DRIL-QUIP INC
Form 10-Q
August 09, 2007

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, 2007

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.)**

13550 HEMPSTEAD HIGHWAY

HOUSTON, TEXAS

77040

(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes ¨ No x

As of August 7, 2007, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 40,437,035.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	December 31, 2006	June 30, 2007
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 135,429	$ 168,867
Trade receivables, net	144,820	140,048
Inventories, net	162,503	170,517
Deferred income taxes	15,424	15,445
Prepaids and other current assets	6,879	4,668
Total current assets	465,055	499,545
Property, plant and equipment, net	129,340	132,411
Other assets	540	539
Total assets	$ 594,935	$ 632,495
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 38,572	$ 31,078
Current maturities of long-term debt	844	865
Accrued income taxes	15,760	11,827
Customer prepayments	39,387	34,673
Accrued compensation	9,916	9,029
Other accrued liabilities	13,326	12,712
Total current liabilities	117,805	100,184
Long-term debt	2,876	2,509
Deferred income taxes	6,757	6,824
Total liabilities	127,438	109,517
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued)		
Common stock:		
50,000,000 shares authorized at $0.01 par value, 40,357,656 and 40,435,782 shares issued and outstanding at December 31, 2006 and June 30, 2007, respectively	404	404
Additional paid-in capital	192,086	194,808
Retained earnings	264,620	312,780
Foreign currency translation adjustment	10,387	14,986
Total stockholders equity	467,497	522,978
Total liabilities and stockholders equity	$ 594,935	$ 632,495

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2006	2007	2006	2007
	(In thousands, except per share data)			
Revenues	$ 108,476	$ 114,701	$ 206,674	$ 232,383
Cost and expenses:				
Cost of sales	63,892	64,492	121,055	132,242
Selling, general and administrative	9,210	12,066	20,387	24,084
Engineering and product development	4,821	5,280	9,716	10,486
	77,923	81,838	151,158	166,812
Operating income	30,553	32,863	55,516	65,571
Interest income	602	1,984	904	3,749
Interest expense	(250)	(61)	(443)	(158)
Income before income taxes	30,905	34,786	55,977	69,162
Income tax provision	9,632	10,677	17,385	21,002
Net income	$ 21,273	$ 24,109	$ 38,592	$ 48,160
Earnings per common share:				
Basic	$ 0.54	$ 0.60	$ 0.99	$ 1.19
Diluted	$ 0.53	$ 0.59	$ 0.96	$ 1.18
Weighted average common shares:				
Basic	39,094	40,436	38,919	40,407
Diluted	40,263	41,003	40,108	40,971

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six months ended June 30, 2006	Six months ended June 30, 2007
	(In thousands)	
Operating activities		
Net income	$ 38,592	$ 48,160
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,165	7,693
Stock-based compensation expense	853	1,047
Gain on sale of equipment	(52)	(222)
Deferred income taxes	(2,979)	108
Changes in operating assets and liabilities:		
Trade receivables, net	(14,381)	7,066
Inventories, net	(51)	(5,390)
Prepaids and other assets	1,233	2,325
Excess tax benefits of stock option exercises	(4,502)	(786)
Trade accounts payable and accrued expenses	9,273	(18,814)
Net cash provided by operating activities	35,151	41,187
Investing activities		
Purchase of property, plant and equipment	(12,264)	(9,578)
Proceeds from sale of equipment	142	907
Net cash used in investing activities	(12,122)	(8,671)
Financing activities		
Proceeds from long-term borrowing	35	
Principal payments on long-term debt	(391)	(425)
Proceeds from exercise of stock options	6,628	890
Excess tax benefit-stock options	4,502	786
Net cash provided by financing activities	10,774	1,251
Effect of exchange rate changes on cash activities	(3,797)	(329)
Increase in cash and cash equivalents	30,006	33,438
Cash and cash equivalents at beginning of period	32,762	135,429
Cash and cash equivalents at end of period	$ 62,768	$ 168,867

The accompanying notes are an integral part of these 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 environment and severe service applications. The Company s principal products consist of subsea and surface wellheads, subsea and surface production trees, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, 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 installation and reconditioning services and rents running tools for use in the installation and retrieval of its 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.

The condensed consolidated financial statements included herein have been prepared by Dril-Quip and are unaudited, except for the balance sheet at December 31, 2006, which 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, 2007, the results of operations for each of the three and six-month periods ended June 30, 2007 and 2006, and the cash flows for each of the six-month periods ended June 30, 2007 and 2006. Although management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate to make the information presented not misleading, 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. The results of operations and the cash flows for the six-month period ended June 30, 2007 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 consolidated audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

2. Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned. 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, 2006.

Cash and cash equivalents

Short-term investments that have a maturity of three months or less from the date of purchase are classified as cash equivalents. The Company invests excess cash in short-term mutual funds rated as the highest quality by nationally recognized rating agencies. The funds primarily invest in short-term money market instruments that blend top-tier, high quality U.S. dollar denominated obligations, which include commercial paper, certificates of deposit, master and promissory notes, municipal securities and repurchase agreements. The Company s investment objectives include the provision of a high level of current income consistent with the preservation of capital and the maintenance of liquidity.

Inventories

Inventory costs are determined principally by the use of the first-in, first-out (FIFO) costing method, and are stated at the lower of cost or market. Inventory is valued principally using standard costs, which are calculated based upon direct costs incurred and overhead allocations. Periodically, obsolescence reviews are performed on slow-moving inventories and reserves are established based on current assessments about future demands and market conditions. The inventory values have been reduced by a reserve for excess and obsolete inventories. Inventory reserves of $18.4 million and $17.8 million were recorded as of June 30, 2007 and 2006, respectively. If market conditions are less favorable than those projected by management, additional inventory reserves may be required.

Property, Plant and Equipment

Property, plant and equipment are carried at cost, with depreciation provided on a straight-line basis over their estimated useful lives.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Current income taxes are provided on income reported for financial statement purposes, adjusted for transactions that do not enter into the computation of income taxes payable in the same year. Deferred tax assets and liabilities are measured using enacted tax rates for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Common Stock

All share and per share data (except par value) have been adjusted for all periods presented for the two-for-one common stock split effective October 5, 2006.

Revenue Recognition

The Company delivers most of its products and services to its customers on an as-needed basis and records revenues as the products are shipped and as services are rendered. Allowances for doubtful accounts are determined generally on a case by case basis. Certain revenues are derived from long-term project contracts which generally require more than one year to fulfill. Revenues and profits on long-term project contracts are recognized under the percentage-of-completion method based on the ratio of costs incurred to total estimated costs. 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, on contracts are recognized when they become known. Contracts for long-term projects contain provisions for customer progress payments. Payments in excess of revenues recognized are included as a customer prepayment liability.

Foreign Currency

The financial statements of foreign subsidiaries are translated into U.S. dollars at period end exchange rates except for revenues and expenses, which are translated at average monthly rates. Translation adjustments are reflected as a separate component of stockholders equity and have no current effect on earnings or cash flows.

Foreign currency exchange transactions are recorded using the exchange rate at the date of the settlement. These amounts are included in selling, general and administrative costs in the consolidated statements of income.

Stock-Based Compensation

The Company has stock option grants outstanding under the Dril-Quip, Inc. 1997 Incentive Plan (as amended, the 1997 Plan). In addition, on May 13, 2004 the Company s stockholders approved the 2004 Incentive Plan of Dril-Quip, Inc. (the 2004 Plan), which reserved up to 2,696,294 shares of Common Stock to be issued in connection with the 2004 Plan. No additional options will be awarded under the 1997 Plan.

Fair Value of Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, receivables, payables, and debt instruments. The carrying values of these financial instruments approximate their respective fair values as they are either short-term in nature or carry interest rates which approximate market rates.

Concentration of Credit Risk

Financial instruments which subject the Company to concentrations of credit risk include trade receivables. The Company grants credit to its customers, which operate primarily in the oil and gas industry. The Company performs periodic credit evaluations of its customers financial condition and generally does not require collateral. The Company maintains reserves for potential losses, and such losses have historically been within management s expectations.

Comprehensive Income

SFAS No. 130, Reporting Comprehensive Income, establishes the rules for the reporting and display of comprehensive income and its components. SFAS No. 130 requires the Company to include unrealized gains or losses on foreign currency translation adjustments in other comprehensive income. Generally, gains are attributed to a weakening U.S. dollar and losses are the result of a strengthening U.S. dollar.

The following table provides comprehensive income for the periods indicated:

	Three months ended June 30,		**Six months ended June 30,**	
	2006	**2007**	**2006**	**2007**
	(In thousands)			
Net income	$ 21,273	$ 24,109	$ 38,592	$ 48,160
Foreign currency translation adjustment	4,135	2,810	5,063	4,599
Comprehensive income	$ 25,408	$ 26,919	$ 43,655	$ 52,759

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 using the treasury stock method.

The net income used in the basic and dilutive earnings per common 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 of common shares outstanding and the weighted average number of common and dilutive potential common shares outstanding for the purpose of calculating basic and diluted earnings per common share:

	Three months ended June 30,		Six months ended June 30,	
	2006	2007	2006	2007
	(In thousands)		(In thousands)	
Number of common shares outstanding at end of period	39,122	40,436	39,122	40,436
Effect of using weighted average common shares outstanding	(28)		(203)	(29)
Weighted average basic common shares outstanding	39,094	40,436	38,919	40,407
Dilutive effect of common stock options	1,169	567	1,189	564
Weighted average diluted common shares outstanding	40,263	41,003	40,108	40,971

New Accounting Standards

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109 (FIN 48), on January 1, 2007. FIN 48 was issued in June 2006 and prescribes that the Company recognize in its financial statements the impact of a tax position that is more likely than not to be sustained upon examination based upon the technical merits of the position, including resolution of any appeals. The interpretation provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition in our financial statements. Our evaluation was performed for the tax years which remain subject to examination by major tax jurisdictions as of August 1, 2007, which are the years ended December 31, 2001, through 2006.

We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. In the event we have received an assessment for interest and/or penalties, it has been classified in the financial statements as selling, general and administrative expense.

In September 2006, the FASB issued FASB Statement 157 Fair Value Measurements (SFAS No. 157), which defines and measures fair value and expands disclosures about fair value measurements. The statement emphasizes that fair value is a market-based measurement and not an entity-specific measurement. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. The Company is evaluating the impact of adopting SFAS No. 157 on its consolidated financial statements.

3. Stock-Based Compensation and Stock Option Awards

During the three and six months ended June 30, 2007, the Company recognized $509,000 and $1,047,000, respectively, of compensation expense compared to $429,000 and $853,000, respectively, for the three and six months ended June 30, 2006. Compensation expense is reported as selling, general and administrative expense, in the accompanying condensed consolidated statements of income. During the three and six months ended June 30, 2007 and 2006 there were no stock options granted. Refer to Note 12 of the Company s 2006 Form 10-K for additional information regarding stock-based compensation plans.

4. Inventories

Inventories consist of the following:

	December 31, 2006	June 30, 2007