DRIL-QUIP INC
Form 10-Q
May 08, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007

OR

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

Commission file number 001-13439

DRIL-QUIP, INC.

(Exact name of registrant as specified in its charter)

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

13550 HEMPSTEAD HIGHWAY

HOUSTON, TEXAS

77040

(Address of principal executive offices)

(Zip Code)

(713) 939-7711

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

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

As of May 4, 2007, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 40,435,782.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	December 31, 2006	March 31, 2007
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 135,429	$ 146,759
Trade receivables, net	144,820	136,496
Inventories, net	162,503	158,368
Deferred income taxes	15,424	16,481
Prepaids and other current assets	6,879	7,170
Total current assets	465,055	465,274
Property, plant and equipment, net	129,340	130,601
Other assets	540	408
Total assets	$ 594,935	$ 596,283
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 38,572	$ 24,040
Current maturities of long-term debt	844	852
Accrued income taxes	15,760	17,637
Customer prepayments	39,387	29,712
Accrued compensation	9,916	7,671
Other accrued liabilities	13,326	12,537
Total current liabilities	117,805	92,449
Long-term debt	2,876	2,689
Deferred income taxes	6,757	6,757
Total liabilities	127,438	101,895
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued)		
Common stock:		
50,000,000 shares authorized at $0.01 par value, 40,357,656 and 40,383,782 shares issued and outstanding at December 31, 2006 and March 31, 2007, respectively	404	404
Additional paid-in capital	192,086	193,137
Retained earnings	264,620	288,671
Foreign currency translation adjustment	10,387	12,176
Total stockholders equity	467,497	494,388
Total liabilities and stockholders equity	$ 594,935	$ 596,283

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended March 31, 2006	2007
	(In thousands, except per share data)	
Revenues	$ 98,198	$ 117,682
Cost and expenses:		
Cost of sales	57,163	67,750
Selling, general and administrative	11,177	12,018
Engineering and product development	4,895	5,206
	73,235	84,974
Operating income	24,963	32,708
Interest income	302	1,765
Interest expense	(193)	(97)
Income before income taxes	25,072	34,376
Income tax provision	7,753	10,325
Net income	$ 17,319	$ 24,051
Earnings per share:		
Basic	$ 0.45	$ 0.60
Diluted	$ 0.44	$ 0.59
Weighted average shares:		
Basic	38,747	40,378
Diluted	39,809	40,933

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Three months ended March 31, 2006	Three months ended March 31, 2007
	(In thousands)	
Operating activities		
Net income	$ 17,319	$ 24,051
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,585	3,877
Stock-based compensation expense	424	538
Gain on sale of equipment	(57)	(94)
Deferred income taxes	(168)	(1,032)
Changes in operating assets and liabilities:		
Trade receivables, net	(8,842)	9,254
Inventories, net	2,734	5,176
Prepaids and other assets	(404)	(110)
Excess tax benefit of stock option exercises	(3,426)	(225)
Trade accounts payable and accrued expenses	(12,629)	(25,928)
Net cash provided by (used in) operating activities	(1,464)	15,507
Investing activities		
Purchase of property, plant and equipment	(4,743)	(4,550)
Proceeds from sale of equipment	112	214
Net cash used in investing activities	(4,631)	(4,336)
Financing activities		
Proceeds from revolving line of credit and long-term borrowing	35	
Principal payments on revolving line of credit and long-term debt	(194)	(212)
Proceeds from exercise of stock options	5,631	289
Excess tax benefit-stock options	3,426	225
Net cash provided by financing activities	8,898	302
Effect of exchange rate changes on cash activities	(1,187)	(143)
Increase in cash and cash equivalents	1,616	11,330
Cash and cash equivalents at beginning of period	32,763	135,429
Cash and cash equivalents at end of period	$ 34,379	$ 146,759

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Organization and Principles of Consolidation

Dril-Quip, Inc., a Delaware corporation (the Company or Dril-Quip) designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. The Company s principal products consist of subsea and surface wellheads, subsea and surface production trees, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, wellhead connectors and diverters. Dril-Quip s products are used by major integrated, large independent and foreign national oil and gas companies in offshore areas throughout the world. Dril-Quip also provides installation and reconditioning services and rents running tools for use in the installation and retrieval of its products.

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

The condensed consolidated financial statements included herein have been prepared by Dril-Quip and are unaudited, except for the balance sheet at December 31, 2006, which has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of March 31, 2007, the results of operations for each of the three-month periods ended March 31, 2007 and 2006, and the cash flows for each of the three-month periods ended March 31, 2007 and 2006. Although management believes the unaudited interim related disclosures in these consolidated financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations and the cash flows for the three-month period ended March 31, 2007 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the consolidated audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

2. Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned. All material intercompany accounts and transactions have been eliminated.

Use of Estimates

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

policies for revenue recognition, inventories and contingent liabilities as discussed more fully in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Cash and cash equivalents

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

Inventories

Inventory costs are determined principally by the use of the first-in, first-out (FIFO) costing method, and are stated at the lower of cost or market. Inventory is valued principally using standard costs, which are calculated based upon direct costs incurred and overhead allocations. Periodically, obsolescence reviews are performed on slow-moving inventories and reserves are established based on current assessments about future demands and market conditions. The inventory values have been reduced by a reserve for excess and obsolete inventories. Inventory reserves of $18.2 million and $16.2 million were recorded as of March 31, 2007 and 2006, respectively. If market conditions are less favorable than those projected by management, additional inventory reserves may be required.

Property, Plant and Equipment

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

Income Taxes

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

Common Stock

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

Revenue Recognition

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

Foreign Currency

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

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

Stock-Based Compensation

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

Fair Value of Financial Instruments

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

Concentration of Credit Risk

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

Comprehensive Income

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

The following table provides comprehensive income for the periods indicated:

	Three months ended March 31,	
	2006	**2007**
	(In thousands)	
Net income	$ 17,319	$ 24,051
Foreign currency translation adjustment	928	1,789
Comprehensive income	$ 18,247	$ 25,840

Earnings Per Share

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

The net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the number of common shares outstanding at March 31 of each year to the weighted average of common shares outstanding and the weighted average number of common and dilutive potential common shares outstanding for the purpose of calculating basic and diluted earnings per common share:

	Three months ended March 31,	
	2006	2007
	(In thousands)	
Number of common shares outstanding at end of period	39,027	40,384
Effect of using weighted average common shares outstanding	(280)	(6)
Weighted average basic common shares outstanding	38,747	40,378
Dilutive effect of common stock options	1,062	555
Weighted average diluted common shares outstanding	39,809	40,933

New Accounting Standards

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

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

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

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

3. Stock-Based Compensation and Stock Option Awards

Stock-based compensation expense recognized as selling, general and administrative expense during the three months ended March 31, 2007 and 2006 totaled $538,000 and $424,000, respectively. No stock-based compensation expense was capitalized during the three months ended March 31, 2007 and 2006. There were no options granted in the first quarter of 2007 and 2006.

The Company recognizes compensation expense on a straight-line basis over the vesting term of the options that are expected to vest. At March 31, 2007, there was $5.4 million of total unrecognized compensation expense related to unvested stock option awards. This expense is expected to be recognized over a weighted average of 2.2 years.

Option activity under the Company s stock compensation plans for the three months ended March 31, 2007 was as follows:

	Number of Shares			
	1997 Plan	2004 Plan	Total	Aggregate intrinsic value (in millions)
Stock options outstanding at December 31, 2006	1,163,050	264,435	1,427,485	$ 35.3
Options granted				
Options forfeited				
Options exercised	26,126		26,126	0.7
Stock options outstanding at March 31, 2007	1,136,924	264,435	1,401,359	$ 40.3
Options exercisable at March 31, 2007	940,089		940,089	$ 32.1

The following summary provides additional information about stock options that are outstanding and exercisable at March 31, 2007:

	Stock Options Outstanding		
Range of Exercise Prices	Number Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life
$7.48 to $12.00	1,119,924	$ 8.73	5.77 years
$16.06	17,000	$ 16.06	3.58 years
$38.97	264,435	$ 38.97	9.58 years
	1,401,359	$ 14.53	6.46 years

	Stock Options Exercisable		
Range of Exercise Prices	Number Exercisable	Weighted Average Exercise Price	Weighted Average Contractual Life
$7.48 to $12.00	923,089	$ 9.00	5.60 years
$16.06	17,000	$ 16.06	3.58 years
	940,089	$ 9.13	5.56 years

4. Inventories

Inventories consist of the following:

	December 31, 2006	March 31, 2007
	(In thousands)	
Raw materials and supplies	$ 40,861	$ 37,967
Work in progress	35,624	33,867
Finished goods	102,891	104,700