DRIL-QUIP INC
Form 10-Q
August 06, 2012

# 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, 2012**

**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, or a non-accelerated filer. See the 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 August 01, 2012 the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 40,422,392.

## PART I FINANCIAL INFORMATION

### Item 1. FINANCIAL STATEMENTS

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(UNAUDITED)**

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| | (In thousands) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 248,143 | $ 298,576 |
| Trade receivables, net | 220,107 | 180,095 |
| Inventories, net | 340,035 | 277,802 |
| Deferred income taxes | 24,059 | 23,868 |
| Prepaids and other current assets | 19,687 | 18,961 |
| Total current assets | 852,031 | 799,302 |
| Property, plant and equipment, net | 286,510 | 274,599 |
| Other assets | 11,397 | 11,957 |
| Total assets | $ 1,149,938 | $ 1,085,858 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 41,666 | $ 35,580 |
| Accrued income taxes | 8,144 | 5,447 |
| Customer prepayments | 63,037 | 76,610 |
| Accrued compensation | 12,001 | 12,584 |
| Other accrued liabilities | 24,950 | 20,779 |
| Total current liabilities | 149,798 | 151,000 |
| Long-term debt, net of current maturities | | |
| Deferred income taxes | 9,503 | 9,614 |
| Total liabilities | 159,301 | 160,614 |
| Commitments and contingencies (Note 8) | | |
| 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, 40,376,275 and 40,175,426 shares issued and outstanding at June 30, 2012 and December 31, 2011 | 404 | 402 |
| Additional paid-in capital | 172,989 | 162,505 |
| Retained earnings | 839,380 | 780,780 |
| Accumulated other comprehensive income (loss) | (22,136) | (18,443) |
| Total stockholders equity | 990,637 | 925,244 |
| Total liabilities and stockholders equity | $ 1,149,938 | $ 1,085,858 |

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, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|
| | (In thousands, except per share data) | | | |
| Revenues: | | | | |
| Products | $ 146,675 | $ 114,479 | $ 296,381 | $ 234,663 |
| Services | 29,895 | 22,515 | 57,313 | 39,998 |
| Total revenues | 176,570 | 136,994 | 353,694 | 274,661 |
| Cost and expenses: | | | | |
| Cost of sales: | | | | |
| Products | 91,830 | 68,585 | 183,953 | 135,506 |
| Services | 16,495 | 13,415 | 31,422 | 26,607 |
| Total cost of sales | 108,325 | 82,000 | 215,375 | 162,113 |
| Selling, general and administrative | 17,418 | 16,037 | 37,850 | 34,298 |
| Engineering and product development | 9,478 | 8,529 | 19,088 | 17,227 |
| | 135,221 | 106,566 | 272,313 | 213,638 |
| Operating income | 41,349 | 30,428 | 81,381 | 61,023 |
| Interest income | 78 | 86 | 181 | 185 |
| Interest expense | (9) | (11) | (14) | (22) |
| Income before income taxes | 41,418 | 30,503 | 81,548 | 61,186 |
| Income tax provision | 11,615 | 8,295 | 22,948 | 17,306 |
| Net income | $ 29,803 | $ 22,208 | $ 58,600 | $ 43,880 |
| Earnings per common share: | | | | |
| Basic | $ 0.74 | $ 0.55 | $ 1.46 | $ 1.10 |
| Diluted | $ 0.74 | $ 0.55 | $ 1.45 | $ 1.09 |
| Weighted average common shares outstanding: | | | | |
| Basic | 40,268 | 40,058 | 40,226 | 40,054 |
| Diluted | 40,453 | 40,312 | 40,432 | 40,316 |

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

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(UNAUDITED)**

| | Three months ended June 30, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|
| | (In thousands) | | | |
| Net income | $ 29,803 | $ 22,208 | $ 58,600 | $ 43,880 |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustments | (12,318) | 2,647 | (3,693) | 9,952 |
| Total comprehensive income | $ 17,485 | $ 24,855 | $ 54,907 | $ 53,832 |

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, 2012 | Six months ended June 30, 2011 |
|---|---|---|
| | (In thousands) | |
| **Operating activities** | | |
| Net income | $ 58,600 | $ 43,880 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 12,431 | 10,606 |
| Stock-based compensation expense | 2,611 | 2,394 |
| Gain on sale of equipment | 34 | (364) |
| Deferred income taxes | (336) | 270 |
| Changes in operating assets and liabilities: | | |
| Trade receivables, net | (40,756) | (31,522) |
| Inventories, net | (63,150) | (17,250) |
| Prepaids and other assets | (1,117) | 1,059 |
| Excess tax benefits of stock option exercises | (1,009) | (249) |
| Trade accounts payable and accrued expenses | 221 | 26,618 |
| Net cash provided by (used in) operating activities | (32,471) | 35,442 |
| **Investing activities** | | |
| Purchase of property, plant and equipment | (27,737) | (32,839) |
| Proceeds from sale of equipment | 1,090 | 2,023 |
| Net cash used in investing activities | (26,647) | (30,816) |
| **Financing activities** | | |
| Principal payments on debt | (24) | (247) |
| Proceeds from exercise of stock options | 7,204 | 386 |
| Excess tax benefits of stock option exercises | 1,009 | 249 |
| Net cash provided by financing activities | 8,189 | 388 |
| Effect of exchange rate changes on cash activities | 496 | (746) |
| Increase (decrease) in cash and cash equivalents | (50,433) | 4,268 |
| Cash and cash equivalents at beginning of period | 298,576 | 245,850 |
| Cash and cash equivalents at end of period | $ 248,143 | $ 250,118 |

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 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 in Macae, Brazil.

The condensed consolidated financial statements included herein have been prepared by Dril-Quip and are unaudited. The balance sheet at December 31, 2011, 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, 2012 and the results of operations, comprehensive income, and the cash flows for each of the six-month periods ended June 30, 2012 and 2011. 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, comprehensive income and the cash flows for the six-month period ended June 30, 2012 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, 2011.

## 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, 2011.

*Revenue Recognition*

*Product Revenue*

The Company earns product revenues from two sources:

- 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 usually do 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, 2012 and December 31, 2011, receivables included $37.7 million and $30.5 million of unbilled receivables, respectively. During the quarter ended June 30, 2012, there were 13 projects representing approximately 18% of the Company s total revenue and approximately 22% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 12 projects during the second quarter of 2011 representing approximately 20% of the Company s total revenues and approximately 24% of its product revenues. For the six months ended June 30, 2012, there were 17 projects representing approximately 18% of the Company s total revenues and 21% of its product revenues, compared to 12 projects which represented approximately 23% of the Company s total revenues and 27% of its product revenues for the six months ended June 30, 2011, 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 provides 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 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, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| | (In thousands) | | | |
| Number of common shares outstanding at end of period basic | 40,376 | 40,058 | 40,376 | 40,058 |
| Effect of using weighted average common shares outstanding | (108) | | (150) | (4) |
| Weighted average basic common shares outstanding basic | 40,268 | 40,058 | 40,226 | 40,054 |
| Dilutive effect of common stock options | 185 | 254 | 206 | 262 |
| Weighted average diluted common shares outstanding diluted | 40,453 | 40,312 | 40,432 | 40,316 |

**3. New Accounting Standards**

In December 2011, the FASB issued Accounting Standards Update ( ASU ) 2011-11, Balance Sheet Disclosures about Offsetting Assets and Liabilities. This ASU was issued to alleviate some of the differences in presentation between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) as to presentations showing gross versus netted amounts. Entities are required to disclose both gross and net information about instruments and transactions that are eligible for offset in the statements of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This ASU is effective for annual reporting periods beginning on or after January 1, 2013 and interim periods within those annual periods. The adoption of this accounting standard update will not have a material impact on the Company s condensed consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income. This ASU amended the guidance on the presentation of comprehensive income in financial statements to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items that are recorded in other comprehensive income. The new accounting guidance requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The provisions of this new guidance were effective for the Company on January 1, 2012. The Company adopted ASU 2011-05 effective with the period ended March 31, 2012. In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income. It was determined that the reclassification would be difficult for preparers and may add unnecessary complexity to financial statements.

**4. Stock Options and Awards**

During each of the three months ended June 30, 2012 and 2011, the Company recognized approximately $1.2 million of stock-based compensation expense. For the six-months ended June 30, 2012 and 2011, stock-based compensation expense totaled $2.6 million and $2.4 million, respectively. Stock-based compensation expense is included in the selling, general and administrative expense line of the Condensed Consolidated Statements of Income. In May 2012, the Company awarded a total of 4,800 shares of restricted stock to its non-employee directors. The shares were valued at $65.34 per share for a total of $313,632 to be expensed ratably over three years. No stock-based compensation expense was capitalized during the three and six months ended June 30, 2012 or 2011. There were no stock options granted in the second quarter of 2012 or 2011. Refer to Note 13 of the Company s Annual Report on Form 10-K for the year ended December 31, 2011 for additional information regarding stock-based compensation plans.

## 5. Inventories

Inventories consist of the following:

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| | (In thousands) | |
| Raw materials and supplies | $ 67,710 | $ 48,240 |
| Work in progress | 87,860 | 75,690 |
| Finished goods | 212,126 | 180,100 |
| | 367,696 | 304,030 |
| Less: allowance for obsolete and excess inventory | (27,661) | (26,228) |
| Total inventory | $ 340,035 | $ 277,802 |

## 6. Geographic Areas

| | Three months ended June 30, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|
| | (In thousands) | | | |
| *Revenues:* | | | | |
| Western Hemisphere | | | | |
| Products | $ 72,890 | $ 49,435 | $ 140,582 | $ 128,877 |
| Services | 16,464 | 8,682 | 32,224 | 15,655 |
| Intercompany | 20,315 | 18,535 | 37,773 | 27,110 |
| Total | $ 109,669 | $ 76,652 | $ 210,579 | $ 171,642 |
| Eastern Hemisphere | | | | |
| Products | $ 41,870 | $ 49,947 | $ 100,522 | $ 76,909 |
| Services | 9,864 | 9,429 | 18,386 | 16,177 |
| Intercompany | (257) | 121 | 3,669 | 457 |
| Total | $ 51,477 | $ 59,497 | $ 122,577 | $ 93,543 |
| Asia-Pacific | | | | |
| Products | $ 31,915 | $ 15,097 | $ 55,277 | $ 28,877 |
| Services | 3,567 | 4,404 | 6,703 | 8,166 |
| Intercompany | 318 | 8 | 343 | 8 |
| Total | $ 35,800 | $ 19,509 | $ 62,323 | $ 37,051 |
| Summary | | | | |
| Products | $ 146,675 | $ 114,479 | $ 296,381 | $ 234,663 |
| Services | 29,895 | 22,515 | 57,313 | 39,998 |

| | | | | |
|---|---|---|---|---|
| Intercompany | 20,376 | 18,664 | 41,785 | 27,575 |
| Eliminations | (20,376) | (18,664) | (41,785) | (27,575) |
| Total | $ 176,570 | $ 136,994 | $ 353,694 | $ 274,661 |
| *Income before income taxes:* | | | | |
| Western Hemisphere | $ 20,399 | $ 11,926 | $ 39,720 | $ 33,555 |
| Eastern Hemisphere | 11,156 | 12,418 | 24,310 | 16,496 |
| Asia-Pacific | 7,334 | 5,885 | 11,779 | 10,390 |
| Eliminations | 2,529 | 274 | 5,739 | 745 |
| Total | $ 41,418 | $ 30,503 | $ 81,548 | $ 61,186 |

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| | (In thousands) | |
| *Total Long-Lived Assets:* | | |
| Western Hemisphere | $ 208,028 | $ 196,380 |
| Eastern Hemisphere | 35,018 | 34,927 |
| Asia-Pacific | 57,714 | 58,058 |
| Eliminations | (2,853) | (2,809) |
| Total | $ 297,907 | $ 286,556 |
| *Total Assets:* | | |
| Western Hemisphere | $ 695,903 | $ 666,915 |
| Eastern Hemisphere | 251,847 | 229,043 |
| Asia-Pacific | 240,533 | 209,143 |
| Eliminations | (38,345) | (19,243) |
| Total | $ 1,149,938 | $ 1,085,858 |

**7. Share Repurchase Plan**

On June 18, 2012, the Company s Board of Directors approved a share repurchase plan of up to $100 million of the Company s common stock. As of June 30, 2012, no shares had been repurchased. The repurchase plan has no expiration date and all shares purchased are expected to be cancelled.

**8. Commitments and Contingencies**

*Deepwater Horizon Incident*

On April 22, 2010, a deepwater U.S. Gulf of Mexico drilling rig known as the *Deepwater Horizon,* operated by BP Exploration & Production, Inc. ( BP ), sank after an explosion and fire that began on April 20, 2010. The Company is a party to an ongoing contract with an affiliate of BP to supply wellhead systems in connection with BP s U.S. Gulf of Mexico operations, and the Company s wellhead and certain of its other equipment were in use on the *Deepwater Horizon* at the time of the incident. A moratorium was placed on offshore deepwater drilling on May 28, 2010 in the U.S. Gulf of Mexico and was lifted on October 12, 2010. In the first quarter of 2011, after delays attributed to new regulations that increased the complexity of the drilling permit process, the issuance of deepwater permits resumed and deepwater drilling activity in the U.S. Gulf of Mexico has steadily increased since that time.

The Company was named, along with other unaffiliated defendants, in both class action and other lawsuits arising from of the *Deepwater Horizon* incident. The actions filed against the Company were consolidated, along with hundreds of other lawsuits not directly naming the Company, 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 ). The lawsuits generally allege, among other things, violation of state and federal environmental and other laws and regulations, negligence, gross negligence, strict liability, personal injury and/or property damages and generally seek awards of unspecified economic, compensatory and punitive damages and/or declaratory relief.

On January 20, 2012 the judge presiding over the MDL Proceeding, another related proceeding filed by affiliates of Transocean Ltd under the Limitation of Liability Act, and the U.S. government s action under the Oil Pollution Act, issued an order that granted the Company s Motion for Summary Judgment and 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.

Additional lawsuits may be filed and additional investigations may be launched in the future. An adverse outcome with respect to any of these lawsuits or investigations, or any lawsuits or investigations that may arise in the future, could have a material adverse effect on the Company s results of operations. The Company intends to continue to vigorously defend any litigation, fine and/or penalty relating to the *Deepwater Horizon* incident. Accordingly, the Company does not believe this litigation will have a material impact and no liability has been accrued in conjunction with these matters.

At the time of the *Deepwater Horizon* incident, the Company had a general liability insurance program with an aggregate coverage limit of $100 million for claims with respect to property damage, injury or death and pollution. The coverage was increased to $200 million in October 2010. The insurance policies may not cover all potential claims and expenses relating to the *Deepwater Horizon* incident. In addition, the Company s policies may not cover fines, penalties or costs and expenses related to government-mandated clean up of pollution. The Company has received a reservation of rights letter from its insurers. The incident may also lead to further tightening of the availability of insurance coverage. If liability limits are increased or the insurance market becomes more restricted, the risks and costs of conducting offshore exploration and development activities may increase, which could materially impact the Company s results of operations.

*Brazilian Tax Issue*

In December 2010 and January 2011, the Company s Brazilian subsidiary was served with assessments collectively valued at approximately BRL24.4 million (approximately USD12.1 million as of June 2012) from the State of Rio de Janiero, Brazil, to cancel credits resulting from the importation of goods and subsequent transfers to the Company s subsidiary in Brazil. The Company believes that its subsidiary should not be subject to the cancellation of credits and is vigorously contesting the assessments in the Brazilian administrative systems. While pending, the amount of interest, penalties and monetary restatement fees on the tax assessments continues to accrue. In January 2012, a decision was rendered by the Brazilian tax authority that reduced one of the assessments by approximately BRL8.4 million (approximately USD4.2 million as of June 2012) due to errors and the lapsing of the statute of limitations with respect to a portion of the assessment. As of June 2012, the total assessment, including interest, penalties and possible monetary restatement fees is approximately BRL19.9 million (approximately USD9.8 million). At this time, the ultimate disposition of this matter cannot be determined and therefore, it is not possible to reasonably estimate the amount of loss that might result from an adverse judgment or settlement of these assessments. Accordingly, no liability has been accrued in conjunction with this matter. The Company does not expect the liability, if any, resulting from these assessments to have a material adverse effect on its operations, comprehensive income, financial position or cash flows.

*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, comprehensive income, 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, 2011.

**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 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 and rental of running tools for use in connection with the installation and retrieval of the Company s products.

*Deepwater Horizon Incident*

On April 22, 2010, a deepwater U.S. Gulf of Mexico drilling rig known as the *Deepwater Horizon,* operated by BP, sank after an explosion and fire that began on April 20, 2010. The Department of Interior issued an order imposing a moratorium on deepwater drilling in the U.S. Gulf of Mexico that was lifted on October 12, 2010. As a result of the *Deepwater Horizon* incident, the Company s revenues and earnings may be affected by, among other things, new or revised governmental laws or regulations relating to offshore oil and gas exploration and production activities, both in the U.S. Gulf of Mexico and in other areas in which the Company s customers operate, and the effect of such laws or regulations on the level of demand for the Company s products and services. For additional information related to the impact of the *Deepwater Horizon* incident as well as information related to litigation and additional governmental investigations and regulations arising out of the incident, see Commitments and Contingencies, Note 8, of the Notes to Condensed Consolidated Financial Statements and Part II, Item 1, Legal Proceedings. As a result of recent scrutiny of the offshore drilling industry triggered by the *Deepwater Horizon* incident, the technical specifications for the Company s existing and future products may change resulting in additional testing of its products to ensure their compliance with such specifications. If the Company s products are unable to satisfy the requirements of the additional testing, or if the costs of the modifications to such products necessary to satisfy the testing are not acceptable to the Company s customers, the customers may terminate their contracts with the Company or decide not to purchase 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 and production activity have historically been characterized by significant volatility.

According to the Energy Information Administration ( EIA ) of the U.S. Department of Energy, average crude oil (West Texas Intermediate Cushing) 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, | |
|---|---|---|---|---|
| | **2012** | **2011** | **2012** | **2011** |
| Crude oil ($/Bbl) | $ 93.29 | $ 102.02 | $ 98.10 | $ 98.08 |
| Natural gas ($/Mcf) | 2.37 | 4.50 | 2.44 | |