DRIL-QUIP INC
Form 10-Q
July 30, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2014

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 x 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 x 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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	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 x

As of July 23, 2014, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 39,977,175.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2014	December 31, 2013
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 342,621	$ 384,356
Trade receivables, net	316,921	279,253
Inventories, net	408,066	368,354
Deferred income taxes	27,299	24,951
Prepaids and other current assets	26,613	21,899
Total current assets	1,121,520	1,078,813
Property, plant and equipment, net	316,288	304,806
Other assets	10,752	10,993
Total assets	$ 1,448,560	$ 1,394,612
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 55,010	$ 38,801
Accrued income taxes	8,136	13,628
Customer prepayments	69,712	45,025
Accrued compensation	18,977	21,556
Other accrued liabilities	17,570	23,780
Total current liabilities	169,405	142,790
Deferred income taxes	9,571	9,804
Total liabilities	178,976	152,594
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, 39,977,175 and 40,822,627 shares issued and outstanding at June 30, 2014 and December 31, 2013	398	407
Additional paid-in capital	109,170	191,965

Retained earnings	1,163,758	1,069,816
Accumulated other comprehensive losses	(3,742)	(20,170)
Total stockholders equity	1,269,584	1,242,018
Total liabilities and stockholders equity	$ 1,448,560	$ 1,394,612

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
	(In thousands, except per share data)			
Revenues:				
Products	$ 189,914	$ 188,859	$ 361,915	$ 349,344
Services	40,401	33,172	72,473	65,842
Total revenues	230,315	222,031	434,388	415,186
Cost and expenses:				
Cost of sales:				
Products	104,208	113,312	195,539	209,985
Services	20,785	19,891	40,241	39,546
Total cost of sales	124,993	133,203	235,780	249,531
Selling, general and administrative	25,520	23,273	49,455	38,902
Engineering and product development	10,848	9,340	21,632	18,361
Total costs and expenses	161,361	165,816	306,867	306,794
Operating income	68,954	56,215	127,521	108,392
Interest income	266	167	349	283
Interest expense	(5)	(6)	(12)	(20)
Income before income taxes	69,215	56,376	127,858	108,655
Income tax provision	17,891	13,449	33,916	25,886
Net income	$ 51,324	$ 42,927	$ 93,942	$ 82,769
Earnings per common share:				
Basic	$ 1.27	$ 1.06	$ 2.32	$ 2.04
Diluted	$ 1.27	$ 1.05	$ 2.31	$ 2.03
Weighted average common shares outstanding:				
Basic	40,327	40,636	40,501	40,583
Diluted	40,562	40,821	40,723	40,767

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

3

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
	(In thousands)			
Net income	$ 51,324	$ 42,927	$ 93,942	$ 82,769
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	10,699	(9,511)	16,428	(24,134)
Total comprehensive income	$ 62,023	$ 33,416	$ 110,370	$ 58,635

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six months ended June 30,	
	2014	**2013**
	(In thousands)	
Operating activities		
Net income	$ 93,942	$ 82,769
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	15,126	14,353
Stock-based compensation expense	5,660	4,136
Gain on sale of equipment	(149)	(22)
Deferred income taxes	(2,507)	(1,751)
Changes in operating assets and liabilities:		
Trade receivables, net	(33,272)	15,203
Inventories, net	(32,708)	(24,658)
Prepaids and other assets	(3,460)	(921)
Excess tax benefits of stock option and awards	(251)	(1,682)
Accounts payable and accrued expenses	24,291	(1,326)
Net cash provided by operating activities	66,672	86,101
Investing activities		
Purchase of property, plant and equipment	(23,218)	(23,101)
Proceeds from sale of equipment	470	299
Net cash used in investing activities	(22,748)	(22,802)
Financing activities		
Repurchase of common stock	(90,022)	
Proceeds from exercise of stock options	1,386	7,749
Excess tax benefits of stock options and awards	251	1,682
Net cash provided by (used in) financing activities	(88,385)	9,431
Effect of exchange rate changes on cash activities	2,726	(4,380)
Increase (decrease) in cash and cash equivalents	(41,735)	68,350
Cash and cash equivalents at beginning of period	384,356	257,191
Cash and cash equivalents at end of period	$ 342,621	$ 325,541

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

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 environments 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 in Macae, Brazil.

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2013, 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, 2014 and the results of operations and comprehensive income for the three- and six-month periods ended June 30, 2014 and 2013 and the cash flows for the six-month periods ended June 30, 2014 and 2013. Certain information and footnote disclosures normally included in the 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 the cash flows for the six-month period ended June 30, 2014 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, 2013.

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 as discussed more fully in the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

Revenue Recognition

Product Revenue

The Company earns 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

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 percent 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. As of June 30, 2014 and December 31, 2013, receivables included $43.9 million and $52.9 million of unbilled receivables, respectively. For the quarter ended June 30, 2014, there were 12 projects representing approximately 5% of the Company s total revenue and approximately 6% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 11 projects during the second quarter of 2013, which represented approximately 6% of the Company s total revenues and approximately 7% of its product revenues. For the six months ended June 30, 2014, there were 16 projects representing approximately 8% of the Company s total revenues and 10% of its product revenues, compared to 15 projects that represented approximately 12% of the Company s total revenues and 14% of its product revenues for the six months ended June 30, 2013, 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 revenue

The Company earns 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 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.

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 number of common shares outstanding at June 30 of each year to the weighted average 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,	
	2014	2013	2014	2013
	(In thousands)			
Weighted average basic common shares outstanding basic	40,327	40,636	40,501	40,583
Dilutive effect of common stock options and awards	235	185	222	184
Weighted average diluted common shares outstanding diluted	40,562	40,821	40,723	40,767

3. New Accounting Standards

In May 2014, the FASB issued ASU 2014-09 Revenue from Contracts with Customer (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 is effective for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. The Company is currently evaluating the new guidance to determine the impact on its consolidated financial statements.

4. Stock-Based Compensation and Stock Awards

During the three months ended June 30, 2014 and 2013, the Company recognized approximately $2.8 million and $2.0 million, respectively, of stock-based compensation expense, which is included in the selling, general and administrative expense line on the Condensed Statement of Income. For the six months ended June 30, 2014 and 2013, stock-based compensation expense totaled $5.7 million and $4.1 million, respectively. No stock-based compensation expense was capitalized during the three or six months ended June 30, 2014 or 2013. There were no stock options or awards granted in the second quarter of 2014 or 2013. In May 2014, 1,602 shares of restricted stock awards vested from a May 2012 grant to the directors.

5. Inventories

Inventories consist of the following:

	June 30, 2014	December 31, 2013
	(In thousands)	
Raw materials	$ 95,441	$ 85,670
Work in progress	134,042	119,929
Finished goods	214,138	195,971
	443,621	401,570
Less: allowance for obsolete and excess inventory	(35,555)	(33,216)
Total inventory	$ 408,066	$ 368,354

6. Geographic Areas

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
	(In thousands)			
Revenues:				
Western Hemisphere				
Products	$ 115,953	$ 95,871	$ 210,342	$ 195,600
Services	18,381	18,567	35,281	34,196
Intercompany	9,063	10,891	19,355	23,278
Total	$ 143,397	$ 125,329	$ 264,978	$ 253,074
Eastern Hemisphere				
Products	$ 43,814	$ 60,647	$ 97,737	$ 98,480
Services	16,514	10,400	27,991	22,567
Intercompany	3,325	596	3,499	751
Total	$ 63,653	$ 71,643	$ 129,227	$ 121,798
Asia-Pacific				
Products	$ 30,147	$ 32,341	$ 53,836	$ 55,264
Services	5,506	4,205	9,201	9,079
Intercompany	962	4,146	2,330	4,277
Total	$ 36,615	$ 40,692	$ 65,367	$ 68,620
Summary				
Products	$ 189,914	$ 188,859	$ 361,915	$ 349,344
Services	40,401	33,172	72,473	65,842
Intercompany	13,350	15,633	25,184	28,306
Eliminations	(13,350)	(15,633)	(25,184)	(28,306)
Total	$ 230,315	$ 222,031	$ 434,388	$ 415,186
Income before income taxes:				
Western Hemisphere	$ 36,010	$ 19,199	$ 72,170	$ 44,145
Eastern Hemisphere	15,827	21,116	31,174	38,124
Asia-Pacific	15,853	13,133	21,308	22,824
Eliminations	1,525	2,928	3,206	3,562
Total	$ 69,215	$ 56,376	$ 127,858	$ 108,655

	June 30, 2014	December 31, 2013

	(In thousands)	
Total Long-Lived Assets:		
Western Hemisphere	$ 224,188	$ 216,104
Eastern Hemisphere	48,185	43,430
Asia-Pacific	57,593	59,192
Eliminations	(2,926)	(2,927)
Total	$ 327,040	$ 315,799
Total Assets:		
Western Hemisphere	$ 785,759	$ 803,069
Eastern Hemisphere	364,355	316,473
Asia-Pacific	332,102	292,600
Eliminations	(33,656)	(17,530)
Total	$ 1,448,560	$ 1,394,612

7. Commitments and Contingencies

Deepwater Horizon Incident

On April 22, 2010, a deepwater U.S. Gulf of Mexico drilling rig known as the *Deepwater Horizon,* that was operated by BP Exploration & Production, Inc. (BP) sank after an explosion and fire that began on April 20, 2010. Pursuant to a contract that the Company entered into with an affiliate of BP, it supplied to BP a wellhead and certain other equipment that were in use on the *Deepwater Horizon* at the time of the incident. The Company was named, along with other unaffiliated defendants, in both class action and other lawsuits arising from the *Deepwater Horizon* incident. These lawsuits were consolidated in the multi-district proceeding *In Re: Oil Spill by the Oil Rig Deepwater Horizon in the Gulf of Mexico, on April 20, 2010* (MDL Proceeding). In 2012, the judge presiding over various lawsuits and proceedings dismissed all claims asserted against the Company in those proceedings with prejudice. On April 9, 2012, the judge issued an order granting a final judgment in favor of the Company with respect to the court s prior order that granted the Company s Motion for Summary Judgment.

One of the lawsuits against the Company consolidated in the MDL Proceeding was a personal injury lawsuit initially filed in a Texas state court. The plaintiff has filed a motion to remand the lawsuit back to the Texas state court. If that lawsuit is remanded to the Texas state court, the Company intends to vigorously defend that lawsuit and does not believe it will have a material adverse impact on its results of operations. Accordingly, no liability has been accrued in conjunction with this matter.

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 prepaid tax) that can be used to offset future state taxes on sales to customers in the State of Rio de Janeiro once certified by the tax authorities under a process that is currently ongoing. When the credits are certified, the Company will have a five-year period in which to utilize them. In December 2010 and January 2011, the Company s Brazilian subsidiary was served with 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 this assessment on the grounds that it would represent double taxation on the importation of the same goods and that the Company is entitled to the credits under applicable Brazilian law. The Company believes that these credits are valid and success in the matter 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 dependency 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 operations, financial position or cash flows.

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 unaudited condensed consolidated financial statements 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, 2013.

Overview

Dril-Quip designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environments 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 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 have historically been characterized by significant volatility.

According to the Energy Information Administration (EIA) of the U.S. Department of Energy, average Brent Crude oil and natural gas (Henry Hub) closing prices are listed below for the periods covered by this report:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Crude oil ($/Bbl)	$ 109.69	$ 102.56	$ 108.93	$ 107.34
Natural gas ($/Mcf)	4.75	4.14	5.04	3.88

During the second quarter of 2014, Brent Crude oil closing prices ranged between $103.37 per barrel and $115.19 per barrel with an average quarterly price of $109.69 per barrel, as compared to a range of $96.84 and $109.66 per barrel with the average quarterly price of $102.56 per barrel for the same period in 2013. For the six months ended June 30, 2014 and 2013, Brent Crude oil closing prices averaged $108.93 per barrel and $107.34 per barrel, respectively, and ranged between $103.37 per barrel and $115.19 per barrel for the 2014 period, as compared to a range of $96.84 per barrel to $118.90 per barrel for the same period in 2013. Brent Crude oil prices ended the second quarter of 2014 at $111.03 per barrel and closed at $104.73 per barrel on July 14, 2014. The Henry Hub natural gas price at June 30, 2014 was $4.53 per Mcf and on July 14, 2014, the closing price was $4.26 per Mcf.

According to the July 2014 release of the Short-Term Energy Outlook published by the EIA, Brent Crude oil prices are projected to average approximately $109.55 per barrel in 2014 and $104.92 per barrel in 2015. In its July 2014 Oil

Market Report, the International Energy Agency projected that world demand growth for oil will be approximately 1.2 million barrels per day in 2014, increasing to 1.4 million barrels per day in 2015. In July 2014, the EIA projected that Henry Hub natural gas prices will average $4.91 per Mcf in 2014 and $4.64 per Mcf in 2015.

Rig Count

Detailed below is the average contracted rig count for the Company s geographic regions for the six months ended June 30, 2014 and 2013. 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 end users of the Company s products.

	Six months ended June 30,			
	2014		**2013**	
	Floating Rigs	**Jack-up Rigs**	**Floating Rigs**	**Jack-up Rigs**
Western Hemisphere	126	98	131	87
Eastern Hemisphere	99	96	92	89
Asia Pacific	54	260	48	239
TOTAL	279	454	271	415

Source: ODS Petrodata RigBase June 30, 2014 and 2013

The table represents rigs under contract and includes rigs currently drilling as well as rigs committed, but not yet drilling. According to ODS-Petrodata RigBase, as of June 30, 2014, there were 71 rigs under contract in the U.S. Gulf of Mexico (43 floating rigs and 28 jack-up rigs), 63 of which were actively drilling (35 floating rigs and 28 jack-up rigs). As of June 30, 2013, there were also 71 rigs under contract in the U.S. Gulf of Mexico, (37 floating rigs and 34 jack-up rigs), all of which were actively drilling.

The Company believes that the number of rigs (semi-submersibles, drillships and jack-up rigs) under construction impacts its revenues 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 ODS-Petrodata, at the end of June 2014 and 2013, there were 244 and 213 rigs, respectively, under construction. The expected delivery dates for the rigs under construction on June 30, 2014 are as follows:

	Floating Rigs	Jack-Up Rigs	Total
2014	19	24	43
2015	28	64	92
2016	21	48	69
2017	15	11	26
After 2017 or unspecified delivery date	14		14
	97	147	244

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. For the first six months of 2013, Brent Crude oil prices ranged between $96.84 per barrel and $118.90 per barrel with an average price of $107.34 per barrel and ended the year at $109.95 per barrel. For the first six months of 2014 the price of Brent Crude oil ranged between $103.37 per barrel and $115.19 per barrel with an average price of $108.93 per barrel and ended the quarter at $111.03 per barrel. 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, or reduce their levels of capital expenditures for exploration and production for a variety of reasons. In addition, a 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 prolonged decline in commodity prices, an extended continuation of the downturn in the global economy or future restrictions or declines in offshore oil and gas exploration and production could have a negative impact on the Company and/or its backlog. The Company s backlog at June 30, 2014 was approximately $1.32 billion compared to approximately $1.14 billion at June 30, 2013 and $1.18 billion at December 31, 2013. 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. At exchange rates in effect at the signing date (2.04 Brazilian real to 1.00 U.S. dollar), the contract is valued at $650 million, net of Brazilian taxes, if all the equipment under the contract is ordered. Amounts will be included in the Company s backlog as purchase orders under this contract are received. As of June 30, 2014, the Company s backlog included approximately $131 million of purchase orders under the new Petrobras contract. Revenues of approximately $30 million have been recognized on this contract through June 30, 2014. The Company has not recognized revenue of approximately $12.4 million during the six months ended June 30, 2014 for certain items of equipment that were completed but not accepted for delivery by Petrobras. Petrobras has asserted that such equipment does not satisfy certain contractual requirements. If the Company is unable to timely resolve these objections, or if Petrobras refuses to accept similar items of completed equipment in the future, the Company s results of operations may be adversely affected.

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 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 for installation of the Company s products, reconditioning services and rental of running tools for installation and retrieval of the Company s products. For the six months ended June 30, 2014 and 2013, the Company derived 83% and 84%, respectively, of its revenues from the sale of its products and 17% and 16% of its revenues from services, respectively. Service revenues generally correlate to revenues from product sales because increased product sales typically generate increased demand for technical advisory services during installation and rental of running tools. The Company has substantial international operations, with approximately 57% and 67% of its revenues derived from foreign sales for the three months ended June 30, 2014 and 2013, respectively, and 60% and 70% for the six months ended June 30, 2014 and 2013, respectively. 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, 2014 and 2013 and 40% and 30%, respectively, for the six months ended June 30, 2014 and 2013.

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 world-wide 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 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, 2014, 16 projects representing approximately 8% of the Company s total revenue and approximately 10% of its product revenue were accounted for using percentage-of-completion accounting, compared to 15 projects representing approximately 12% of the Company s total revenue and approximately 14% of its product revenue for the first six months of 2013. 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 percent 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.

The following table sets forth, for the periods indicated, a breakdown of the Company s U.S. Gulf of Mexico products and services revenues:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
	(In millions)			
Revenues:				
Products				
Subsea equipment	$ 74.3	$ 58.9	$ 126.7	$ 97.3
Surface equipment	1.4	0.1	3.7	0.1
Offshore rig equipment	9.1	0.4	18.8	0.9
Total products	84.8	59.4	149.2	98.3
Services	14.3	13.9	26.0	25.0
Total U.S. Gulf of Mexico revenues	$ 99.1	$ 73.3	$ 175.2	$ 123.3

Subsea equipment revenues rose $15.4 million to $74.3 million from $58.9 million and offshore rig equipment revenues increased $8.7 million to $9.1 million from $0.4 million for the three months ended June 30, 2014 and 2013, respectively. These increases are largely due to the increases in demand, evidenced by the increase in backlog, and the increase in the number of rigs under construction as of June 30, 2014 compared to June 30, 2013. For the three months ended June 30, 2014 and 2013, the Company s U.S. Gulf of Mexico service revenues as a percentage of worldwide revenues was 6% for both periods.

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 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, compensation expense, stock-based compensation expense, legal expenses, foreign currency transaction gains and losses and other related administrative functions.

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.

Results of Operations

The following table sets forth, for the periods indicated, certain condensed statements of income data expressed as a percentage of revenues:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Revenues:				
Products	82.5%	85.1%	83.3%	84.1%
Services	17.5	14.9	16.7	15.9
Total revenues	100.0	100.0	100.0	100.0
Cost of sales:				
Products	45.2	51.0	45.0	50.6
Services	9.1	9.0	9.3	9.5
Total cost of sales	54.3	60.0	54.3	60.1
Selling, general and administrative expenses	11.0	10.5	11.4	9.4
Engineering and product development expenses	4.7	4.2	5.0	4.4
Operating income	30.0	25.3	29.3	26.1
Interest income	0.1	0.1	0.1	0.1
Interest expense				
Income before income taxes	30.1	25.4	29.4	26.2
Income tax provision	7.8	6.1	7.8	6.2
Net income	22.3%	19.3%	21.6%	20.0%

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,	
	2014	2013	2014	2013
		(In millions)		
Revenues:				
Products				