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DRIL-QUIP INC
Form 10-K405
March 25, 2002

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

FORM 10-K

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

For the fiscal year ended December 31, 2001

Commission file number: 001-13439

Dril-Quip, Inc.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

74-2162088
(IRS Employer
Identification No.)

13550 Hempstead Highway
Houston, Texas
(Address of principal executive
offices)

77040
(Zip code)

Registrant's telephone number, including area code: (713) 939-7711

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class ----- | Name of Each Exchange On Which Registered ----- |
|--|---|
| Common Stock, \$.01 par value per share | New York Stock Exchange |
| Rights to purchase Series A Junior Participating Preferred Stock | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: None

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to

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the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

At March 20, 2002, the aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant was approximately \$158,166,000 based on the closing price of such stock on such date of \$24.30.

At March 20, 2002, the number of shares outstanding of registrant's Common Stock was 17,293,373.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for its 2002 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A are incorporated by reference in Part III of this Form 10-K.

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FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K includes certain statements that may be

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deemed to be "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Statements contained in all parts of this document that are not historical facts are forward looking statements that involve risks and uncertainties that are beyond Dril-Quip's control. You can identify Dril-Quip's forward looking statements by the words "anticipate," "estimate," "expect," "may," "project," "believe" and similar expressions. These forward-looking statements include the following types of information and statements as they relate to Dril-Quip:

- . scheduled, budgeted and other future capital expenditures;
- . working capital requirements;
- . the availability of expected sources of liquidity;
- . statements regarding the market for Dril-Quip products;
- . statements regarding the exploration and production activities of Dril-Quip customers; and
- . all statements regarding future operations, financial results, business plans and cash needs.

These statements are based upon certain assumptions and analyses made by management of Dril-Quip in light of its experience and its perception of historical trends, current conditions, expected future developments and other factors it believes are appropriate in the circumstances. Such statements are subject to a number of assumptions, risks and uncertainties, including but not limited to, those relating to the volatility of oil and natural gas prices and cyclical nature of the oil and gas industry, Dril-Quip's international operations, operating risks, Dril-Quip's dependence on key employees, Dril-Quip's dependence on skilled machinists and technical personnel, Dril-Quip's reliance on product development and possible technological obsolescence, control by certain stockholders, the potential impact of governmental regulation and environmental matters, competition, reliance on significant customers, political instability, acts of terrorism or war, the risk factors discussed herein and other factors detailed in Dril-Quip's other filings with the Securities and Exchange Commission. Prospective investors are cautioned that any such statements are not guarantees of future performance, and that, should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual outcomes may vary materially from those indicated.

PART I

Item 1. Business

General

Dril-Quip, Inc., a Delaware corporation ("Dril-Quip" or the "Company"), is one of the world's leading manufacturers of highly engineered offshore drilling and production equipment which 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, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, wellhead connectors and diverters. The Company also provides installation and reconditioning services and rents running tools for use in connection with the installation and

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retrieval of its products.

Dril-Quip has developed its broad line of subsea equipment, surface equipment and offshore rig equipment primarily through its internal product development efforts. The Company believes that it has achieved significant market share and brand name recognition with respect to its established products due to the technological capabilities, reliability, cost effectiveness and operational timesaving features of these products. In particular, the

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Company's Quik-Thread(R) and Quik-Stab(R) specialty connectors, MS-15(R) mudline hanger systems and SS-10(R) and SS-15(R) subsea wellheads are among the most widely used in the industry. During the 1990s, the Company introduced a number of new products, including diverters, wellhead connectors, dual-bore and single-bore subsea production trees, subsea and platform valves, platform wellheads, platform trees, drilling risers and Spar and TLP production risers. Dril-Quip is currently involved in the development of a number of new products, including liner hangers, slug suppression systems, and control systems.

Dril-Quip markets its products through its offices and sales representatives located in all of the major international energy markets throughout the world. In 2001, the Company generated approximately 53% of its revenues from foreign sales. The Company manufactures its products at its facilities located in Houston, Texas; Aberdeen, Scotland; and Singapore, and maintains additional facilities for fabrication and/or reconditioning in Brazil, Norway, Denmark and Australia. Dril-Quip's manufacturing operations are vertically integrated, with the Company performing substantially all of its forging, heat treating, machining, fabrication, inspection, assembly and testing at its own facilities.

The Company was co-founded in 1981 by Larry E. Reimert, Gary D. Smith, J. Mike Walker and Gary W. Loveless. Together, Messrs. Reimert, Smith and Walker have over 90 years of combined experience in the oilfield equipment industry, essentially all of which has been with the Company and its major competitors. In addition, key department managers have been with the Company over 10 years, on average.

Industry Overview

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. The level of capital expenditures is generally dependent upon the prevailing view of future oil and gas prices, which are influenced by numerous factors affecting the supply and demand for oil and gas, including worldwide economic activity, interest rates and the cost of capital, environmental regulation, tax policies, and the ability of OPEC and other producing nations to set and maintain production levels and prices. Capital expenditures are also dependent on the cost of exploring for and producing oil and gas, the sale and expiration dates of offshore leases in the United States and overseas, the discovery rate of new oil and gas reserves in offshore areas and technological advances. Oil and gas prices and the level of offshore drilling and production activity have historically been characterized by significant volatility.

During 2001, the worldwide economic recession, combined with declining oil and gas prices and the events of September 11, 2001, led to weakness in the

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oil service sector. The Company expects this weakness to continue at least through the first half of 2002. In any event, any significant future declines in hydrocarbon prices would likely have a material adverse effect on the Company's results of operations. There can be no assurance that the current oil price levels will lead to increased oil and gas exploration and production activity or that demand for the Company's products and services will reflect such improvement, if any.

Products and Services

Product Group

Dril-Quip designs, manufactures, fabricates, inspects, assembles, tests and markets subsea equipment, surface equipment and offshore rig equipment. In 2001, the Company derived approximately 86% of its revenues from the sale of its products. The Company's products are used to explore for oil and gas on offshore drilling rigs, such as floating rigs and jack-ups, and for drilling and production of oil and gas wells on offshore platforms, TLPs, Spars and moored vessels such as FPSOs. TLPs are floating production platforms that are connected to the ocean floor via vertical mooring tethers (called tension legs). A Spar is a floating cylindrical structure approximately six or seven times longer than its diameter that is anchored in place (like a Spar buoy). FPSOs are floating production, storage and offloading monohull moored vessels. Sales of the Company's equipment in connection with TLPs, Spars and FPSOs are becoming increasingly important sources of revenues.

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Subsea Equipment. Subsea equipment is used in the drilling and production of offshore oil and gas wells around the world. Included in the subsea equipment product line are subsea wellheads, mudline hanger systems, specialty connectors and associated pipe, subsea production trees, valves and TLP and Spar well systems.

Subsea wellheads are pressure-containing forged and machined metal housings in which casing hangers are landed and sealed subsea to suspend casing (downhole pipe). As drilling depth increases, successively smaller diameter casing strings are installed, each suspended by an independent casing hanger. Subsea wellheads are utilized when drilling from floating drilling rigs, either semi-submersible or drillship types, and TLPs and Spars. In 1999, the Company introduced its SS-15 Big Bore Subsea Wellhead System, which was designed to accommodate additional casing strings installed through a conventional marine riser and a subsea blowout preventer. The Company generally supplies subsea wellheads to customers from inventory.

Mudline hanger systems are used in jack-up drilling operations to support the weight of the various casing strings at the ocean floor while drilling a well. They also provide a method to disconnect the casing strings in an orderly manner at the ocean floor after the well has been drilled, and subsequently reconnect to enable production of the well by either tying it back vertically to a subsequently-installed platform or by installing a subsea tree. The Company generally supplies mudline hanger systems to customers from inventory.

Large diameter weld-on specialty connectors (threaded or stab type) are used in offshore wells drilled from floating drilling rigs, jack-ups, fixed platforms, TLPs and Spars. Specialty connectors join lengths of conductor or large diameter (16-inch or greater) casing. Specialty connectors provide a more rapid connection than other methods of connecting lengths of pipe. Connectors may be sold individually or as an assembly after being welded to sections of Company or customer supplied pipe. Dril-Quip's weld-on specialty

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connectors are designed to prevent cross threading and provide a quick, convenient method of joining casing joints with structural integrity compatible with casing strength. The Company generally supplies specialty connectors individually or specialty connectors welded to pipe from inventory.

A subsea production tree is an assembly composed of valves, a wellhead connector, control equipment and various other components installed on a subsea wellhead or a mudline hanger system and used to control the flow of oil and gas from a producing well. Subsea trees may be either stand alone satellite type or template mounted cluster arrangements. Both types typically produce via flowlines to a central control point located on a platform, TLP, Spar or FPSO. The use of subsea production trees has become an increasingly important method for producing wells located in hard-to-reach deepwater areas or economically marginal fields located in shallower waters. The Company is an established manufacturer of more complicated dual-bore production trees, which are used in severe service applications. In addition, Dril-Quip manufactures a patented single bore (SingleBore(TM)) subsea completion system which features a hydraulic mechanism instead of a wireline-installed mechanism that allows the operator to plug the tubing hanger annulus remotely from the surface via a hydraulic control line and subsequently unplug it when the well is put on production. This mechanism eliminates the need for an expensive multibore installation and workover riser, thereby saving both cost and installation time. In addition, Dril-Quip introduced a new guidelineless subsea production tree in 1999 for use in ultra-deepwater applications. This tree features remote multiple flowline and control connections, utilizing remotely operated intervention tools. During 2000, the first tree of this type was successfully installed in approximately 6,000 feet of water off the coast of Brazil, the first of several that have been supplied to this area. The Company's subsea production trees are generally custom designed and manufactured to customer specifications.

Surface Equipment. Surface equipment is principally used for flow control on offshore production platforms, TLPs and Spars. Included in the Company's surface equipment product line are platform wellheads and platform production trees. Dril-Quip's development of platform wellheads and platform production trees was facilitated by adaptation of its existing subsea wellhead and tree technology to surface wellheads and trees.

Platform wellheads are pressure-containing forged and machined metal housings in which casing hangers are landed and sealed at the platform deck to suspend casings. The Company emphasizes the use of metal-to-metal

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sealing wellhead systems with operational time-saving features which can be used in high pressure, high temperature and corrosive drilling and production applications.

After installation of a wellhead, a platform production tree, consisting of gate valves, a wellhead connector, controls, tree cap and associated equipment, is installed on the wellhead to control and regulate oil or gas production. Platform production trees are similar to subsea production trees but utilize less complex equipment and more manual, rather than hydraulically activated, valves and connectors. Platform wellheads and platform production trees and associated equipment are designed and manufactured in accordance with customer specifications.

Offshore Rig Equipment. Offshore rig equipment includes drilling and production riser systems, wellhead connectors and diverters. The drilling riser system consists of (i) lengths of riser pipe and associated riser connectors that secure one to another; (ii) the telescopic joint, which

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connects the entire drilling riser system to the diverter at the rig and provides a means to compensate for vertical motion of the rig relative to the ocean floor; and (iii) the wellhead connector, which provides a means for remote connection and disconnection of the drilling riser system to and from the BOP stack. Production risers provide a vertical conduit from the subsea wellhead to a TLP, Spar or FPSO. The wellhead connector also provides remote connection/disconnection of the BOP stack, production tree or production riser to/from the wellhead. Diversers are used to provide protection from shallow gas blowouts and to divert gases off of the rig during the drilling operation.

Wellhead connectors and drilling and production riser systems are also used on both TLPs and Spars, which are being installed more frequently in deepwater applications. The principal markets for offshore rig equipment are new rigs, rig upgrades, TLPs and Spars. Diversers, drilling and production risers and wellhead connectors are generally designed and manufactured to customer specifications.

Certain products of the Company are used in potentially hazardous drilling, completion and production applications that can cause personal injury, product liability and environmental claims. Litigation arising from a catastrophic occurrence at a location where the Company's equipment and/or services are used may in the future result in the Company being named as a defendant in lawsuits asserting potentially large claims. The Company maintains insurance coverage that it believes is customary in the industry. Such insurance does not, however, provide coverage for all liabilities (including liability for certain events involving pollution), and there is no assurance that its insurance coverage will be adequate to cover claims that may arise or that the Company will be able to maintain adequate insurance at rates it considers reasonable. The occurrence of an event not fully covered by insurance could have a material adverse effect on the financial condition and results of operations of the Company.

Service Group

Dril-Quip's Service Group provides field installation services, reconditioning of its products which are customer-owned, and rental running tools for installation and retrieval of its products. These services are provided from the Company's worldwide locations and represented approximately 14% of revenues in 2001.

Field Installation. Dril-Quip provides field installation services through the use of its technicians. These technicians assist in the onsite installation of Company products and are available on a 24-hour call out from the Company's facilities located in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Esbjerg, Denmark; Singapore; Perth, Australia; and Macae, Brazil.

Reconditioning. The Company provides reconditioning of its products at its facilities in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Singapore; and Macae, Brazil.

Rental. The Company rents running and installation tools for use in installing its products. These tools are used to install and retrieve Company products which are purchased by customers. Running tools are available from Dril-Quip's locations in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Esbjerg, Denmark; Beverwijk, Holland; Singapore; Perth, Australia; and Macae, Brazil.

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Dril-Quip has major manufacturing facilities in Houston, Texas; Aberdeen, Scotland; and Singapore. Each location conducts a broad variety of processes, including machining, fabrication, inspection, assembly and testing. The Houston facility provides forged and heat treated products to all the major manufacturing facilities.

The Company's Houston and Aberdeen manufacturing plants are ISO 9001 and American Petroleum Institute certified. In addition, the Company's manufacturing facility in Singapore is ISO 9001 certified. See "Properties--Major Manufacturing Facilities." Dril-Quip maintains its high standards of product quality through the use of quality assurance specialists who work with product manufacturing personnel throughout the manufacturing process by inspecting and documenting equipment as it is processed through the Company's manufacturing facilities. The Company has the capability to manufacture various products from each of its product lines at its major manufacturing facilities and believes that this localized manufacturing capability is essential in order to compete with the Company's major competitors.

The Company's manufacturing process is vertically integrated, producing, in house, a majority of its forging requirements and essentially all of its heat treatment, machining, fabrication, inspection, assembly and testing. The Company's primary raw material is cast steel ingots, from which it produces steel shaped forgings at its forging and heat treatment facility. The Company routinely purchases steel ingots from approximately four suppliers on a purchase order basis and does not have any long-term supply contracts. The Company's Houston facility provides forgings and heat treatment for its Aberdeen and Singapore facilities. The Company's major competitors depend on outside sources for all or a substantial portion of their forging and heat treatment requirements. The Company has made significant capital investments in developing its vertically integrated manufacturing capability. Prolonged periods of low demand in the market for offshore drilling and production equipment could have a greater effect on the Company than on certain of its competitors that have not made large capital investments in facilities.

Dril-Quip's manufacturing facilities utilize state-of-the-art computer numerically controlled ("CNC") machine tools and equipment, which contribute to the Company's product quality and timely delivery. The Company has also developed a cost effective, in-house machine tool rebuild capability which produces "like new" machine upgrades with customized features to enhance the economic manufacture of its specialized products. The Company purchases quality used machine tools as they become available and stores them at its facilities to be rebuilt and upgraded as the need arises. Rebuilding used machine tools allows for greater customization suitable for manufacturing Dril-Quip proprietary product lines. This provides the added advantage of requiring only in-house expertise for repairs and maintenance of these machines. A significant portion of the Company's manufacturing capacity growth has been through the rebuild/upgrade of quality used machine tools, including the replacement of outdated control systems with state-of-the-art CNC controls.

The Company has increased its facilities at its Eldridge site in Houston, Texas from approximately 280,000 square feet at the end of 1997 to approximately 851,000 square feet at the end of 2001. Dril-Quip has consolidated its Houston manufacturing operations by moving its finish machining, assembly and warehouse functions from its Hempstead Highway location to its larger, state-of-the-art Eldridge Parkway facility.

Customers

The Company's principal customers are major integrated oil and gas companies, large independent oil and gas companies and foreign national oil

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and gas companies. Offshore drilling contractors and engineering and construction companies also represent a minor customer base. The Company's customers are generally oil and gas companies that are well-known participants in offshore exploration and production.

The Company is not dependent on any one customer or group of customers. In 2001, the Company's top 15 customers represented approximately 87% of total revenues, with BP p.l.c. accounting for approximately 17%, and ChevronTexaco Corp. accounting for approximately 13% of revenues. During 2000, no single customer accounted for more than 10% of the Company's total revenues. The number and variety of the Company's products required in a given year by any one customer depends upon the amount of that customer's capital expenditure budget devoted

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to offshore exploration and production in any single year and on the results of competitive bids for major projects. Consequently, a customer that accounts for a significant portion of revenues in one fiscal year may represent an immaterial portion of revenues in subsequent years. While the Company is not dependent on any one customer or group of customers, the loss of one or more of its significant customers could, at least on a short-term basis, have an adverse effect on the Company's results of operations.

Marketing and Sales

Dril-Quip markets its products and services throughout the world directly through its sales personnel in two domestic and eleven international locations. In addition, in certain foreign markets where the Company does not maintain offices, it utilizes independent sales representatives to enhance its marketing and sales efforts. Some of the locations in which Dril-Quip has sales representatives are India, Canada, Mexico, the Philippines, Brazil, Indonesia, Malaysia, China, Japan, and the Middle East. Although they do not have authority to contractually bind the Company, these representatives market the Company's products in their respective territories in return for sales commissions. The Company also places print advertising from time to time in trade and technical publications targeted to its customer base. It also participates in industry conferences and trade shows to enhance industry awareness of its products.

The Company's customers generally order products on a purchase order basis. Orders are typically filled within two weeks to three months after receipt of a purchase order, depending on the type of product and whether it is sold out of inventory or requires some customization. Contracts for certain of the Company's larger, more complex products, such as subsea production trees, drilling risers and equipment for TLPs and Spars can take a year or more to complete.

The primary factors influencing a customer's decision to purchase the Company's products are the quality, reliability and reputation of the product, price and technologically superior features. Timely delivery of equipment is also very important to customer operations and the Company maintains an experienced sales coordination staff to help assure such delivery. For large drilling and production system orders, project management teams coordinate customer needs with engineering, manufacturing and service organizations, as well as with subcontractors and vendors.

A portion of the Company's business consists of designing, manufacturing, selling and installing equipment for major projects pursuant to competitive bids, and the number of such projects in any year fluctuates. The Company's profitability on such projects is critically dependent on making accurate and

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cost effective bids and performing efficiently in accordance with bid specifications. Various factors can adversely affect the Company's performance on individual projects, with potential adverse effects on project profitability.

Product Development and Engineering

The technological demands of the oil and gas industry continue to increase as offshore exploration and drilling expand into more hostile environments. Conditions encountered in these environments include well pressures of up to 15,000 psi (pounds per square inch), mixed flows of oil and gas under high pressure that may also be highly corrosive and water depths in excess of 8,000 feet. Since its founding, Dril-Quip has actively engaged in continuing product development to generate new products and improve existing products. When developing new products, the Company typically seeks to design the most technologically advanced version for a particular application to establish its reputation and qualification in that product. Thereafter, the Company leverages its expertise in the more technologically advanced product to produce less costly and complex versions of the product for less demanding applications. The Company also focuses its activities on reducing the overall cost to the customer, which includes not only the initial capital cost but also operating and installation costs associated with its products.

The Company has continually introduced new products and product enhancements since its founding in 1981. In the 1990s, the Company introduced a series of new products, including diverters, wellhead connectors, SingleBore(TM) subsea trees, improved severe service dual bore subsea trees, subsea and platform valves, platform

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wellheads, platform trees, subsea tree workover riser systems, drilling risers and TLP and Spar production riser systems.

Dril-Quip's product development work is conducted at its facilities in Houston, Texas and Aberdeen, Scotland. In addition to the work of its product development staff, the Company's application engineering staff provides engineering services to customers in connection with the design and sales of its products. The Company's ability to develop new products and maintain technological advantages is important to its future success. There can be no assurance that the Company will be able to develop new products, successfully differentiate itself from its competitors or adapt to evolving markets and technologies.

The Company believes that the success of its business depends more on the technical competence, creativity and marketing abilities of its employees than on any individual patent, trademark or copyright. Nevertheless, as part of its ongoing product development and manufacturing activities, Dril-Quip's policy has been to seek patents when appropriate on inventions concerning new products and product improvements. All patent rights for products developed by employees are assigned to the Company and almost all of the Company's products have components that are covered by patents.

Dril-Quip has numerous U.S. registered trademarks, including Dril-Quip(R), Quik-Thread(R), Quick-Stab(R), Multi-Thread(R), MS-15(R), SS-15(R), SS-10(R), SU-90(R) and DX(R). The Company has registered its trademarks in the countries where such registration is deemed material.

Although in the aggregate the Company's patents and trademarks are of considerable importance to the manufacturing and marketing of many of its products, the Company does not consider any single patent or trademark or

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group of patents or trademarks to be material to its business as a whole, except the Dril-Quip(R) trademark. The Company also relies on trade secret protection for its confidential and proprietary information. The Company routinely enters into confidentiality agreements with its employees and suppliers. There can be no assurance, however, that others will not independently obtain similar information or otherwise gain access to the Company's trade secrets.

Competition

Dril-Quip faces significant competition from other manufacturers of exploration and production equipment. Several of its primary competitors are diversified multinational companies with substantially larger operating staffs and greater capital resources than those of the Company and which, in many instances, have been engaged in the manufacturing business for a much longer time than the Company. The Company competes principally with ABB Vetco Gray Inc. (a subsidiary of Asea Brown Boveri, more commonly referred to as ABB), the petroleum production equipment segment of Cooper Cameron Corporation, FMC Technologies, Inc. and Kvaerner National Ltd. (a division of Kvaerner A.S.).

Because of their relative size and diversity of products, several of these companies have the ability to provide "turnkey" services for offshore drilling and production applications, which enables them to use their own products to the exclusion of Dril-Quip's products. The Company also competes to a lesser extent with a number of other companies in various products. The principal competitive factors in the petroleum drilling and production equipment markets are quality, reliability and reputation of the product, price, technology, service and timely delivery.

Employees

The total number of the Company's employees as of December 31, 2001 was 1,495. Of these, 1,014 were located in the United States. The Company's employees are not covered by collective bargaining agreements, and the Company considers its employee relations to be good.

The Company's operations depend in part on its ability to attract a skilled labor force. While the Company believes that its wage rates are competitive and that its relationship with its skilled labor force is good, a significant

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increase in the wages paid by competing employers could result in a reduction of the Company's skilled labor force, increases in the wage rates paid by the Company or both. If either of these events were to occur, in the near-term, the profits realized by the Company from work in progress would be reduced and, in the long-term, the production capacity and profitability of the Company could be diminished and the growth potential of the Company could be impaired.

Governmental Regulations

Many aspects of the Company's operations are affected by political developments and are subject to both domestic and foreign governmental regulations, including those relating to oilfield operations, worker safety and the protection of the environment. In addition, the Company depends on the demand for its services from the oil and gas industry and, therefore, is affected by changing taxes, price controls and other laws and regulations relating to the oil and gas industry generally, including those specifically directed to offshore operations. The adoption of laws and regulations curtailing exploration and development drilling for oil and gas for economic

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or other policy reasons could adversely affect the Company's operations by limiting demand for the Company's products.

In recent years, increased concern has been raised over the protection of the environment. Offshore drilling in certain areas has been opposed by environmental groups and, in certain areas, has been restricted. To the extent that new laws or other governmental actions prohibit or restrict offshore drilling or impose additional environmental protection requirements that result in increased costs to the oil and gas industry in general and the offshore drilling industry in particular, the business of the Company could be adversely affected. The Company cannot determine to what extent its future operations and earnings may be affected by new legislation, new regulations or changes in existing regulations.

The Company's operations are affected by numerous foreign, federal, state and local environmental laws and regulations. The technical requirements of these laws and regulations are becoming increasingly expensive, complex and stringent. These laws may provide for "strict liability" for damages to natural resources or threats to public health and safety, rendering a party liable for the environmental damage without regard to negligence or fault on the part of such party. Sanctions for noncompliance may include revocation of permits, corrective action orders, administrative or civil penalties and criminal prosecution. Certain environmental laws provide for joint and several strict liability for remediation of spills and releases of hazardous substances. In addition, companies may be subject to claims alleging personal injury or property damage as a result of alleged exposure to hazardous substances, as well as damage to natural resources. Such laws and regulations may also expose the Company to liability for the conduct of or conditions caused by others, or for acts of the Company that were in compliance with all applicable laws at the time such acts were performed. Compliance with environmental laws and regulations may require the Company to obtain permits or other authorizations for certain activities and to comply with various standards or procedural requirements. The Company believes that its facilities are in substantial compliance with current regulatory standards.

Based on the Company's experience to date, the Company does not currently anticipate any material adverse effect on its business or consolidated financial position as a result of future compliance with existing environmental laws and regulations controlling the discharge of materials into the environment. However, future events, such as changes in existing laws and regulations or their interpretation, more vigorous enforcement policies of regulatory agencies, or stricter or different interpretations of existing laws and regulations, may require additional expenditures by the Company, which may be material.

Item 2. Properties

Major Manufacturing Facilities

| Location | Building Size (Approximate Square Feet) | Land (Approximate Acreage) | Owned or Leased |
|--|--|----------------------------------|-----------------|
| ----- | ----- | ----- | ----- |
| Houston, Texas --13550 Hempstead Highway..... | 175,000 | 15 | Owned |

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| | | | |
|---------------------------------|---------|-----|------------------|
| | 14,000 | -- | Leased (offices) |
| --6401 N. Eldridge Parkway..... | 851,000 | 218 | Owned |
| Aberdeen, Scotland..... | 137,000 | 14 | Owned |
| | 15,000 | -- | Leased (offices) |
| Singapore..... | 53,000 | -- | Owned |
| | -- | 3.4 | Leased |

Dril-Quip's manufacturing facilities in Houston and Aberdeen are capable of manufacturing each of its products, and the facility in Singapore is capable of manufacturing most of the Company's established products.

Sales, Service and Reconditioning Facilities

| Location(1) | Building Size (Approximate Square Feet) | Land (Approximate Acreage) | Activity |
|--------------------------|--|----------------------------------|--|
| New Orleans, Louisiana.. | 2,300 | -- | Sales/Service |
| Beverwijk, Holland..... | 5,200 | 0.2 | Sales/Warehouse |
| Perth, Australia..... | 1,600 | -- | Sales/Service |
| Darwin, Australia..... | 2,500 | 1.0 | Service/Warehouse |
| Stavanger, Norway..... | 42,000 | 6.1 | Sales/Service/Reconditioning/Warehouse/Fabrica |
| Esbjerg, Denmark..... | 19,400 | 1.2 | Sales/Service/Reconditioning/Warehouse |
| Macaé, Brazil..... | 32,000 | 10.0 | Sales/Service/Reconditioning/ Warehouse/Fabric |
| Paris, France..... | 1,000 | -- | Sales |

(1) All facilities leased except Stavanger, Norway location which is owned.

The Company also performs sales, service and reconditioning activities at its facilities in Houston, Aberdeen and Singapore. As part of its capital expansion program, the Company has expanded its facilities in Stavanger and Singapore to meet growing demands for its products and services in those areas.

Item 3. Legal Proceedings

The Company is 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 actions, in the opinion of management, the ultimate liability with respect thereto will not have a material adverse effect on the Company's financial position.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders of the Company during the quarter ended December 31, 2001.

Item S-K 401(b). Executive Officers of the Registrant

Pursuant to Instruction 3 to Item 401(b) of Regulation S-K and General Instruction G(3) to Form 10-K, the following information is included in Part I of this Form 10-K:

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The following table sets forth the names, ages (as of March 15, 2002) and positions of the Company's executive officers:

| Name ---- | Age --- | Position ----- |
|-----------------------|------------|---|
| Larry E. Reimert..... | 54 | Co-Chairman of the Board and Co-Chief Executive Officer |
| Gary D. Smith..... | 59 | Co-Chairman of the Board and Co-Chief Executive Officer |
| J. Mike Walker..... | 58 | Co-Chairman of the Board and Co-Chief Executive Officer |
| Jerry M. Brooks..... | 50 | Chief Financial Officer |

Larry E. Reimert is Co-Chairman of the Board and Co-Chief Executive Officer with principal responsibility for engineering, product development and finance. He has been the Director--Engineering, Product Development and Finance, as well as a member of the Board of Directors, since the Company's inception in 1981. Prior to that, he worked for Vetco Offshore, Inc. in various capacities, including Vice President of Technical Operations, Vice President of Engineering and Manager of Engineering. Mr. Reimert holds a BSME degree from the University of Houston and a MBA degree from Pepperdine University.

Gary D. Smith is Co-Chairman of the Board and Co-Chief Executive Officer with principal responsibility for sales, service, training and administration. He has been the Director--Sales, Service, Training and Administration, as well as a member of the Board of Directors, since the Company's inception in 1981. Prior to that, he worked for Vetco Offshore, Inc. in various capacities, including General Manager and Vice President of Sales and Service.

J. Mike Walker is Co-Chairman of the Board and Co-Chief Executive Officer with principal responsibility for manufacturing, purchasing and facilities. He has been the Director--Manufacturing, Purchasing and Facilities, as well as a member of the Board of Directors, since the Company's inception in 1981. Prior to that, he served as the Director of Engineering, Manager of Engineering and Manager of Research and Development with Vetco Offshore, Inc. Mr. Walker holds a BSME degree from Texas A&M University, an MSME degree from the University of Texas at Austin and a Ph.D. in mechanical engineering from Texas A&M University.

Jerry M. Brooks has been Chief Financial Officer since March 1999. Prior to that, he served as Chief Accounting Officer since joining the Company in 1992. From 1980 to 1991, he held various positions with Chiles Offshore Corporation, most recently as Chief Financial Officer, Secretary and Treasurer. Mr. Brooks holds a BBA in Accounting and an MBA from the University of Texas at Austin.

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PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The Company's Common Stock is publicly traded on the New York Stock Exchange under the symbol DRQ. The following table sets forth the quarterly high and low sales prices of the Common Stock as reported on the New York Stock Exchange for the indicated quarters of fiscal 2000 and 2001:

Sales Price (\$)

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| Quarter Ended | 2000 | | 2001 | |
|-------------------|--------|-------|-------|-------|
| | High | Low | High | Low |
| March 31..... | 49.125 | 28.75 | 34.31 | 23.45 |
| June 30..... | 49.25 | 36.25 | 34.85 | 19.85 |
| September 30..... | 48.00 | 36.00 | 21.50 | 13.40 |
| December 31..... | 41.75 | 19.00 | 24.88 | 13.85 |

There were approximately 50 stockholders of record of the Company's Common Stock as of March 20, 2002. This number does not include the number of security holders for whom shares are held in a "nominee" or "street" name.

The Company currently intends to retain any earnings for the future operation and development of its business and does not currently anticipate paying any dividends in the foreseeable future. The Board of Directors will review this policy on a regular basis in light of the Company's earnings, financial condition and market opportunities.

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Item 6. Selected Financial Data

The information set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes thereto included elsewhere in this Report.

| | Year Ended December 31, | | | | |
|---|-------------------------|-----------|-----------|-----------|-----------|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| (In Thousands, Except Per Share Amounts) | | | | | |
| Statement of Operations Data: | | | | | |
| Revenues..... | \$146,823 | \$177,642 | \$156,368 | \$163,953 | \$202,900 |
| Cost of sales..... | 99,800 | 118,923 | 106,419 | 111,267 | 140,920 |
| Selling, general and administrative expenses..... | 16,313 | 21,293 | 21,253 | 23,164 | 26,357 |
| Engineering and product development expenses..... | 9,158 | 11,968 | 11,022 | 12,116 | 14,533 |
| | 125,271 | 152,184 | 138,694 | 146,547 | 181,810 |
| Operating income..... | 21,552 | 25,458 | 17,674 | 17,406 | 21,090 |
| Interest expense (income).... | 2,027 | (1,197) | (440) | 495 | 2,452 |
| | 19,525 | 26,655 | 18,114 | 16,911 | 18,638 |
| Income before income taxes... | 6,587 | 9,228 | 6,349 | 5,880 | 6,436 |
| Net income..... | \$ 12,938 | \$ 17,427 | \$ 11,765 | \$ 11,031 | \$ 12,202 |
| Diluted earnings per share... | \$.87 | \$ 1.01 | \$.68 | \$.63 | \$.70 |
| Weighted average shares outstanding..... | 14,895 | 17,275 | 17,277 | 17,505 | 17,352 |

Statement of Cash Flows Data:

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| | | | | | |
|---|-----------|-----------|-----------|------------|-----------|
| Net cash provided by (used in) operating activities.... | \$ 10,325 | \$ 9,118 | \$ 18,433 | \$(12,193) | \$ (725) |
| Net cash used in investing activities..... | (10,240) | (29,450) | (19,748) | (23,111) | (24,866) |
| Net cash provided by (used in) financing activities.... | 31,386 | (203) | (165) | 30,279 | 30,214 |
| Other Data: | | | | | |
| EBITDA(1)..... | \$ 26,541 | \$ 31,108 | \$ 24,352 | \$ 24,834 | \$ 29,687 |
| Depreciation and amortization..... | 4,989 | 5,650 | 6,678 | 7,428 | 8,597 |
| Capital expenditures..... | 10,375 | 29,642 | 19,909 | 23,180 | 25,018 |

As of December 31,

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|----------------|------|------|------|------|------|
| (In Thousands) | | | | | |

| | | | | | |
|-------------------------------|-----------|-----------|-----------|-----------|-----------|
| Balance Sheet Data: | | | | | |
| Working capital..... | \$ 89,373 | \$ 83,595 | \$ 81,912 | \$105,635 | \$131,098 |
| Total assets..... | 152,921 | 177,246 | 179,463 | 233,341 | 279,959 |
| Total debt..... | 518 | 315 | 149 | 28,935 | 58,888 |
| Total stockholders' equity... | 124,161 | 141,912 | 152,624 | 161,790 | 172,865 |

(1) EBITDA, or "earnings from continuing operations before interest expense, interest income, income taxes, depreciation and amortization," is not a generally accepted accounting principle measure, but is a supplemental financial measurement used by the Company in the evaluation of its business. EBITDA should not be construed as an alternative to net income or to cash flow from operations or any other measure of performance in accordance with generally accepted accounting principles, and is presented solely as a supplemental disclosure.

Item 7. 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 certain aspects of the Company's financial position and results of operations during the periods included in the accompanying consolidated financial statements. This discussion should be read in conjunction with the Company's Consolidated Financial Statements and Notes thereto presented elsewhere in this Report.

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Overview

Dril-Quip manufactures highly engineered offshore drilling and production equipment which 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, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, wellhead connectors and diverters. Dril-Quip also provides installation and reconditioning services and rents running tools for use in connection with the installation and retrieval of its products.

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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.

During 2001, the worldwide economic recession, combined with declining oil and gas prices and the events of September 11, 2001, led to weakness in the oil service sector. The Company expects this weakness to continue at least through the first half of 2002. In any event, any significant future declines in hydrocarbon prices would likely have a material adverse effect on the Company's results of operations. There can be no assurance that the current oil price levels will lead to increased oil and gas exploration and production activity or that demand for the Company's products and services will reflect such improvement, if any.

The Company operates its business and markets its products and services in all of the significant oil and gas producing areas in the world and is, therefore, subject to the risks customarily attendant to international operations and investments in foreign countries. These risks include nationalization, expropriation, war, acts of terrorism and civil disturbance, restrictive action by local governments, limitation on repatriation of earnings, change in foreign tax laws and change in currency exchange rates, any of which could have an adverse effect on either the Company's ability to manufacture its products in its facilities abroad or the demand in certain regions for the Company's products or both. To date, the Company has not experienced any significant problems in foreign countries arising from local government actions or political instability, but there is no assurance that such problems will not arise in the future. Interruption of the Company's international operations could have a material adverse effect on its overall operations.

Dril-Quip's revenues are generated by its two operating groups: the Product Group and the Service Group. The Product Group manufactures offshore drilling and production equipment, and the Service Group provides installation and reconditioning services as well as rental running tools for installation and retrieval of its products. In 2001, the Company derived 86% of its revenues from the sale of its products and 14% of its revenues from services. Revenues from the Service Group generally correlate to revenues from product sales, because increased product sales generate increased revenues from installation services and rental running tools. The Company has substantial international operations, with approximately 48%, 58% and 53% of its revenues derived from foreign sales in 1999, 2000 and 2001, respectively. During the same years, approximately 70% of all products sold were manufactured in the United States.

Historically, Drip-Quip recognized revenues upon the delivery of a completed product. Beginning in 1997, the Company began receiving orders relating to larger and more complex projects that have longer manufacturing time frames. The Company accounts for such projects on a percentage of completion basis and revenues are generally recognized on the ratio of costs incurred to the total estimated costs. Accordingly, price and cost estimates are reviewed periodically as the work progresses, and adjustments proportionate to the percentage of completion are reflected in the period when such estimates are revised.

The principal elements of cost of sales are labor, raw materials and manufacturing overhead. Variable costs, such as labor, raw materials, supplies and energy, generally account for approximately two-thirds of the Company's cost of

sales. The Company has experienced increased labor costs over the past few years due to the limited supply of skilled workers. Fixed costs, such as the fixed portion of manufacturing overhead, constitute the remainder of the Company's cost of sales. The Company continually seeks to improve its efficiency and cost position. Cost of sales as a percentage of revenues is also influenced by the product mix sold in any particular quarter and market conditions. The Company's costs related to its foreign operations do not significantly differ from its domestic costs.

Results of Operations

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

| | Year Ended December 31, | | |
|---|----------------------------|-------|-------|
| | 1999 | 2000 | 2001 |
| Revenues: | | | |
| Product Group..... | 88.3% | 86.0% | 85.6% |
| Service Group..... | 11.7 | 14.0 | 14.4 |
| | ----- | ----- | ----- |
| Total..... | 100.0 | 100.0 | 100.0 |
| Cost of sales..... | 68.1 | 67.9 | 69.4 |
| Selling, general and administrative expenses..... | 13.6 | 14.1 | 13.0 |
| Engineering and product development expenses..... | 7.0 | 7.4 | 7.2 |
| | ----- | ----- | ----- |
| Operating income..... | 11.3 | 10.6 | 10.4 |
| Interest expense (income)..... | (0.3) | 0.3 | 1.2 |
| | ----- | ----- | ----- |
| Income before income taxes..... | 11.6 | 10.3 | 9.2 |
| Income tax provision..... | 4.1 | 3.6 | 3.2 |
| | ----- | ----- | ----- |
| Net income..... | 7.5% | 6.7% | 6.0% |
| | ===== | ===== | ===== |

Year ended December 31, 2001 Compared to Year Ended December 31, 2000

Revenues. Revenues increased by \$38.9 million, or approximately 24%, to \$202.9 million in 2001 from \$164 million in 2000. The increase was due to increased domestic sales in the United States of \$25.8 million, increased sales of \$15.2 million in the European area, and \$6.3 million in the Asia Pacific area, offset by decreased export sales from the United States of \$8.4 million.

Cost of Sales. Cost of sales increased by \$29.6 million, or 27%, to \$140.9 million for the twelve months ended December 31, 2001 from \$111.3 million for the same period in 2000. As a percentage of revenues, cost of sales was approximately 69.4% in 2001 and 67.9% in 2000. This increase was primarily due to increases in manufacturing costs and changes in product mix.

Selling, General and Administrative Expenses. For the twelve months ended December 31, 2001, selling, general and administrative expenses increased by

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\$3.2 million, or approximately 14%, to \$26.4 from \$23.2 million in the 2000 period. Selling, general and administrative expenses decreased as a percentage of revenues from 14.1% in 2000 to 13% in 2001. Increased expenditures in this area were made for the purposes of expanding the Company's worldwide sales force and increasing its proposal and project management capabilities.

Engineering and Product Development Expenses. During the year ended December 31, 2001, engineering and product development expenses increased by \$2.4 million, or approximately 20%, to \$14.5 million from \$12.1 million during the same period in 2000. This increase primarily reflects expenses related to the development of new products. As a percentage of revenues, engineering and product development expenses decreased from 7.4% in 2000 to 7.2% in 2001.

Interest Expense/Income. Interest expense for 2001 was approximately \$2.5 million, compared to \$495,000 for 2000. This change resulted primarily from borrowings made under the Company's unsecured revolving line of credit for operating activities and capital expenditures.

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Net Income. Net income increased by approximately 11%, from \$11.0 million in 2000 to \$12.2 million in 2001 for the reasons set forth above.

Year Ended December 31, 2000 Compared to Year Ended December 31, 1999

Revenues. Revenues increased by \$7.6 million, or approximately 5%, to \$164 million in 2000 from \$156.4 million in 1999. In general, this increase was the result of modest increases in worldwide exploration and development activity by the major oil companies. Revenue increases of \$10.7 million in the European area were offset by decreased sales of \$3.0 million in the United States area and \$100,000 in the Asia Pacific area. Domestic sales in the United States area decreased by \$13.2 million, or 16%, while export sales in the United States area increased by \$10.2 million, or 46%.

Cost of Sales. Cost of sales increased by \$4.9 million, or 5%, to \$111.3 million for the twelve months ended December 31, 2000 from \$106.4 million for the same period in 1999. As a percentage of revenues, cost of sales was approximately 68% in both 1999 and 2000.

Selling, General and Administrative Expenses. For the twelve months ended December 31, 2000, selling, general and administrative expenses increased by \$1.9 million, or 9%, to \$23.2 from \$21.3 million in the 1999 period. Selling, general and administrative expenses increased as a percentage of revenues from 13.6% in 1999 to approximately 14% in 2000. Increased expenditures in this area were made for the purposes of expanding the Company's worldwide sales force and increasing its proposal and project management capabilities.

Engineering and Product Development Expenses. During the year ended December 31, 2000, engineering and product development expenses increased by \$1.1 million, or 10%, to \$12.1 million from \$11.0 million during the same period in 1999. This increase primarily reflects expenses related to the development of new products. As a percentage of revenues, engineering and product development expenses increased slightly from 7.0% in 1999 to approximately 7.4% in 2000.

Interest Expense/Income. Interest expense for 2000 was \$495,000, compared to interest income of \$440,000 for the prior year.

Net Income. Net income decreased by approximately 6%, from \$11.8 million in 1999 to \$11.0 million in 2000 for the reasons set forth above.

Liquidity and Capital Resources

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The primary liquidity needs of the Company are (i) to fund capital expenditures to increase manufacturing capacity, improve and expand facilities and manufacture additional rental running tools and (ii) to fund working capital. The Company's principal sources of funds are cash flows from operations and bank indebtedness.

Net cash provided by operating activities was \$18.4 million in 1999. Net cash used in operating activities was \$12.2 million in 2000, and \$725,000 in 2001. Cash provided by net income, depreciation and amortization, reductions in trade receivables and increases in accounts payables and accrued expenses were offset by increases in worldwide inventories.

Capital expenditures by the Company were \$19.9 million, \$23.2 million and \$25.0 million in 1999, 2000 and 2001, respectively. Principal payments on long term debt were \$165,000, \$92,000 and \$632,000 in 1999, 2000 and 2001, respectively.

The following table presents long-term contractual obligations of the Company and the related payments due in total and by year as of December 31, 2001 (in thousands):

| Contractual Obligations | Payments due by year | | | | | | Total |
|-------------------------------|----------------------|---------|----------|---------|---------|---------------|----------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | After 2006 | |
| Long-term debt maturities.... | \$1,074 | \$1,068 | \$50,568 | \$1,068 | \$ 980 | \$4,130 | \$58,888 |
| Lease obligations..... | 726 | 482 | 239 | 22 | 22 | 55 | 1,546 |
| Total..... | \$1,800 | \$1,550 | \$50,807 | \$1,090 | \$1,002 | \$4,185 | \$60,434 |

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The Company has a credit facility with Guaranty Bank, FSB providing an unsecured revolving line of credit of up to \$60 million. At the option of the Company, borrowing under this facility bears interest at either a rate equal to LIBOR (London Interbank Offered Rate) plus 1.75% or the Guaranty Bank base rate. The facility calls for quarterly interest payments and terminates on May 18, 2004. As of December 31, 2001, the Company had drawn down \$49.5 million under this facility for operating activities and capital expenditures.

Dril-Quip (Europe) Limited has a credit agreement with the Bank of Scotland dated March 21, 2001 in the amount of U.K. Pounds Sterling 3.7 million (approximately U.S. \$5.5 million). Borrowing under this facility bears interest at the Bank of Scotland base rate, currently 4%, plus 1%, and is repayable in 120 equal monthly installments, plus interest. Substantially all of this facility was used to finance capital expenditures in Norway.

Dril-Quip Asia Pacific PTE Ltd. has a secured term loan with the Overseas Union Bank dated August 29, 2001 in the amount of Singapore Dollars \$6.0 million (approximately U.S. \$3.2 million). Borrowing under this facility bears interest at the swap rate, approximately 1.4%, plus 1.5% and is repayable in 40 equal quarterly installments, plus interest. This facility was used to finance capital expenditures in Singapore.

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The Company believes that cash generated from operations plus cash on hand and its existing line of credit will be sufficient to fund operations, working capital needs and anticipated capital expenditure requirements. However, any significant future declines in hydrocarbon prices could have a material adverse effect on the Company's liquidity. Should market conditions result in unexpected cash requirements, the Company believes that additional borrowing from commercial lending institutions would be readily available and more than adequate to meet such requirements.

Backlog

Backlog consists of firm customer orders for which a purchase order has been received, satisfactory credit or financing arrangements exist and delivery is scheduled. The Company's backlog was approximately \$120 million at December 31, 2001, an increase of \$27 million or 29% over the backlog of \$93 million at December 31, 2000. The Company expects to fill approximately 80% of the December 31, 2001 backlog by December 31, 2002. The remaining backlog at December 31, 2001 consists of longer-term projects which are being designed and manufactured to customer specifications rather than sold out of inventory. The Company can give no assurance that backlog will remain at current levels. Sales of the Company's products are affected by prices for oil and natural gas, which fluctuated significantly during 2000 and 2001. Any future decline in oil and natural gas prices could reduce new customer orders, which would cause the Company's backlog to decline. All of the Company's projects currently included in its backlog are subject to change and/or termination at the option of the customer. In the 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.

Geographic Areas

The Company's operations are divided into three geographic areas based upon the locations of its manufacturing facilities: the United States (Houston, Texas); Europe, Middle East and Africa (Aberdeen, Scotland) and Asia-Pacific (Singapore). The United States area includes sales to both North and South America. The area of Europe, Middle East and Africa includes primarily sales to the North Sea, the Middle East and Africa. The Asia-Pacific area includes sales primarily to Australia, Thailand, Malaysia and Indonesia.

Revenues for each of these areas are dependent upon the ultimate sale of products and services to the Company's customers. For information on revenues by geographic area, see note 10 to the consolidated financial statements on page 31. Revenues of the United States area are also influenced by its sale of products to the European and Asia-Pacific subsidiaries. Accordingly, the operating incomes of each area are closely tied to third-party sales, and the operating income of the United States area is also dependent upon its level of intercompany sales.

Currency Risk

Through its subsidiaries, the Company conducts a portion of business in currencies other than the United States dollar, principally the British pound sterling and the Norwegian kroner. The Company generally attempts to minimize its currency exchange risk by seeking international contracts payable in local currency in amounts equal to

the Company's estimated operating costs payable in local currency and in U.S. dollars for the balance of the contract. Because of this strategy, the Company has not experienced significant transaction gains or losses associated with

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changes in currency exchange rates and does not anticipate such exposure to be material in the future. In 1999, 2000 and 2001, the Company had net losses of approximately \$150,000, \$434,000 and a gain of \$85,000, respectively. The losses in 1999, 2000 and the gain in 2001 were the result of currency fluctuations related to payables and trade receivables. There is no assurance that the Company will be able to protect itself against such fluctuations in the future. Historically, the Company has not conducted business in countries that limit repatriation of earnings. However, as the Company expands its international operations, it may begin operating in countries that have such limitations. Further, there can be no assurance that the countries in which the Company currently operates will not adopt policies limiting repatriation of earnings in the future. The Company also has significant investments in countries other than the United States, principally its manufacturing operations in Aberdeen, Scotland and, to a lesser extent, Singapore and Norway. The functional currency of these foreign operations is the local currency and, accordingly, financial statement assets and liabilities are translated at current exchange rates. Resulting translation adjustments are reflected as a separate component of stockholders' equity and have no current effect on earnings or cash flow.

Critical Accounting Policies

The Company's discussion and analysis of its financial condition and results of operations are based on the Company's Consolidated Financial Statements, which have been prepared in accordance with United States generally accepted accounting principles. The preparation of the Consolidated Financial Statements requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates. The Company believes the following accounting policies affect its more significant judgments and estimates used in preparation of its consolidated financial statements.

Revenue Recognition. For the majority of our sales, we record revenue at the time our manufacturing process is complete and the products have been shipped to the customer. Certain of our revenues are derived from long-term contracts, which generally require more than one year to fulfill. Revenues and cost of sales and related profits from long-term contracts are recognized under the percentage-of-completion method based on a cost incurred basis. Losses on long-term contracts are recognized when they become known. Contracts for long-term projects usually contain provisions for customer progress payments. Payments and billings in excess of revenues recognized are deferred and are included as a customer prepayment liability. Allowances on accounts receivable are provided primarily on the specific-identification method.

Inventories. Inventory costs are determined principally by the use of the first-in, first-out (FIFO) method, and are stated at the lower of cost or market. We value our inventory principally using standard costs that are calculated based upon direct costs incurred and overhead allocations. Periodically, we also perform obsolescence reviews on our slow moving inventories and establish reserves based on current assessments about future demands and market conditions. If market conditions are less favorable than those projected by management, additional inventory reserves may be required.

We do not have any significant derivative instruments and we do not have any off-balance sheet hedging or financing arrangements or contracts or operations that rely upon credit or similar ratings.

New Accounting Standards

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Effective January 1, 2001, Dril-Quip adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended ("FAS 133"). This statement establishes accounting and reporting standards for derivative instruments and hedging activities. Under FAS 133, all derivatives must be recognized as assets or liabilities and measured at fair value. The adoption of this statement did not have a significant impact on Dril-Quip's financial position or results of operations.

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In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations ("FAS 141") and No. 142, Goodwill and Other Intangible Assets ("FAS 142"). FAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under FAS 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives. The amortization provisions of FAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt FAS 142 effective January 1, 2002. FAS 142 is not expected to have a significant impact on Dril-Quip's financial position or results of operations.

In October 2001, the FASB issued Statements of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement is effective for fiscal years beginning after December 15, 2001. The Company will adopt this statement effective January 1, 2002. This statement established a single accounting model for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Additionally, the statement expands the definition of a discontinued operation from a segment of business to a component of an entity that has been disposed of or is classified as held for sale and can be clearly distinguished, operationally and for reporting purposes, from the rest of the entity. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period incurred. Adoption of this statement is not expected to have a significant effect on Dril-Quip's financial position or results of operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 8. Financial Statements and Supplementary Data

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REPORT OF INDEPENDENT AUDITORS

Board of Directors and Stockholders
 Dril-Quip, Inc.

We have audited the accompanying consolidated balance sheets of Dril-Quip, Inc., as of December 31, 2001 and 2000, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Dril-Quip, Inc., at December 31, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Houston, Texas
 February 26, 2002

DRIL-QUIP, INC.

CONSOLIDATED STATEMENTS OF INCOME

| | Year Ended December 31, | | |
|---|---|------------|---------------|
| | ----- 1999 | 2000 | 2001 ----- |
| | (In Thousands, Except Share Amounts) | | |
| Revenues..... | \$ 156,368 | \$ 163,953 | \$ 202,900 |
| Cost and expenses: | | | |
| Cost of sales..... | 106,419 | 111,267 | 140,920 |
| Selling, general, and administrative..... | 21,253 | 23,164 | 26,357 |
| Engineering and product development..... | 11,022 | 12,116 | 14,533 |
| | ----- | ----- | ----- |

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| | | | |
|---------------------------------|------------|------------|------------|
| | 138,694 | 146,547 | 181,810 |
| | ----- | ----- | ----- |
| Operating income..... | 17,674 | 17,406 | 21,090 |
| Interest expense (income)..... | (440) | 495 | 2,452 |
| | ----- | ----- | ----- |
| Income before income taxes..... | 18,114 | 16,911 | 18,638 |
| Income tax provision..... | 6,349 | 5,880 | 6,436 |
| | ----- | ----- | ----- |
| Net income..... | \$ 11,765 | \$ 11,031 | \$ 12,202 |
| | ===== | ===== | ===== |
| Earnings per share: | | | |
| Basic..... | \$.68 | \$.64 | \$.71 |
| | ===== | ===== | ===== |
| Fully diluted..... | \$.68 | \$.63 | \$.70 |
| | ===== | ===== | ===== |
| Weighted average shares | | | |
| Basic..... | 17,245,000 | 17,274,249 | 17,292,295 |
| | ===== | ===== | ===== |
| Fully diluted..... | 17,277,101 | 17,504,785 | 17,351,726 |
| | ===== | ===== | ===== |

The accompanying notes are an integral part of these statements.

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DRIL-QUIP, INC.

CONSOLIDATED BALANCE SHEETS

| | December 31, | |
|--|----------------|-----------|
| | 2000 | 2001 |
| | ----- | ----- |
| ASSETS | (In Thousands) | |
| Current assets: | | |
| Cash and cash equivalents..... | \$ 5,870 | \$ 11,326 |
| Trade receivables..... | 63,345 | 59,789 |
| Inventories..... | 69,481 | 98,283 |
| Deferred taxes..... | 5,367 | 5,320 |
| Prepays and other current assets..... | 2,243 | 2,642 |
| | ----- | ----- |
| Total current assets..... | 146,306 | 177,360 |
| Property, plant, and equipment, net..... | 86,723 | 102,310 |
| Other assets..... | 312 | 289 |
| | ----- | ----- |
| Total assets..... | \$233,341 | \$279,959 |
| | ===== | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | | |
|-----------------------|-----------|-----------|
| Current liabilities: | | |
| Accounts payable..... | \$ 24,438 | \$ 28,009 |

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| | | |
|---|-----------|-----------|
| Current maturities of long-term debt..... | 495 | 1,074 |
| Accrued income taxes..... | 857 | 490 |
| Customer prepayments..... | 7,251 | 7,725 |
| Accrued compensation..... | 4,185 | 5,675 |
| Other accrued liabilities..... | 3,445 | 3,289 |
| | ----- | ----- |
| Total current liabilities..... | 40,671 | 46,262 |
| Long-term debt..... | 28,440 | 57,814 |
| Deferred taxes..... | 2,440 | 3,018 |
| | ----- | ----- |
| Total liabilities..... | 71,551 | 107,094 |
| 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, 17,290,498 and 17,293,373 issued and outstanding at December 31, 2000 and 2001..... | 173 | 173 |
| Additional paid-in capital..... | 64,660 | 64,737 |
| Retained earnings..... | 102,813 | 115,015 |
| Foreign currency translation adjustment..... | (5,856) | (7,060) |
| | ----- | ----- |
| Total stockholders' equity..... | 161,790 | 172,865 |
| | ----- | ----- |
| Total liabilities and stockholders' equity..... | \$233,341 | \$279,959 |
| | ===== | ===== |

The accompanying notes are an integral part of these statements.

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DRIL-QUIP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Year Ended December 31, | | |
|--|-------------------------|-----------|-----------|
| | 1999 | 2000 | 2001 |
| | ----- | | |
| | (In Thousands) | | |
| | ----- | | |
| Operating activities | | | |
| Net income..... | \$ 11,765 | \$ 11,031 | \$ 12,202 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization..... | 6,678 | 7,428 | 8,597 |
| Loss (gain) on sale of equipment..... | 139 | (51) | (36) |
| Deferred income taxes..... | (599) | (78) | 608 |
| Changes in operating assets and liabilities: | | | |
| Trade receivables..... | 7,570 | (26,935) | 2,763 |
| Inventories..... | 1,166 | (18,304) | (29,748) |
| Prepays and other assets..... | 229 | (1,135) | (426) |
| Trade accounts payable and accrued expenses..... | (8,515) | 15,851 | 5,315 |
| | ----- | ----- | ----- |
| Net cash provided by (used in) operating activities..... | 18,433 | (12,193) | (725) |

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| | | | |
|--|-----------|----------|-----------|
| Investing activities | | | |
| Purchase of property, plant, and equipment..... | (19,909) | (23,180) | (25,018) |
| Proceeds from sale of equipment..... | 161 | 69 | 152 |
| | ----- | ----- | ----- |
| Net cash used in investing activities..... | (19,748) | (23,111) | (24,866) |
| Financing activities | | | |
| Proceeds from revolving line of credit and long-term borrowings..... | -- | 29,001 | 30,769 |
| Principal payments on long-term debt..... | (165) | (92) | (632) |
| Proceeds from sale of stock..... | -- | 1,370 | 77 |
| | ----- | ----- | ----- |
| Net cash provided by (used in) financing activities..... | (165) | 30,279 | 30,214 |
| Effect of exchange rate changes on cash activities..... | 67 | 439 | 833 |
| | ----- | ----- | ----- |
| Increase (decrease) in cash..... | (1,413) | (4,586) | 5,456 |
| Cash at beginning of period..... | 11,869 | 10,456 | 5,870 |
| | ----- | ----- | ----- |
| Cash at end of period..... | \$ 10,456 | \$ 5,870 | \$ 11,326 |
| | ===== | ===== | ===== |

The accompanying notes are an integral part of these statements.

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DRIL-QUIP, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

| | Common Stock | Paid-In Capital | Retained Earnings | Unrealized Translation Adjustment | Total |
|-----------------------------------|-----------------|--------------------|----------------------|---|-----------|
| | ----- | ----- | ----- | ----- | ----- |
| | (In Thousands) | | | | |
| Balance at December 31, 1998..... | \$172 | \$63,291 | \$ 80,017 | \$ (1,568) | \$141,912 |
| | ----- | ----- | ----- | ----- | ----- |
| Translation adjustment..... | -- | -- | -- | (1,053) | (1,053) |
| Net income..... | -- | -- | 11,765 | -- | 11,765 |
| | ----- | ----- | ----- | ----- | ----- |
| Comprehensive income..... | -- | -- | -- | -- | 10,712 |
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 1999..... | 172 | 63,291 | 91,782 | (2,621) | 152,624 |
| | ----- | ----- | ----- | ----- | ----- |
| Translation adjustment..... | -- | -- | -- | (3,235) | (3,235) |
| Net income..... | -- | -- | 11,031 | -- | 11,031 |
| | ----- | ----- | ----- | ----- | ----- |
| Comprehensive income..... | -- | -- | -- | -- | 7,796 |
| Options Exercised..... | 1 | 1,369 | -- | -- | 1,370 |
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2000..... | 173 | 64,660 | 102,813 | (5,856) | 161,790 |
| | ----- | ----- | ----- | ----- | ----- |
| Translation adjustment..... | -- | -- | -- | (1,204) | (1,204) |
| Net income..... | -- | -- | 12,202 | -- | 12,202 |
| | ----- | ----- | ----- | ----- | ----- |

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| | | | | | |
|-----------------------------------|------|----------|-----------|------------|-----------|
| Comprehensive income..... | -- | -- | -- | -- | 10,998 |
| Options Exercised..... | -- | 77 | -- | -- | 77 |
| | ---- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2001..... | 173 | \$64,737 | \$115,015 | \$ (7,060) | \$172,865 |
| | ==== | ===== | ===== | ===== | ===== |

The accompanying notes are an integral part of these statements.

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2001

1. Organization

Dril-Quip, Inc. (the "Company"), manufactures offshore drilling and production equipment, which 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 connector and diverters for use 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 connection with the installation and retrieval of its products. The Company has four subsidiaries that manufacture and market the Company's products abroad. Dril-Quip (Europe) Limited is located in Aberdeen, Scotland, with branches in Norway, Holland, and Denmark. Dril-Quip Asia Pacific PTE Ltd. is located in Singapore. DQ Holdings PTY Ltd. is located in Perth, Australia and Dril-Quip do Brasil Ltda. is located in Macae, Brazil.

2. Significant Accounting Policies

Principles of Consolidation

The 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 generally accepted accounting principles 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.

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. At December 31, 2000, cash and cash equivalents included \$366,000, invested in United States Treasury money market funds.

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Inventories

The Company's inventories are reported at the lower of cost (first-in, first-out method) or market.

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 liability method. Deferred income taxes are provided on income and expenses which are reported in different periods for income tax and financial reporting purposes.

Revenue Recognition

The Company delivers most of its products on an as-needed basis by its customers and records revenues as the products are shipped. Certain revenues are derived from long-term contracts which generally require more than one

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

year to fulfill. Revenues and profits on long-term contracts are recognized under the percentage-of-completion method based on a cost-incurred basis. 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. At December 31, 2001 and 2000, trade receivables included \$3,468,000 and \$18,827,000 respectively, in unbilled revenue, and inventories had been reduced by \$9,510,000 and \$24,309,000, respectively, for activities relating to long-term contracts.

Foreign Currency

The financial statements of foreign subsidiaries are translated into U.S. dollars at current exchange rates except for revenues and expenses, which are translated at average rates during each reporting period. Translation adjustments are reflected as a separate component of stockholders' equity and have no current effect on earnings or cash flows. These adjustments amounted to a loss of \$1,053,000, \$3,235,000 and \$1,204,000 in 1999, 2000 and 2001, respectively.

Foreign currency exchange transactions are recorded using the exchange rate at the date of the settlement. Exchange gains (losses) were approximately (\$150,000) in 1999, (\$434,000) in 2000 and \$85,000 in 2001, net of income taxes. These amounts are included in the consolidated statements of income.

Stock-Based Compensation

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123. "Accounting For Stock Based Compensation" ("SFAS No. 123"). Accordingly, no compensation cost has been recognized for stock options granted under the Company's incentive plan.

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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 consist principally of 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 customer's 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 requires the reporting of comprehensive income, which includes net income plus unrealized foreign currency translation gains and losses. Comprehensive income has been reported in the Consolidated Statements of Changes in Stockholders' Equity.

Interest Capitalization

The Company capitalizes interest on significant construction projects for which interest costs are being incurred. These projects principally consist of construction or expansion of the Company's facilities. The company capitalized approximately \$220,000 of interest in 2001 and \$283,000 of interest in 2000 and none in 1999.

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

New Accounting Standards

Effective January 1, 2001, Dril-Quip adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended ("FAS 133"). This statement establishes accounting and reporting standards for derivative instruments and hedging activities. Under FAS 133, all derivatives must be recognized as assets or liabilities and measured at fair value. The adoption of this statement did not have a significant impact on Dril-Quip's financial position or results of operations.

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statements of Financial Accounting Standards No. 141, Business Combinations ("FAS 141") and No. 142, Goodwill and Other Intangible Assets ("FAS 142"). FAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under FAS 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment. Separable intangible

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assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives. The amortization provisions of FAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt FAS 142 effective January 1, 2002. FAS 142 is not expected to have a significant impact on Dril-Quips financial position or results of operations.

In October 2001, the FASB issued Statements of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement is effective for fiscal years beginning after December 15, 2001. The Company will adopt this statement effective January 1, 2002. This statement established a single accounting model for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Additionally, the statement expands the definition of a discontinued operation from a segment of business to a component of an entity that has been disposed of or is classified as held for sale and can be clearly distinguished, operationally and for reporting purposes, from the rest of the entity. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period incurred. Adoption of this statement is not expected to have a significant effect on Drip-Quip's financial position or results of operations.

3. Inventories

Inventories consist of the following:

| | December 31, | |
|--|----------------|----------|
| | 2000 | 2001 |
| | (In Thousands) | |
| Raw materials and supplies..... | \$13,728 | \$28,774 |
| Work in progress..... | 22,805 | 22,418 |
| Finished goods and purchased supplies..... | 32,948 | 47,091 |
| | \$69,481 | \$98,283 |

4. Property, Plant, and Equipment

Property, plant, and equipment consist of:

| | Estimated Useful Lives | December 31, | |
|------------------------------------|------------------------------|----------------|-----------|
| | | 2000 | 2001 |
| | | (In Thousands) | |
| Land and improvements..... | 10-25 years | \$ 11,715 | \$ 12,215 |
| Buildings..... | 15-40 years | 42,855 | 51,489 |
| Machinery and equipment..... | 3-10 years | 81,491 | 94,742 |
| | | 136,061 | 158,446 |
| Less accumulated depreciation..... | | 49,338 | 56,136 |

\$ 86,723 \$102,310
 =====

DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

5. Long-Term Debt

Long-term debt consists of the following:

| | December 31, | |
|-------------------------------------|----------------|----------|
| | 2000 | 2001 |
| | (In Thousands) | |
| Bank Financing..... | \$28,421 | \$58,196 |
| Equipment financing agreements..... | 514 | 692 |
| | ----- | ----- |
| | 28,935 | 58,888 |
| Less current portion..... | 495 | 1,074 |
| | ----- | ----- |
| | \$28,440 | \$57,814 |
| | ===== | ===== |

The Company has a credit facility with Guaranty Bank, FSB providing an unsecured revolving line of credit of up to \$60 million. At the option of the Company, borrowing under this facility bears interest at either a rate equal to LIBOR (London Interbank Offered Rate) plus 1.75% or the Guaranty Bank base rate. In addition, the facility calls for quarterly interest payments and terminates on May 18, 2004. As of December 31, 2001, the Company had drawn down \$49.5 million under this facility for operating activities and capital expenditures.

Dril-Quip (Europe) Limited has a credit agreement with the Bank of Scotland dated March 21, 2001 in the amount of U.K. Pounds Sterling 3.7 million (approximately U.S. \$5.5 million). Borrowing under this facility bears interest at the Bank of Scotland base rate, currently 4%, plus 1%, and is repayable in 120 equal monthly installments, plus interest. This facility was used to finance capital expenditures in Norway.

Dril-Quip Asia Pacific PTE Ltd. has a secured term loan with the Overseas Union Bank dated August 29, 2001 in the amount of Singapore Dollars \$6 million (approximately U.S. \$3.2 million). Borrowing under this facility bears interest at the swap rate, approximately 1.4%, plus 1.5% and is repayable in 40 equal quarterly installments, plus interest. This facility was used to finance capital expenditures in Singapore.

Interest paid on long-term debt for the years ended December 31, 1999, 2000 and 2001 was \$55,000, \$471,000 and \$2,644,000 respectively. Scheduled maturities of long-term debt are as follows: 2002--\$1,074,000; 2003--

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\$1,068,000; 2004--\$50,568,000; 2005--\$1,068,000; 2006--\$980,000 and thereafter--\$4,130,000.

6. Income Taxes

Income before income taxes consisted of the following:

| | 1999 | 2000 | 2001 |
|---------------|----------------|----------|----------|
| | ----- | ----- | ----- |
| | (In Thousands) | | |
| Domestic..... | \$20,758 | \$16,988 | \$15,372 |
| Foreign..... | (2,644) | (77) | 3,266 |
| | ----- | ----- | ----- |
| Total..... | \$18,114 | \$16,911 | \$18,638 |
| | ===== | ===== | ===== |

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

The income tax provision consists of the following:

| | 1999 | 2000 | 2001 |
|---------------------|----------------|---------|---------|
| | ----- | ----- | ----- |
| | (In Thousands) | | |
| Current: | | | |
| Federal..... | \$6,620 | \$5,463 | \$5,345 |
| Foreign..... | 330 | 437 | 466 |
| | ----- | ----- | ----- |
| Total current..... | 6,950 | 5,900 | 5,811 |
| Deferred: | | | |
| Federal..... | 232 | 187 | -0- |
| Foreign..... | (833) | (207) | 625 |
| | ----- | ----- | ----- |
| Total deferred..... | (601) | (20) | 625 |
| | ----- | ----- | ----- |
| | \$6,349 | \$5,880 | \$6,436 |
| | ===== | ===== | ===== |

The difference between the effective tax rate reflected in the provision for income taxes and the U.S. federal statutory rate was as follows:

| 1999 | 2000 | 2001 |
|------|------|------|
| ---- | ---- | ---- |

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| | | | |
|---|-------|-------|-------|
| Federal income tax statutory rate..... | 35.0% | 35.0% | 35.0% |
| Benefit of foreign sales corporation..... | (1.6) | (2.3) | (.8) |
| Other..... | 1.6 | 2.1 | .3 |
| | ---- | ---- | ---- |
| Effective tax rate..... | 35.0% | 34.8% | 34.5% |
| | ==== | ==== | ==== |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets are as follows:

| | December 31, | |
|--|-------------------|---------|
| | 2000 | 2001 |
| | (In Thousands) | |
| Deferred tax liability: | | |
| Property, plant and equipment..... | \$2,440 | \$3,018 |
| Deferred tax assets: | | |
| Deferred profit on intercompany sales..... | 2,941 | 2,986 |
| Other--net..... | 2,426 | 2,334 |
| | ----- | ----- |
| Total deferred tax assets..... | 5,367 | 5,320 |
| | ----- | ----- |
| Net deferred tax asset..... | \$2,927 | \$2,302 |
| | ===== | ===== |

Undistributed earnings of the Company's foreign subsidiaries are considered to be indefinitely reinvested and, accordingly, no provision for U.S. federal income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable.

The Company paid approximately, \$8,116,000, \$5,458,000 and \$6,044,000 in income taxes in 1999, 2000 and 2001, respectively.

DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

7. Employee Benefit Plans

The Company has a defined-contribution 401(k) plan covering domestic employees and a defined-contribution pension plan covering certain foreign employees. The Company generally makes contributions to the plans equal to each participant's eligible contributions for the plan year up to a specified

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percentage of the participant's annual compensation. The Company's contribution expense was, \$744,000, \$785,000 and \$820,000 in 1999, 2000 and 2001, respectively.

8. Commitments and Contingencies

The Company leases certain office, shop and warehouse facilities, automobiles, and equipment. The Company expenses all lease payments when incurred. Total lease expense incurred was \$1,266,000, \$1,093,000 and \$1,276,000 in 1999, 2000 and 2001, respectively. Annual minimum lease commitments at December 31, 2001 are as follows: 2002--\$726,000; 2003 --\$482,000; 2004--\$239,000; 2005--\$22,000; 2006--\$22,000 and thereafter--\$55,000.

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 risk 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 future developments will not adversely impact the Company.

The Company is involved in a number of legal actions arising in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the consolidated financial statements of the Company, although no assurance can be given with respect to the ultimate outcome of this litigation.

9. Stockholders' Equity

Under a Stockholder Rights Plan adopted by the Board of Directors in 1997, each share of common stock includes one Right to purchase from the Company a unit consisting of one one-hundredth of a share (a "Fractional Share") of Series A Junior Participating Preferred Stock at a specified purchase price per Fractional Share, subject to adjustment in certain events. The Rights will cause substantial dilution to any person or group that attempts to acquire the Company without the approval of the Company's Board of Directors.

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

10. Geographic Areas

| | 1999 | 2000 | 2001 |
|----------------|----------------|-----------|-----------|
| | ----- | ----- | ----- |
| | (In Thousands) | | |
| Revenues | | | |
| United States: | | | |
| Domestic..... | \$ 82,634 | \$ 69,401 | \$ 95,179 |
| Export..... | 22,269 | 32,474 | 24,100 |

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| | | | |
|--------------------------------------|-----------|-----------|-----------|
| Intercompany..... | 10,727 | 16,128 | 29,607 |
| | ----- | ----- | ----- |
| Total United States..... | 115,630 | 118,003 | 148,886 |
| Europe, Middle East, and Africa..... | 42,989 | 53,567 | 71,529 |
| Asia-Pacific..... | 9,112 | 9,017 | 15,336 |
| Eliminations..... | (11,363) | (16,634) | (32,851) |
| | ----- | ----- | ----- |
| Total..... | \$156,368 | \$163,953 | \$202,900 |
| | ===== | ===== | ===== |
| Operating Income | | | |
| United States..... | \$ 21,645 | \$ 19,050 | \$ 18,612 |
| Europe, Middle East, and Africa..... | (2,160) | 511 | 2,061 |
| Asia-Pacific..... | (545) | (273) | 1,157 |
| Eliminations..... | (1,266) | (1,882) | (740) |
| | ----- | ----- | ----- |
| Total..... | \$ 17,674 | \$ 17,406 | \$ 21,090 |
| | ===== | ===== | ===== |
| Identifiable Assets | | | |
| United States..... | \$127,233 | \$171,203 | \$192,601 |
| Europe, Middle East, and Africa..... | 49,048 | 59,138 | 81,420 |
| Asia-Pacific..... | 8,395 | 8,460 | 11,484 |
| Eliminations..... | (5,213) | (5,460) | (5,546) |
| | ----- | ----- | ----- |
| Total..... | \$179,463 | \$233,341 | \$279,959 |
| | ===== | ===== | ===== |

Export sales from the United States to unaffiliated customers consist of worldwide sales outside the territorial waters of the United States. Europe sales are primarily to the North Sea, with lesser sales to Africa and the Middle East, while Asia-Pacific's sales are primarily to Australia, Thailand, Malaysia, and Indonesia.

Eliminations of operating profits are related to intercompany inventory transfers that are deferred until shipment is made to third party customers.

In 1999 Chevron USA Production Company accounted for approximately 15% of consolidated sales. During 2000, no single customer accounted for more than 10% of the Company's total revenues. In 2001, BP p.l.c. and ChevronTexaco Corp. accounted for approximately 17% and 13% of consolidated sales, respectively.

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

11. Employee Stock Option Plan and Awards

On September 19, 1997 the Company adopted the Dril-Quip, Inc. 1997 Incentive Plan (as amended, the "1997 Plan") and the Company reserved 1,700,000 shares of Common Stock for use in connection with the 1997 Plan. During 2001, the Company reserved an additional 700,000 shares for use in connection with the 1997 Plan. Persons eligible for awards under the 1997 Plan are employees

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holding positions of responsibility with the Company or any of its subsidiaries. Options granted under the 1997 Plan have a term of ten years and become exercisable in cumulative annual increments of one-fourth of the total number of shares of Common Stock subject thereto, beginning on the first anniversary of the date of the grant. Option activity for the years ended December 31, 1997, 1998, 1999, 2000 and 2001 were as follows:

| | Number of Options | Weighted Average Exercise Price |
|---------------------------------------|----------------------|--|
| | ----- | ----- |
| Outstanding at January 1, 1997..... | 0 | \$ 0.00 |
| Granted--1997 Plan..... | 411,250 | 24.00 |
| | ----- | ----- |
| Outstanding at December 31, 1997..... | 411,250 | 24.00 |
| Granted--1997 Plan..... | 261,596 | 19.81 |
| | ----- | ----- |
| Outstanding at December 31, 1998..... | 672,846 | 22.37 |
| Granted--1997 Plan..... | 250,280 | 23.44 |
| | ----- | ----- |
| Outstanding at December 31, 1999..... | 923,126 | 22.66 |
| Exercised--1997 Plan..... | (45,498) | 23.54 |
| Granted--1997 Plan..... | 216,214 | 32.13 |
| | ----- | ----- |
| Outstanding at December 31, 2000..... | 1,093,842 | 24.50 |
| Exercised--1997 Plan..... | (2,875) | 22.95 |
| Granted--1997 Plan..... | 321,495 | 18.00 |
| | ----- | ----- |
| Outstanding at December 31, 2001..... | 1,412,462 | \$23.03 |
| | ===== | ===== |

| | Number of Options | Weighted Average Exercise Price |
|---------------------------|----------------------|--|
| | ----- | ----- |
| Exercisable, December 31, | | |
| 1998..... | 102,813 | \$24.00 |
| 1999..... | 271,024 | \$22.99 |
| 2000..... | 456,308 | \$22.77 |
| 2001..... | 738,268 | \$23.42 |

The following table summarizes information about stock options outstanding at December 31, 2001.

| Range of Exercise Prices | Number Outstanding | Weighted Average Exercise Price | Weighted Average Contractual Life |
|--------------------------|-----------------------|--|--|
| ----- | ----- | ----- | ----- |
| \$18.00 to \$24.00..... | 1,196,248 | \$21.38 | 7.53 years |
| \$32.13..... | 216,214 | 31.13 | 8.82 years |
| | ----- | ----- | ----- |

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1,412,462 \$23.03 \$7.73 years
 ===== ===== =====

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DRIL-QUIP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

December 31, 2001

The Company applied Accounting Principles Board Opinion No. 25 ("APB No. 25") and related interpretations in accounting for this plan. No compensation cost has been recognized in the results of operations, as the exercise price for options granted under this plan is equal to the market price on the date of grant. Under FAS No. 123, pro forma information is required to reflect the estimated effect on net income and earnings per share as if the Company has accounted for the stock options using the fair value method. The fair value was estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions:

| | 1999 | 2000 | 2001 |
|---|---------|---------|---------|
| | ----- | ----- | ----- |
| Risk-free interest rate..... | 6.0% | 5.0% | 4.9% |
| Volatility factor of the stock price..... | .761 | .645 | .637 |
| Expected life of options (in years)..... | 5 | 5 | 5 |
| Expected dividend yield..... | 0.0% | 0.0% | 0.0% |
| Calculated fair value per share..... | \$15.49 | \$18.82 | \$10.78 |

Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under the above plan consistent with the method available under SFAS No. 123, the Company's net income and earnings per share for the years ended December 31, 1999, 2000 and 2001 would have been reduced to the pro forma amounts listed below.

| | Year Ended December 31, | | |
|--------------------|-------------------------|----------|----------|
| | ----- | ----- | ----- |
| | 1999 | 2000 | 2001 |
| | ----- | ----- | ----- |
| Net Income | | | |
| As reported..... | \$11,765 | \$11,031 | \$12,202 |
| | ===== | ===== | ===== |
| Pro forma..... | \$11,071 | \$ 9,289 | \$ 9,979 |
| | ===== | ===== | ===== |
| Earnings per share | | | |
| Basic..... | \$.68 | \$.64 | \$.71 |
| | ===== | ===== | ===== |
| Diluted..... | \$.68 | \$.63 | \$.70 |
| | ===== | ===== | ===== |
| Pro forma | | | |
| Basic..... | \$.64 | \$.54 | \$.58 |

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| | | | | | | |
|--------------|----|-----|----|-----|----|-----|
| Diluted..... | \$ | .64 | \$ | .53 | \$ | .58 |
|--------------|----|-----|----|-----|----|-----|

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12. Quarterly Results of Operations: (unaudited)

| | Quarter Ended | | | |
|-----------------------|--------------------------------------|----------|----------|----------|
| | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| | (In Thousands, Except Share Amounts) | | | |
| 2001 | | | | |
| Revenues..... | \$47,105 | \$48,900 | \$54,356 | \$52,539 |
| Operating income..... | 4,904 | 5,353 | 5,422 | 5,411 |
| Net income..... | 2,808 | 3,086 | 3,150 | 3,158 |
| Earnings per share: | | | | |
| Basic(1)..... | 0.16 | 0.18 | 0.18 | 0.18 |
| Diluted(1)..... | 0.16 | 0.18 | 0.18 | 0.18 |

| | Quarter Ended | | | |
|-----------------------|--------------------------------------|----------|----------|----------|
| | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| | (In Thousands, Except Share Amounts) | | | |
| 2000 | | | | |
| Revenues..... | \$35,008 | \$39,345 | \$44,525 | \$45,075 |
| Operating income..... | 3,622 | 4,444 | 4,769 | 4,571 |
| Net income..... | 2,390 | 2,842 | 2,934 | 2,865 |
| Earnings per share: | | | | |
| Basic(1)..... | 0.14 | 0.16 | 0.17 | 0.17 |
| Diluted(1)..... | 0.14 | 0.16 | 0.17 | 0.16 |

(1) The sum of the quarterly per share amounts may not equal the annual amount reported, as per share amounts are computed independently for each quarter and for the full year.

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None.

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PART III

Item 10. Directors and Executive Officers of the Registrant

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The information required by this item is set forth under the captions "Election of Directors" and "--Compliance with Section 16(a) of the Exchange Act" in the Company's definitive Proxy Statement (the "2002 Proxy Statement") for its annual meeting of stockholders to be held on May 15, 2002, which sections are incorporated herein by reference.

Pursuant to Item 401(b) of Regulation S-K, the information required by this item with respect to executive officers of the Company is set forth in Part I of this report.

Item 11. Executive Compensation

The information required by this item is set forth in the sections entitled "Election of Directors--Director Compensation" and "Executive Compensation" in the 2002 Proxy Statement, which sections are incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this item is set forth in the section entitled "Security Ownership of Certain Beneficial Owners and Management" in the 2002 Proxy Statement, which section is incorporated herein by reference.

Item 13. Certain Relationships and Related Party Transactions

The information required by this item is set forth in the section entitled "Election of Directors--Certain Transactions" in the 2002 Proxy Statement, which section is incorporated herein by reference.

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PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) (1) Financial Statements

All financial statements of the registrant are set forth under Item 8 of this Annual Report on Form 10-K.

(a) (2) Financial Statement Schedules

All schedules and other statements for which provision is made in the applicable regulations of the Commission have been omitted because they are not required under the relevant instructions or are inapplicable.

(a) (3) Exhibits

Dril-Quip will furnish any exhibit to a stockholder upon payment by the stockholder of the Company's reasonable expenses to furnish the exhibit.

| Exhibit No. ----- | Description ----- |
|-------------------------|--|
| *3.1 | --Restated Certificate of Incorporation of the Company (Incorporated herein by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)). |
| *3.2 | --Bylaws of the Company (Incorporated herein by reference to Exhibit |

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3.3 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).

- *3.3 --Certificate of Designations for Series A Junior Participating Preferred Stock (Incorporated herein by reference to Exhibit 3.3 to the Company's Report on Form 10-Q for the Quarter ended September 30, 1997).
- *4.1 --Form of certificate representing Common Stock (Incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).
- *4.2 --Registration Rights Agreement among the Company and certain stockholders (Incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).
- *4.3 --Rights Agreement between the Company and ChaseMellon Shareholder Services, L.L.C., as rights agent (Incorporated herein by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).
- *10.1 --Credit Agreement between the Company and Guaranty Bank, FSB dated May 18, 2001 (Incorporated by reference to Exhibit 10.2 to the Company's report on Form 10-Q for the quarter ended June 30, 2001 (SEC File No. 001-13439)).
- *10.2 --Credit Agreement between Dril-Quip (Europe) Limited and Bank of Scotland dated November 18, 1999 (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the Quarter ended March 30, 2000 (SEC File No. 001-13439)).
- +*10.3 --Form of Employment Agreement between the Company and each of Messrs. Reimert, Smith and Walker (Incorporated herein by reference to Exhibit 10.12 to the Company's Registration Statement On Form S-1 (Registration No. 333-33447)).
- +*10.4 --1997 Incentive Plan of Dril-Quip, Inc. (as amended March 16, 2001) (Incorporated herein by reference to Appendix B to the Company's Proxy Statement, filed on March 23, 2001, for the annual meeting of Stockholders held on May 10, 2001 (SEC File No. 001-13439)).
- *21.1 --Subsidiaries of the Registrant. (Incorporated herein by reference to Exhibit 21.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1998 (SEC File No. 001-13439)).
- 23.1 --Consent of Ernst & Young LLP.

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* Incorporated herein by reference as indicated.

+ Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to the requirements of Item 14(c) of Form 10-K.

(b) Reports on Form 8-K

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on March 22, 2002.

DRIL-QUIP, INC.

/s/ Larry E. Reimert

By: _____

Larry E. Reimert
Co-Chairman of the Board of
Directors

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Name ----- | Capacity ----- | Date ----- |
|---|--|----------------|
| /s/ J. Mike Walker ----- J. Mike Walker | Co-Chairman of the Board and Director (Co- Principal Executive Officer) | March 22, 2002 |
| /s/ Larry E. Reimert ----- Larry E. Reimert | Co-Chairman of the Board and Director (Co- Principal Executive Officer) | March 22, 2002 |
| /s/ Gary D. Smith ----- Gary D. Smith | Co-Chairman of the Board and Director (Co- Principal Executive Officer) | March 22, 2002 |
| /s/ Jerry M. Brooks ----- Jerry M. Brooks | Chief Financial Officer (Principal Financial and Accounting Officer) | March 22, 2002 |
| /s/ Gary W. Loveless ----- Gary W. Loveless | Director | March 22, 2002 |
| /s/ James M. Alexander ----- James M. Alexander | Director | March 22, 2002 |
| /s/ Gary L. Stone ----- Gary L. Stone | Director | March 22, 2002 |

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