be given with respect to the ultimate outcome of such legal action, in the opinion of management, the ultimate liability with respect thereto will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is management's discussion and analysis of certain significant factors that have affected aspects of the Company's financial position, results of operations, comprehensive income and cash flows during the periods included in the accompanying unaudited condensed consolidated financial statements. This discussion should be read in conjunction with the Company's unaudited condensed consolidated financial statements and notes therein presented elsewhere herein as well as the discussion under "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Overview

Dril-Quip designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. The Company designs and manufactures subsea equipment, surface equipment and offshore rig equipment for use by major integrated, large independent and foreign national oil and gas companies and drilling contractors in offshore areas throughout the world. The Company's principal products consist of subsea and surface wellheads, subsea and surface production trees, subsea control systems and manifolds, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, liner hangers, wellhead connectors and diverters. Dril-Quip also provides technical advisory assistance on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products. In addition, Dril-Quip customers may rent or purchase running tools from the Company for use in the installation and retrieval of the Company's products.

Oil and Gas Prices

Both the market for offshore drilling and production equipment and services and the Company's business are substantially dependent on the condition of the oil and gas industry and, in particular, the willingness of oil and gas companies to make capital expenditures on exploration, drilling and production operations offshore. Oil and gas prices and the level of offshore drilling activity have historically been characterized by significant volatility.

According to the Energy Information Administration (EIA) of the U.S. Department of Energy, Brent Crude oil prices per barrel are listed below for the periods covered by this report:

	Three months ended June 30,		Six months ended June 30,	
Brent Crude Oil Price per Barrel	2016	2015	2016	2015
Low	$35.88	$55.73	$26.01	$45.13
High	50.73	66.33	50.73	66.33
Average	45.57	61.65	39.80	57.84
Closing	48.05	60.31	48.05	60.31

According to the July 2016 release of the Short-Term Energy Outlook published by the EIA, Brent Crude oil prices are expected to average approximately $43.03 per barrel in 2016 and $51.82 per barrel in 2017. In its July 2016 Oil Market Report, the International Energy Agency projected that world demand for oil will be approximately 96.1 million barrels per day in 2016, increasing to 97.4 million barrels per day in 2017.

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Rig Count

Detailed below is the average contracted offshore rig count (rigs currently drilling as well as rigs committed, but not yet drilling) for the Company's geographic regions for the six months ended June 30, 2016 and 2015. The rig count data includes floating rigs (semi-submersibles and drillships) and jack-up rigs. The Company has included only these types of rigs as they are the primary assets used to deploy the Company's products.

	Six months ended June 30,			
	2016		2015	
	Floating Rigs	Jack-up Rigs	Floating Rigs	Jack-up Rigs
Western Hemisphere	93	47	121	73
Eastern Hemisphere	67	70	90	90
Asia-Pacific	30	223	44	257
TOTAL	190	340	255	420

Source: IHS—Petrodata RigBase – June 30, 2016 and 2015

According to IHS-Petrodata RigBase, as of June 30, 2016, there were 504 rigs under contract for the Company's geographic regions (174 floating rigs and 330 jack-up rigs), which represents a 21.7% decrease from the rig count of 644 rigs (239 floating rigs and 405 jack-up rigs) as of June 30, 2015.

The Company believes that the number of rigs (semi-submersibles, drillships and jack-up rigs) under construction impacts its revenues and backlog because in certain cases, its customers order some of the Company's products during the construction of such rigs. As a result, an increase in rig construction activity tends to favorably impact the Company's backlog while a decrease in rig construction activity tends to negatively impact the Company's backlog.

According to IHS-Petrodata RigBase, as of June 30, 2016 and 2015, there were 186 and 209 rigs, respectively, under construction, which represents an approximate 11.0% decline in rigs under construction. The expected delivery dates for the rigs under construction at June 30, 2016 are as follows:

	Floating Rigs	Jack-Up Rigs	Total
2016	19	48	67
2017	25	52	77
2018	11	11	22
2019	9	3	12
After 2019 or unspecified delivery date	3	5	8
	67	119	186

However, given the sustained low level in oil and gas prices and oversupply of offshore drilling rigs, the Company believes it is possible that delivery of some rigs under construction could be postponed or cancelled, limiting the opportunity for supply of the Company's products.

Regulation

The demand for the Company's products and services is also affected by laws and regulations relating to the oil and gas industry in general, including those specifically directed to offshore operations. The adoption of new laws and regulations, or changes to existing laws or regulations that curtail exploration and development drilling for oil and gas for economic or other policy reasons, could adversely affect the Company's operations by limiting demand for its products.

Business Environment

Oil and gas prices and the level of offshore drilling and production activity have been characterized by significant volatility in recent years. Worldwide military, political, economic and other events have contributed to oil and natural gas price volatility and are likely to continue to do so in the future. Lower crude oil and natural gas prices have resulted in a trend of customers seeking to renegotiate contract terms with the Company, including reductions in the prices of its products and

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services, extensions of delivery terms and, in some instances, contract cancellations or revisions. In some cases, a customer may already hold an inventory of the Company's equipment, which may delay the placement of new orders. In addition, some of the Company's customers could experience liquidity or solvency issues or could otherwise be unable or unwilling to perform under a contract, which could ultimately lead a customer to enter bankruptcy or otherwise encourage a customer to seek to repudiate, cancel or renegotiate a contract. An extended period of reduced crude oil and natural gas prices may accelerate these trends. If the Company experiences significant contract terminations, suspensions or scope adjustments to its contracts, then its financial condition, results of operations and cash flows may be adversely impacted.

The Company expects continued volatility in both crude oil and natural gas prices, as well as in the level of drilling and production related activities. Even during periods of high prices for oil and natural gas, companies exploring for oil and gas may cancel or curtail programs, seek to renegotiate contract terms, including the price of products and services, or reduce their levels of capital expenditures for exploration and production for a variety of reasons. A continued significant and prolonged decline in hydrocarbon prices would likely have a material adverse effect on the Company's results of operations.

The Company believes that its backlog should help mitigate the impact of negative market conditions; however, a continued decline in commodity prices or an extended downturn in the global economy or future restrictions on or declines in offshore oil and gas exploration and production could have a negative impact on the Company and its backlog. The Company's backlog at June 30, 2016 was approximately $460 million, compared to approximately $1.0 billion at June 30, 2015 and approximately $685 million at December 31, 2015. In June 2016, the Company was awarded a contract valued at approximately $40 million to supply subsea drilling and production equipment and related services to Kangean Energy Indonesia, Ltd., a contractor for SKK Migas, for the development of its Terang/Sirasun/Batur gas fields project located offshore Indonesia. Of the $40 million contract, $29 million is related to equipment, which is included in the Company's backlog at June 30, 2016, and $11 million is related to services, which is not included in backlog. The Company's backlog balance during the six months ended June 30, 2016 was positively impacted by $4 million in translation adjustments due primarily to the strengthening of the Brazilian real against the U.S. dollar and negatively impacted by approximately $74 million in cancellations, of which $52 million was attributable to the cancellation of one contract during the first quarter of 2016 for wellhead equipment for a development project.

In August 2012, the Company's Brazilian subsidiary, Dril-Quip do Brasil LTDA, was awarded a four-year contract by Petroleo Brasileiro S.A. ("Petrobras"), Brazil's national oil company. The contract was valued at $650 million, net of Brazilian taxes, at exchange rates in effect at that time (approximately $413 million based on the June 30, 2016 exchange rate of 3.21 Brazilian real to 1.00 U.S. dollar) if all equipment under the contract was ordered. Amounts are included in the Company's backlog as purchase orders under the contract are received. Revenues of approximately $115 million have been recognized on this contract through June 30, 2016. As of June 30, 2016, the Company's backlog included $49 million of purchase orders under this Petrobras contract. The Company has not yet recognized revenue of approximately $18 million as of June 30, 2016 for certain items of equipment that were completed but not yet accepted for delivery by Petrobras. If Petrobras does not ultimately accept these items for delivery or if they refuse to accept these or similar items completed in the future, the Company's results of operations may be adversely affected. The Company expects to enter into a three-month extension of this Petrobras contract which would extend the term until October 27, 2016 pending the resolution of ongoing discussions regarding a longer term extension. The Company cannot provide assurances that an agreement will be reached on the three-month extension or on a longer term extension or that Petrobras will order all of the equipment under any such contract extension.

As a result of declining oil prices and the Company's decreasing backlog, the Company's total number of employees worldwide decreased from 2,720 as of December 31, 2014 to 2,319 as of December 31, 2015 and to 2,067 as of June 30, 2016 due to employee attrition and workforce reductions.

The Company operates its business and markets its products and services in most of the significant oil and gas producing areas in the world and is, therefore, subject to the risks customarily attendant to international operations and investments in foreign countries. These risks include nationalization, expropriation, war, acts of terrorism and civil disturbance, restrictive action by local governments, limitation on repatriation of earnings, change in foreign tax laws

and change in currency exchange rates, any of which could have an adverse effect on either the Company’s ability to manufacture its products in its facilities abroad or the demand in certain regions for the Company’s products or both. To date, the Company has not experienced any significant problems in foreign countries arising from local government actions or political instability, but there is no assurance that such problems will not arise in the future. Interruption of the Company’s international operations could have a material adverse effect on its overall operations. The June 23, 2016 referendum by British voters to exit the European Union (“Brexit”) adversely impacted global markets, including currencies, and resulted in a decline in the value of the British pound sterling, as compared to the U.S. dollar and other currencies. Volatility in exchange rates could be expected to continue in the short term as the United Kingdom (U.K.) negotiates its exit from the European Union. A weaker British pound sterling compared to the U.S. dollar during a reporting period would cause local currency results of the Company's U.K. operations to be translated into fewer U.S. dollars. Continued

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adverse consequences such as deterioration in economic conditions and volatility in currency exchange rates could have a negative impact on the Company's financial position and results of operations.

Revenues. Dril-Quip’s revenues are generated from two sources: products and services. Product revenues are derived from the sale of offshore drilling and production equipment. Service revenues are earned when the Company provides technical advisory assistance and rental tools during installation and retrieval of the Company’s products. Additionally, the Company earns service revenues when rework and reconditioning services are provided. For the three months ended June 30, 2016 and 2015, the Company derived 81% and 82%, respectively, of its revenues from the sale of its products and 19% and 18%, respectively, of its revenues from services. For the six months ended June 30, 2016 and 2015, the Company derived 81% and 82%, respectively, of its revenues from the sale of its products and 19% and 18%, respectively, of its revenues from services. Service revenues generally correlate to revenues from product sales because increased product sales typically generate increased demand for technical advisory assistance services during installation and rental of running tools. The Company has substantial international operations, with approximately 57% and 67%, respectively, of its revenues derived from foreign sales for the three months ended June 30, 2016 and 2015, and 57% and 65%, respectively, for the six months ended June 30, 2016 and 2015. Substantially all of the Company’s domestic revenue relates to operations in the U.S. Gulf of Mexico. Domestic revenue approximated 43% and 33%, respectively, of the Company’s total revenues for the three months ended June 30, 2016 and 2015 and 43% and 35%, respectively, for the six months ended June 30, 2016 and 2015.

Product contracts are negotiated and sold separately from service contracts. In addition, service contracts are not typically included in the product contracts or related sales orders and are not offered to the customer as a condition of the sale of the Company’s products. The demand for products and services is generally based on worldwide economic conditions in the offshore oil and gas industry, and is not based on a specific relationship between the two types of contracts. Substantially all of the Company’s sales are made on a purchase order basis. Purchase orders are subject to change and/or termination at the option of the customer. In case of a change or termination, the customer is required to pay the Company for work performed and other costs necessarily incurred as a result of the change or termination.

Generally, the Company attempts to raise its prices as its costs increase. However, the actual pricing of the Company’s products and services is impacted by a number of factors, including global oil prices, competitive pricing pressure, the level of utilized capacity in the oil service sector, maintenance of market share, the introduction of new products and general market conditions.

The Company accounts for larger and more complex projects that have relatively longer manufacturing time frames on a percentage-of-completion basis. For the six months ended June 30, 2016, 10 projects representing approximately 15% of the Company's total revenues and approximately 19% of its product revenues were accounted for using percentage-of-completion accounting, compared to 13 projects representing approximately 16% of the Company's total revenues and approximately 19% of its product revenues for the first six months 2015. For the quarter ended June 30, 2016, there were 6 projects representing approximately 16% of the Company’s total revenues and approximately 19% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 10 projects during the second quarter of 2015, which represented approximately 17% of the Company’s total revenues and approximately 21% of its product revenues. This percentage may fluctuate in the future. Revenues accounted for in this manner are generally recognized based upon a calculation of the percentage complete, which is used to determine the revenue earned and the appropriate portion of total estimated cost of sales. Accordingly, price and cost estimates are reviewed periodically as the work progresses, and adjustments proportionate to the percentage complete are reflected in the period when such estimates are revised. Losses, if any, are recorded in full in the period they become known. Amounts received from customers in excess of revenues recognized are classified as a current liability.

Cost of Sales. The principal elements of cost of sales are labor, raw materials and manufacturing overhead. Cost of sales as a percentage of revenues is influenced by the product mix sold in any particular period, costs from projects accounted for under the percentage-of-completion method, over/under manufacturing overhead absorption and market conditions. The Company’s costs related to its foreign operations do not significantly differ from its domestic costs.

Selling, General and Administrative Expenses. Selling, general and administrative expenses include the costs associated with sales and marketing, general corporate overhead, business development expenses, compensation

expense, stock-based compensation expense, legal expenses, foreign currency transaction gains and losses and other related administrative functions. The Company's U.K. subsidiary, whose functional currency is the British pound sterling, conducts a portion of its operations in U.S. dollars. As a result, this subsidiary holds significant monetary assets denominated in U.S. dollars. These monetary assets are subject to changes in exchange rates between the U.S. dollar and the British pound sterling, which has resulted in pre-tax non-cash foreign currency gains during the six months ended June 30, 2016 totaling $22.9 million. The British pound sterling to U.S. dollar exchange rates as of December 31, 2015, March 31, 2016 and June 30, 2016 were 1.48 to 1.00, 1.44 to 1.00 and 1.33 to 1.00, respectively. The Brexit vote, which took place during the second quarter of 2016, resulted in a decline in the value of the British pound sterling, as compared to the U.S. dollar and other currencies.

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Engineering and Product Development Expenses. Engineering and product development expenses consist of new product development and testing, as well as application engineering related to customized products.
Income Tax Provision. The Company’s effective income tax rate has historically been lower than the statutory rate primarily due to foreign income tax rate differentials, research and development credits and deductions related to domestic manufacturing activities.

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Results of Operations

The following table sets forth, for the periods indicated, certain statement of operations data expressed as a percentage of revenues:

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Revenues:				
Products	81.5 %	81.8 %	81.3 %	82.4 %
Services	18.5	18.2	18.7	17.6
Total revenues:	100.0	100.0	100.0	100.0
Cost of sales:				
Products	45.9	45.7	46.1	46.3
Services	10.2	9.0	9.9	8.7
Total cost of sales:	56.1	54.7	56.0	55.0
Selling, general and administrative expenses	4.1	15.6	6.1	11.5
Engineering and product development expenses	8.1	5.3	7.3	5.4
Operating income	31.7	24.4	30.6	28.2
Interest income	0.4	0.1	0.3	—
Income before income taxes	32.1	24.5	30.9	28.2
Income tax provision	6.7	6.3	7.3	7.2
Net income	25.4 %	18.2 %	23.6 %	21.0 %

The following table sets forth, for the periods indicated, a breakdown of our products and service revenues:

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
	(In millions)			
Revenues:				
Products				
Subsea equipment	$100.8	$160.6	$221.9	$328.6
Surface equipment	5.8	5.8	9.9	11.3
Offshore rig equipment	9.4	9.7	19.4	23.7
Total products	116.0	176.1	251.2	363.6
Services	26.4	39.2	57.8	77.7
Total revenues	$142.4	$215.3	$309.0	$441.3

Three Months Ended June 30, 2016 Compared to Three Months Ended June 30, 2015

Revenues. Revenues decreased by $72.9 million, or approximately 33.8%, to $142.4 million in the three months ended June 30, 2016 from $215.3 million in the three months ended June 30, 2015. Product revenues decreased by approximately $60.1 million for the three months ended June 30, 2016 compared to the same period in 2015 as a result of decreased revenues of $59.8 million in subsea equipment and $0.3 million in offshore rig equipment. Product revenues decreased in the Eastern Hemisphere, Western Hemisphere and Asia-Pacific by $30.9 million, $19.8 million and $9.4 million, respectively, largely due

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to the decline in oil and gas prices resulting in decreases in the demand for exploration and production equipment, especially subsea equipment. In any given time period, the revenues recognized between the various product lines and geographic areas will vary depending upon the timing of shipments to customers, completion status of the projects accounted for under the percentage-of-completion accounting method, market conditions and customer demand. Service revenues decreased by approximately $12.8 million resulting from decreased service revenues of $4.7 million in the Western Hemisphere, $2.5 million in Asia-Pacific and $5.6 million in the Eastern Hemisphere. The majority of the decreases in service revenues related to decreased rental of the Company's running and installation tools, largely due to the decline in oil and gas prices leading to decreased exploration and production activities.

Cost of Sales. Cost of sales decreased by $37.8 million, or approximately 32.1%, to $79.9 million for the three months ended June 30, 2016 from $117.7 million for the same period in 2015 as a result of lower revenues. As a percentage of revenues, cost of sales increased to 56.1% from 54.7% in the three months ended June 30, 2016 as compared to the same period in 2015, primarily as a result of pricing concessions.

Selling, General and Administrative Expenses. For the three months ended June 30, 2016, selling, general and administrative expenses decreased by approximately $27.8 million, or 82.9%, to $5.8 million from $33.6 million for the same period in 2015. The decrease was due to a significant pre-tax foreign currency transaction gain of $15.4 million in the second quarter of 2016 compared to a loss of $11.8 million in the second quarter of 2015. The transaction gain was caused by a 7.6% decline in the value of the British pound sterling against the U.S. dollar from March 31, 2016 to June 30, 2016 primarily as a result of Brexit. In the second quarter of 2015, the value of the British pound sterling increased by 6.1% as compared to the U.S. dollar. Selling, general and administrative expenses as a percentage of revenues decreased to 4.1% in the second quarter of 2016 from 15.6% in the second quarter of 2015.

Engineering and Product Development Expenses. For the three months ended June 30, 2016, engineering and product development expenses totaled $11.6 million compared to $11.4 million for the same period in 2015, a increase of $0.2 million, or 1.6%. Engineering and product development expenses as a percentage of revenues increased to 8.1% in the second quarter of 2016 from 5.3% in the second quarter of 2015 mainly resulting from the 33.8% decrease in revenues.

Income Tax Provision. Income tax expense for the three months ended June 30, 2016 was $9.6 million on income before taxes of $45.7 million, resulting in an effective income tax rate of approximately 21.0%. Income tax expense for the three months ended June 30, 2015 was $13.5 million on income before taxes of $52.7 million, resulting in an effective income tax rate of approximately 25.6%. The decrease in the effective income tax rate percentage primarily reflects the changes in taxable income among the Company's three geographic areas, which have different income tax rates.

Net Income. Net income was approximately $36.1 million for the three months ended June 30, 2016 and $39.2 million for the same period in 2015 for the reasons set forth above.

Six Months Ended June 30, 2016 Compared to Six Months Ended June 30, 2015

Revenues. Revenues decreased by $132.3 million, or approximately 30.0%, to $309.0 million in the six months ended June 30, 2016 from $441.3 million in the six months ended June 30, 2015. Product revenues decreased by approximately $112.4 million for the six months ended June 30, 2016 compared to the same period in 2015 as a result of decreased revenues of $106.7 million in subsea equipment, $1.4 million in surface equipment and $4.3 million in offshore rig equipment. Product revenues decreased in the Eastern Hemisphere, Western Hemisphere and Asia-Pacific by $77.2 million, $33.0 million and $2.2 million, respectively, largely due to the decline in oil and gas prices resulting in decreases in the demand for exploration and production equipment, especially subsea equipment. In any given time period, the revenues recognized between the various product lines and geographic areas will vary depending upon the timing of shipments to customers, completion status of the projects accounted for under the percentage-of-completion accounting method, market conditions and customer demand. Service revenues decreased by approximately $19.9 million resulting from decreased service revenues of $10.0 million in the Western Hemisphere, $4.3 million in the Eastern Hemisphere and $5.6 million in Asia-Pacific. The majority of the decreases in service revenues related to decreased rental of the Company's running and installation tools, largely due to the decline in oil and gas prices leading to decreased exploration and production activities.

Cost of Sales. Cost of sales decreased by $69.8 million, or approximately 28.8%, to $173.0 million for the six months ended June 30, 2016 from $242.8 million for the same period in 2015 as a result of lower revenues. As a percentage of revenues, cost of sales increased slightly to 56.0% from 55.0% in the six months ended June 30, 2016 as compared to the same period in 2015, primarily as a result of pricing concessions.
Selling, General and Administrative Expenses. For the six months ended June 30, 2016, selling, general and administrative expenses decreased by approximately $31.6 million, or 62.5%, to $19.0 million from $50.6 million for the same period in 2015, primarily due to a pre-tax foreign currency transaction gain of $22.7 million in the first six months of 2016

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compared to a loss of $5.4 million for the same period in 2015. The foreign exchange gain was caused by a 10.1% decline in the value of the British pound sterling against the U.S. dollar from December 31, 2015 to June 30, 2016 primarily as a result of Brexit. During the first six months of 2015, the value of the British pound sterling strengthened slightly. Stock award expense totaled $6.3 million for the six months ended June 30, 2016 as compared to $6.5 million for the same period in 2015. The remaining decrease is due to a reduction in personnel and related costs associated with workforce reductions. Selling, general and administrative expenses as a percentage of revenues decreased to 6.1% in the first six months of 2016 from 11.4% for the same period in 2015.

Engineering and Product Development Expenses. For the six months ended June 30, 2016, engineering and product development expenses totaled $22.5 million compared to $23.6 million for the same period in 2015, a decrease of $1.1 million, or 4.8%. The majority of the decrease was due to a reduction in personnel and related costs associated with workforce reductions. Engineering and product development expenses as a percentage of revenues increased to 7.3% in the first six months of 2016 from 5.4% for the same period in 2015 mainly resulting from the 30.0% decrease in revenues.

Income Tax Provision. Income tax expense for the six months ended June 30, 2016 was $22.7 million on income before taxes of $95.6 million, resulting in an effective income tax rate of approximately 23.7%. Income tax expense for the six months ended June 30, 2015 was $31.6 million on income before taxes of $124.5 million, resulting in an effective income tax rate of approximately 25.4%. The decrease in the effective income tax rate percentage primarily reflects the changes in taxable income among the Company’s three geographic areas, which have different income tax rates.

Net Income. Net income was approximately $72.9 million for the six months ended June 30, 2016 and $92.9 million for the same period in 2015 for the reasons set forth above.

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Liquidity and Capital Resources

Cash flows provided by (used in) type of activity were as follows:

	Six Months Ended June 30,	
	2016	2015
	(In thousands)	
Operating activities	$162,861	$113,011
Investing activities	(15,137)	(11,068)
Financing activities	(23,704)	(17,934)
	124,020	84,009
Effect of exchange rate changes on cash activities	(13,627)	(41)
Increase (decrease) in cash and cash equivalents	$110,393	$83,968

Statements of cash flows for entities with international operations that are local currency functional exclude the effects of the changes in foreign currency exchange rates that occur during any given period, as these are non-cash changes. As a result, changes reflected in certain accounts on the Condensed Consolidated Statements of Cash Flows may not reflect the changes in corresponding accounts on the Condensed Consolidated Balance Sheets.

The primary liquidity needs of the Company are (i) to fund capital expenditures to improve and expand facilities and manufacture additional running tools and (ii) to fund working capital. The Company’s principal source of funds is cash flows from operations.

Net cash provided by operating activities increased $49.9 million for the first six months of 2016 compared to the same period in 2015, primarily due to decreases in operating assets and liabilities of $72.1 million offset partially by lower net income of $20.0 million.

The decrease in operating assets and liabilities for the first six months of 2016 was due to a $64.2 million decrease in trade receivables primarily related to increased collection efforts and a decline in revenues. Prepaids and other assets decreased by $20.7 million due to decreases in vendor prepayments and the amortization of miscellaneous prepaid expenses. Accounts payable and accrued expenses decreased by approximately $13.5 million due to a reduction in customer prepayments of $10.0 million and a decrease in accrued compensation of $3.4 million.

The decrease in operating assets and liabilities for the first six months of 2015 of $3.4 million primarily reflected a decrease in trade receivables of $70.5 million, partially offset by a $67.5 million decrease in accounts payable and accrued expenses. Trade receivables decreased in 2015 largely due to significant collections attributable to milestone billings on our percentage-of-completion projects in the first quarter of 2015. Inventory decreased due to lower balances in finished goods. Accounts payable and accrued expenses decreased due to a decrease in customer prepayments from recognition of revenues under the percentage-of-completion method and payments of accrued federal and local taxes.

Capital expenditures by the Company were $15.3 million and $11.2 million in the first six months of 2016 and 2015, respectively. The capital expenditures for the first six months of 2016 were $9.5 million for machinery and equipment, $5.2 million for facilities and $0.6 million for other capital expenditures. The capital expenditures for the first six months of 2015 were primarily $5.3 million for machinery and equipment, $4.9 million for running tools and other expenditures of $1.0 million.

The exercise of stock options generated cash to the Company of $0.5 million in the first six months of 2016 as compared to $2.0 million in the same period of 2015.

On February 26, 2015, the Company announced that its Board of Directors had authorized a stock repurchase plan under which the Company was authorized to repurchase up to $100 million of its common stock. The Company repurchased and cancelled 1,184,700 shares under this plan in 2015 for a total cost of $75.8 million. During the second quarter of 2016, the Company completed the stock repurchase program by repurchasing and canceling 400,500

shares under this plan for a total cost of $24.2 million.

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On July 26, 2016, the Board of Directors authorized a new stock repurchase plan under which the Company can repurchase up to $100 million of its common stock. The repurchase plan has no set expiration date and any repurchased shares are expected to be cancelled. No repurchases have been made pursuant to this plan.

As of June 30, 2016, the Company has no commercial lending arrangement or lines of credit. The Company believes that cash generated from operations plus cash on hand will be sufficient to fund operations, working capital needs and anticipated capital expenditure requirements for the next twelve months. However, continued significant declines in hydrocarbon prices, catastrophic events or significant changes in regulations affecting the Company or its customers could have a material adverse effect on the Company’s liquidity. Should market conditions result in unexpected cash requirements, the Company believes that borrowing from commercial lending institutions would be available and adequate to meet such requirements.

Off-Balance Sheet Arrangements

The Company has no derivative instruments and no off-balance sheet hedging or financing arrangements, contracts or operations.

Other Matters

From time to time, the Company enters into discussions or negotiations to acquire other businesses or enter into joint ventures. The timing, size or success of any such efforts and the associated potential capital commitments are unpredictable and dependent on market conditions and opportunities existing at the time. The Company may seek to fund all or part of any such efforts with proceeds from debt or equity issuances. Debt or equity financing may not, however, be available at that time due to a variety of events, including, among others, the Company’s credit ratings, industry conditions, general economic conditions and market conditions.

Critical Accounting Policies

Refer to our Annual Report on Form 10-K for the year ended December 31, 2015 for a discussion of our critical accounting policies. During the six months ended June 30, 2016, there were no material changes in our judgments and assumptions associated with the development of our critical accounting policies.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is currently exposed to certain market risks related to interest rate changes on its short-term investments and fluctuations in foreign exchange rates. The Company does not engage in any material hedging transactions, forward contracts or currency trading which could mitigate the market risks inherent in such transactions. There have been no material changes in market risks for the Company from December 31, 2015.

Foreign Exchange Rate Risk

The Company has operations in various countries around the world and conducts business in a number of different currencies. Our significant foreign subsidiaries may also have monetary assets and liabilities not denominated in their functional currency. These monetary assets and liabilities are exposed to changes in currency exchange rates which may result in non-cash gains and losses primarily due to fluctuations between the U.S. dollar and each subsidiary's functional currency.

The Company experienced a foreign currency pre-tax gain of approximately $15.4 million during the three months ended June 30, 2016 and a pre-tax gain of $22.7 million during the six months ended June 30, 2016, compared to approximately $11.8 million and $5.4 million in pre-tax losses during the three and six months ended June 30, 2015, respectively. These gains and losses were primarily due to the exchange rate fluctuations between the U.S. dollar and the British pound sterling.

The Company does not engage in any material hedging transactions, forward contracts or currency trading which could mitigate the effects and risks inherent in such transactions. Additionally, there is no assurance that the Company will be able to protect itself against currency fluctuations in the future.

Item 4. Controls and Procedures

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including the Company’s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company’s disclosure controls and procedures as of the end of the period

covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2016 to provide reasonable assurance that information required to be

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disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.
There has been no change in the Company's internal controls over financial reporting that occurred during the quarter ended June 30, 2016 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

For a description of the Company's legal proceedings, see "Commitments and Contingencies," Note 7 to the Notes to Condensed Consolidated Financial Statements.

Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In February 2015, the Company announced that its Board of Directors authorized a stock repurchase plan under which the Company is authorized to repurchase up to $100 million of its common stock. The following table summarizes the repurchase and cancellation of common stock under that plan during the three months ended June 30, 2016.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Maximum Dollar Value (in millions) of Shares that May Yet Be Purchased Under the Program
April 2016	—	$—	—	$ 24.2
May 2016	345,600	60.56	345,600	3.3
June 2016	54,900	60.21	54,900	—
Total	400,500	$60.51	400,500	$ —

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FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain statements that may be deemed to be “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Statements contained in all parts of this document that are not historical facts are forward-looking statements that involve risks and uncertainties that are beyond the control of Dril-Quip, Inc. (the “Company” or “Dril-Quip”). You can identify the Company’s forward-looking statements by the words “anticipate,” “estimate,” “expect,” “may,” “project,” “believe” and similar expression by the Company’s discussion of strategies or trends. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, no assurance can be given that these expectations will prove to be correct. These forward-looking statements include the following types of information and statements as they relate to the Company:

- future operating results and cash flow;
- scheduled, budgeted and other future capital expenditures;
- working capital requirements;
- the need for and the availability of expected sources of liquidity;
- the introduction into the market of the Company’s future products;
- the market for the Company’s existing and future products;
- the Company’s ability to develop new applications for its technologies;
- the exploration, development and production activities of the Company’s customers;
- compliance with present and future environmental regulations and costs associated with environmentally related penalties, capital expenditures, remedial actions and proceedings;
- effects of pending legal proceedings;
- changes in customers’ future product and service requirements that may not be cost effective or within the Company’s capabilities; and
- future operations, financial results, business plans and cash needs.

These statements are based on assumptions and analyses in light of the Company’s experience and perception of historical trends, current conditions, expected future developments and other factors the Company believes were appropriate in the circumstances when the statements were made. Forward-looking statements by their nature involve substantial risks and uncertainties that could significantly impact expected results, and actual future results could differ materially from those described in such statements. While it is not possible to identify all factors, the Company continues to face many risks and uncertainties. Among the factors that could cause actual future results to differ materially are the risks and uncertainties discussed under “Item 1A. Risk Factors” in Part I of the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 and the following:

- the volatility of oil and natural gas prices;
- the cyclical nature of the oil and gas industry;
- uncertainties associated with the United States and worldwide economies;
- uncertainties regarding political tensions in the Middle East, Africa and elsewhere;
- current and potential governmental regulatory actions in the United States and regulatory actions and political unrest in other countries;
- uncertainties regarding future oil and gas exploration and production activities, including new regulations, customs requirements and product testing requirements;
- operating interruptions (including explosions, fires, weather-related incidents, mechanical failure, unscheduled downtime, labor difficulties, transportation interruptions, spills and releases and other environmental risks);
- project terminations, suspensions or scope adjustments to contracts reflected in the Company’s backlog;
- the Company’s reliance on product development;
- technological developments;
- the Company’s reliance on third-party technologies;

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- acquisition and merger activities involving the Company or its competitors;
- the Company’s dependence on key employees and skilled machinists, fabricators and technical personnel;
- the Company’s reliance on sources of raw materials;
- impact of environmental matters, including future environmental regulations;
- competitive products and pricing pressures;
- fluctuations in foreign currency, including those attributable to Brexit;
- the ability of the Organization of Petroleum Exporting Countries (OPEC) to set and maintain production levels and pricing;
- the Company’s reliance on significant customers;
- creditworthiness of the Company’s customers;
- fixed-price contracts;
- changes in general economic, market or business conditions;
- access to capital markets;
- negative outcome of litigation, threatened litigation or government proceedings;
- terrorist threats or acts, war and civil disturbances; and
- the interpretation of foreign tax laws with respect to our foreign subsidiaries.

Many of such factors are beyond the Company’s ability to control or predict. Any of the factors, or a combination of these factors, could materially affect the Company’s future results of operations and the ultimate accuracy of the forward-looking statements. Management cautions against putting undue reliance on forward-looking statements or projecting any future results based on such statements or present or prior earnings levels. Every forward-looking statement speaks only as of the date of the particular statement, and the Company undertakes no obligation to publicly update or revise any forward-looking statement.

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Item 6.

(a) Exhibits

The following exhibits are filed herewith:

Exhibit No.	Description
*3.1	— Restated Certificate of Incorporation of the Company (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on May 20, 2014).
*3.2	— Certificate of Designations of Series A Junior Participating Preferred Stock of the Company (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on November 25, 2008).
*3.3	— Amended and Restated Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on May 20, 2014).
*4.1	— Form of certificate representing Common Stock (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447).
*4.2	— Rights Agreement dated as of November 24, 2008 between Dril-Quip, Inc. and Mellon Investor Services LLC, as Rights Agent (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on November 25, 2008).
31.1	— Rule 13a-14(a)/15d-14(a) Certification of Blake T. DeBerry.
31.2	— Rule 13a-14(a)/15d-14(a) Certification of Jerry M. Brooks.
32.1	— Section 1350 Certification of Blake T. DeBerry.
32.2	— Section 1350 Certification of Jerry M. Brooks.
101.INS	— XBRL Instance Document
101.SCH	— XBRL Schema Document
101.CAL	— XBRL Calculation Document
101.DEF	— XBRL Definition Linkbase Document
101.LAB	— XBRL Label Linkbase Document
101.PRE	— XBRL Presentation Linkbase Document

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* Incorporated herein by reference as indicated.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DRIL-QUIP, INC.

Date: July 29, 2016 BY: /s/ Jerry M. Brooks
Jerry M. Brooks,
Vice President—Finance and
Chief Financial Officer
(Principal Accounting Officer and
Duly Authorized Signatory)

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