

DRIL-QUIP INC  
Form 10-Q  
August 07, 2008

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**FORM 10-Q**

(MARK ONE)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008

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**  
(State or other jurisdiction of  
incorporation or organization)

**74-2162088**  
(I.R.S. Employer Identification No.)

**13550 HEMPSTEAD HIGHWAY**

**HOUSTON, TEXAS**

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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  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  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller

reporting company)

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

As of August 1, 2008, the number of shares outstanding of the registrant's common stock, par value \$.01 per share, was 39,655,300.

## PART I FINANCIAL INFORMATION

## Item 1. FINANCIAL STATEMENTS

## DRIL-QUIP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	December 31, 2007	June 30, 2008
	(In thousands)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 201,732	\$ 109,454
Trade receivables, net	142,064	156,601
Inventories, net	183,031	212,805
Deferred income taxes	16,303	17,515
Prepays and other current assets	9,468	7,538
Total current assets	552,598	503,913
Property, plant and equipment, net	141,646	165,207
Other assets	5,578	5,635
Total assets	\$ 699,822	\$ 674,755
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 27,078	\$ 39,500
Current maturities of long-term debt	857	857
Accrued income taxes	7,057	7,689
Customer prepayments	38,324	13,583
Accrued compensation	10,451	7,643
Other accrued liabilities	14,639	14,600
Total current liabilities	98,406	83,872
Long-term debt	2,054	1,622
Deferred income taxes	6,867	6,711
Total liabilities	107,327	92,205
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, 40,793,713 and 39,655,300 shares issued and outstanding at December 31, 2007 and June 30, 2008, respectively		
	408	397
Additional paid-in capital	205,835	140,271
Retained earnings	372,561	425,655
Foreign currency translation adjustment	13,691	16,227
Total stockholders' equity	592,495	582,550
Total liabilities and stockholders' equity	\$ 699,822	\$ 674,755

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The accompanying notes are an integral part of these statements.

## DRIL-QUIP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2008	2007	2008
	(In thousands, except per share data)			
Revenues	\$ 114,701	\$ 142,544	\$ 232,383	\$ 274,957
Cost and expenses:				
Cost of sales	64,492	83,726	132,242	161,545
Selling, general and administrative	12,066	14,187	24,084	27,805
Engineering and product development	5,280	6,871	10,486	13,135
	81,838	104,784	166,812	202,485
Operating income	32,863	37,760	65,571	72,472
Interest income	1,984	929	3,749	2,633
Interest expense	(61)	(44)	(158)	(102)
Income before income taxes	34,786	38,645	69,162	75,003
Income tax provision	10,677	10,942	21,002	21,909
Net income	\$ 24,109	\$ 27,703	\$ 48,160	\$ 53,094
Earnings per common share:				
Basic	\$ 0.60	\$ 0.69	\$ 1.19	\$ 1.31
Diluted	\$ 0.59	\$ 0.68	\$ 1.18	\$ 1.29
Weighted average common shares:				
Basic	40,436	40,435	40,407	40,617
Diluted	41,003	40,859	40,971	41,026

The accompanying notes are an integral part of these statements.

## DRIL-QUIP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six months ended June 30,	
	2007	2008
	(In thousands)	
<b>Operating activities</b>		
Net income	\$ 48,160	\$ 53,094
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,693	8,290
Stock-based compensation expense	1,047	1,497
Gain on sale of equipment	(222)	(90)
Deferred income taxes	108	(1,319)
Changes in operating assets and liabilities:		
Trade receivables, net	7,066	(12,759)
Inventories, net	(5,390)	(28,926)
Prepays and other assets	2,325	2,458
Excess tax benefits of stock option exercises	(786)	(399)
Trade accounts payable and accrued expenses	(18,814)	(15,409)
Net cash provided by operating activities	41,187	6,437
<b>Investing activities</b>		
Purchase of property, plant and equipment	(9,578)	(30,242)
Proceeds from sale of equipment	907	721
Net cash used in investing activities	(8,671)	(29,521)
<b>Financing activities</b>		
Repurchase of common stock		(67,860)
Principal payments on long-term debt	(425)	(439)
Proceeds from exercise of stock options	890	376
Excess tax benefits of stock option exercises	786	399
Net cash provided by (used in) financing activities	1,251	(67,524)
Effect of exchange rate changes on cash activities	(329)	(1,670)
Increase (decrease) in cash and cash equivalents	33,438	(92,278)
Cash and cash equivalents at beginning of period	135,429	201,732
Cash and cash equivalents at end of period	\$ 168,867	\$ 109,454

The accompanying notes are an integral part of these statements.

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**DRIL-QUIP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. Organization and Principles of Consolidation**

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

The condensed consolidated financial statements included herein have been prepared by Dril-Quip and are unaudited, except for the balance sheet at December 31, 2007, which has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of June 30, 2008, the results of operations for each of the three and six-month periods ended June 30, 2008 and 2007, and the cash flows for each of the six-month periods ended June 30, 2008 and 2007. Although management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations and the cash flows for the six-month period ended June 30, 2008 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, 2007.

**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, 2007.

*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 interest bearing accounts and money market 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 \$21.6 million and \$19.2 million were recorded as of June 30, 2008 and December 31, 2007, 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 basis of assets and liabilities.

*Revenue Recognition*

For the majority of the Company's sales, revenue is recorded at the time the manufacturing process is complete and the products have been shipped to the consumer. For these sales, ownership is transferred to the customer at the time of shipment. Service revenues are recorded at the time the service is rendered. The Company uses the percentage-of-completion method on long-term project contracts. Long-term project contracts have the following characteristics:

The contracts call for products which are designed to customer specifications;

The structural design is unique and requires significant engineering and manufacturing efforts generally requiring more than one year in duration;

The contracts contain specific terms as to milestones, progress billings and delivery dates;

Product requirement cannot be filled directly from the Company's standard inventory.

For each project, the Company prepares a detailed analysis of estimated costs, profit margin, completion date and risk factors which include availability of material, production efficiencies and other factors that may impact the project. On a quarterly basis, management reviews the progress of each project, which may result in revisions of previous estimates, including revenue recognition. Historically, the Company's estimates of total costs and costs to complete have approximated actual costs incurred to complete the project.

Under the percentage-of-completion method, revenue is recognized based on the percentage of costs incurred to date compared to total estimated cost to complete. Losses, if any, are recorded in full in the period they first become evident.

Under the percentage-of-completion method, billings do not always correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the Condensed Consolidated Balance Sheets. Likewise, revenue recognized may exceed customer billings in which case the amounts are reported in trade receivables. Unbilled revenues are expected to be billed and collected within one year. At June 30, 2008 and December 31, 2007, receivables included \$35.9 million and \$18.1 million of unbilled receivables, respectively. For the six months ended June 30, 2008, 21 projects representing approximately 30% of the Company's revenue were accounted for using percentage-of-completion accounting.

#### *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 effect on current 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 Condensed Consolidated Statements of Income.

#### *Fair Value of Financial Instruments*

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

#### *Concentration of Credit Risk*

Financial instruments which subject the Company to concentrations of credit risk include primarily 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.

In addition, the Company invests excess cash in interest bearing accounts and money market mutual funds. These money market funds, rated as the highest quality by nationally recognized rating agencies, are not insured or guaranteed by any governmental agency. Changes in the financial markets and in interest rates could affect the interest earned on short-term investments.

#### *Comprehensive Income*

Statements of Financial Accounting Standards (SFAS) No. 130, Reporting Comprehensive Income, establishes the rules for the reporting and display of comprehensive income and its components. SFAS No. 130

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requires the Company to include unrealized gains or losses on foreign currency translation adjustments in other comprehensive income. Generally, gains are attributed to a weakening U.S. dollar and losses are the result of a strengthening U.S. dollar.

The following table provides comprehensive income for the periods indicated:

	Three months ended June 30,		Six months ended June 30,	
	2007	2008	2007	2008
	(In thousands)			
Net income	\$ 24,109	\$ 27,703	\$ 48,160	\$ 53,094
Foreign currency translation adjustment	2,810	2,925	4,599	2,536
<b>Comprehensive income</b>	<b>\$ 26,919</b>	<b>\$ 30,628</b>	<b>\$ 52,759</b>	<b>\$ 55,630</b>

### *Earnings Per Share*

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

The net income used in the basic and dilutive earnings per common share calculations is the same. The following table reconciles the number of common shares outstanding at June 30 of each year to the weighted average of common shares outstanding and the weighted average number of common and dilutive potential common shares outstanding for the purpose of calculating basic and diluted earnings per common share:

	Three months ended June 30,		Six months ended June 30,	
	2007	2008	2007	2008
	(In thousands)			
Number of common shares outstanding at end of period	40,436	39,655	40,436	39,655
Effect of using weighted average common shares outstanding		780	(29)	962
<b>Weighted average basic common shares outstanding</b>	<b>40,436</b>	<b>40,435</b>	<b>40,407</b>	<b>40,617</b>
Dilutive effect of common stock options	567	424	564	409
<b>Weighted average diluted common shares outstanding</b>	<b>41,003</b>	<b>40,859</b>	<b>40,971</b>	<b>41,026</b>

### *New Accounting Standards*

In December 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 141 (revised 2007), Business Combinations (SFAS 141(R)). SFAS 141(R) replaces Statement No. 141, Business Combinations . The statement retains the purchase method of accounting used in business combinations but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will adopt SFAS 141(R) on January 1, 2009 for business combinations we engage in on or after this date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements an amendment to ARB No. 51 (SFAS 160) which establishes accounting and reporting standards for noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The provision of SFAS 160 are effective for fiscal years beginning after December 15, 2008. The Company does not believe the provisions of this statement will materially effect the results of operations.



In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159)*. SFAS 159 permits entities to choose to measure eligible financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for years beginning after November 15, 2007. We adopted SFAS 159 on January 1, 2008 and did not elect to apply the fair value method to any eligible assets or liabilities at that time.

In September 2006, the FASB issued SFAS Statement No. 157, *Fair Value Measurements (SFAS 157)*, which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures under fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on February 12, 2008, the FASB issued FSP (FASB Staff Position) FAS 157-2 which would delay the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP partially defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. Effective January 1, 2008, we adopted SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-2. See Note 6 for further information on the impact of this standard to financial assets and liabilities.

### 3. Stock-Based Compensation and Stock Option Awards

During the three and six months ended June 30, 2008, the Company recognized approximately \$740,000 and \$1.5 million, respectively, of compensation expense compared to \$509,000 and \$1.0 million, respectively, for the three and six months ended June 30, 2007. Compensation expense is reported as selling, general and administrative expense, in the accompanying Condensed Consolidated Statements of Income. No stock-based compensation expense was capitalized during the three and six months ended June 30, 2008 and 2007. During the three and six months ended June 30, 2008 and 2007, there were no stock options granted. Refer to Note 12 of the Company's 2007 Form 10-K for additional information regarding stock-based compensation plans.

### 4. Inventories

Inventories consist of the following:

	December 31, 2007	June 30, 2008
	(In thousands)	
Raw materials and supplies	\$ 42,138	\$ 46,928
Work in progress	47,327	56,604
Finished goods	112,793	130,843
	202,258	234,375
Less: allowance for obsolete and excess inventory	(19,227)	(21,570)
	\$ 183,031	\$ 212,805

## 5. Geographic Areas

	Three months ended June 30,		Six months ended June 30,	
	2007	2008	2007	2008
	(In thousands)		(In thousands)	
<i>Revenues:</i>				
Western Hemisphere				
Products	\$ 44,391	\$ 53,734	\$ 95,117	\$ 120,207
Services	9,484	12,278	19,303	21,159
Intercompany	16,866	9,658	36,207	36,812
Total	\$ 70,741	\$ 75,670	\$ 150,627	\$ 178,178
Eastern Hemisphere				
Products	\$ 35,875	\$ 45,594	\$ 70,680	\$ 77,903
Services	7,389	8,359	13,794	17,501
Intercompany	1,064	55	1,282	987
Total	\$ 44,328	\$ 54,008	\$ 85,756	\$ 96,391
Asia Pacific				
Products	\$ 16,021	\$ 18,387	\$ 30,385	\$ 31,772
Services	1,541	4,192	3,104	6,415
Intercompany	1,321	799	4,516	1,376
Total	\$ 18,883	\$ 23,378	\$ 38,005	\$ 39,563
Summary				
Products	\$ 96,287	\$ 117,715	\$ 196,182	\$ 229,882
Services	18,414	24,829	36,201	45,075
Intercompany	19,251	10,512	42,005	39,175
Eliminations	(19,251)	(10,512)	(42,005)	(39,175)
Total	\$ 114,701	\$ 142,544	\$ 232,383	\$ 274,957
<i>Income before income taxes:</i>				
Western Hemisphere				
	\$ 19,166	\$ 17,189	\$ 41,323	\$ 46,024
Eastern Hemisphere				
	6,140	11,129	13,540	17,871
Asia Pacific				
	6,946	8,747	14,226	12,356
Eliminations	2,534	1,580	73	(1,248)
Total	\$ 34,786	\$ 38,645	\$ 69,162	\$ 75,003

	December 31, 2007	June 30, 2008
	(In thousands)	
<i>Total Long-Lived Assets:</i>		
Western Hemisphere	\$ 125,914	\$ 148,330
Eastern Hemisphere	29,169	30,561
Asia Pacific	15,496	16,404
Eliminations	(23,355)	(24,453)
 Total	 \$ 147,224	 \$ 170,842
<i>Total Assets:</i>		
Western Hemisphere	\$ 463,528	\$ 408,349
Eastern Hemisphere	167,128	175,822
Asia Pacific	78,494	100,724
Eliminations	(9,328)	(10,140)
 Total	 \$ 699,822	 \$ 674,755

#### 6. Fair Value of Financial Instruments

On January 1, 2008, we adopted SFAS No. 157 Fair Value Measurements ( SFAS 157 ) which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and expands disclosures under fair value measurements. In accordance with FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157 ( FSP 157-2 ), we will defer the adoption of SFAS 157 for our nonfinancial assets and nonfinancial liabilities, except those items recognized or disclosed at a fair value on an annual or more frequently recurring basis, until January 1, 2009. The adoption of SFAS 157 did not have an effect on our fair value measurements. We did not have any assets or liabilities that would be recognized or disclosed on a fair value basis as of June 30, 2008. Cash and cash equivalents include money market funds which are carried at cost.

#### 7. Share Repurchase Plan

In May 2008, the Company's Board of Directors approved a share repurchase program of up to \$100 million of the Company's common stock. As of June 30, 2008, 1,167,225 shares have been repurchased for a total of approximately \$67.9 million at an average price of \$58.14 per share (including commissions.) All repurchased shares were subsequently retired prior to the end of the second quarter. As of June 30, 2008, approximately \$32.1 million remained available under this program.

#### 8. Commitments and Contingencies

In August 2007, our Brazilian subsidiary was served with assessments collectively valued at approximately \$12.8 million from the State of Rio de Janeiro, Brazil, to collect a state tax on the importation of goods. We believe that our subsidiary is not liable for the taxes and plan to vigorously contest the assessments in the Brazilian administrative and judicial systems. At this time, the ultimate disposition of this matter cannot be determined and therefore, it is not possible to reasonably estimate the amount of loss or the range of possible losses that might result from an adverse judgment or settlement of these assessments. Accordingly, no liability has been accrued in conjunction with this matter. We do not expect the liability, if any, resulting from these assessments to have a material adverse effect on the Company's operations, financial position or cash flows.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following is management's discussion and analysis of certain significant factors that have affected certain aspects of the Company's financial position, results of operations and cash flows during the periods included in the accompanying unaudited condensed consolidated financial statements. This discussion should be read in conjunction with the unaudited condensed consolidated financial statements included elsewhere herein, the discussion under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the annual consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

**Overview**

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

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.

*Revenues.* Dril-Quip's revenues are generated from two sources: products and services. Product revenues are derived from the sale of offshore drilling and production equipment. Service revenues are earned when the Company provides installation and reconditioning services as well as rental of running tools for installation and retrieval of its products. For each of the six-month periods ended June 30, 2008 and 2007, the Company derived 84% of its revenues from the sale of its products and 16% of its revenues from services. Service revenues generally correlate to revenues from product sales because increased product sales normally generate increased revenues from installation services and rental of running tools. Substantially all of Dril-Quip's sales are made on a purchase order basis. Purchase orders are subject to change and/or termination at the option of the customer. In case of a change or termination, the customer is required to pay the Company for work performed and other costs necessarily incurred as a result of the change or termination.

The Company accounts for larger and more complex projects that have relatively longer manufacturing time frames on a percentage-of-completion basis. For the first six months of 2008, 21 projects representing approximately 30% of the Company's revenues were accounted for using percentage-of-completion accounting. This percentage may fluctuate in the future. Revenues accounted for in this manner 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 percent complete are reflected in the period when such estimates are revised. Losses, if any, are recognized when they first become known. Amounts received from customers in excess of revenues recognized are classified as a current liability.

The Company has substantial international operations, with approximately 72% and 66% of its revenues derived from foreign sales for each of the three-month periods ended June 30, 2008 and 2007, and 70% and 65% for each of the six-month periods ended June 30, 2008 and 2007, respectively.

*Cost of Sales.* The principal elements of cost of sales are labor, raw materials and manufacturing overhead. Cost of sales as a percentage of revenues is influenced by the product mix sold in any particular period and market conditions. The Company's costs related to its foreign operations do not significantly differ from its domestic costs.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses include the costs associated with sales and marketing, general corporate overhead, compensation expense, stock option expense, legal expenses, foreign currency transaction gains and losses, and other related administrative functions.

*Engineering and Product Development Expenses.* Engineering and product development expenses consist of new product development and testing, as well as application engineering related to customized products.

*Income Tax Provision.* Dril-Quip's effective income tax rate has historically been lower than the statutory rate primarily due to foreign income tax rate differentials.

## Results of Operations

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

	Three months ended June 30,		Six months ended June 30,	
	2007	2008	2007	2008
Revenues:				
Product Group	83.9%	82.6%	84.4%	83.6%
Service Group	16.1	17.4	15.6	16.4
Total	100.0	100.0	100.0	100.0
Cost of sales	56.2	58.7	56.9	58.7
Selling, general and administrative expenses	10.5	10.0	10.4	10.1
Engineering and product development expenses	4.6	4.8	4.5	4.8
Operating income	28.7	26.5	28.2	26.4
Interest income	1.7	0.6	1.6	0.9
Interest expense	(0.1)		(0.1)	
Income before income taxes	30.3	27.1	29.7	27.3
Income tax provision	9.3	7.7	9.0	8.0
Net income	21.0%	19.4%	20.7%	19.3%

### *Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007.*

*Revenues.* Revenues increased by \$27.8 million, or approximately 24.2%, to \$142.5 million in the three months ended June 30, 2008 from \$114.7 million in the three months ended June 30, 2007. The net increase resulted primarily from increased product revenues in the Western Hemisphere, Eastern Hemisphere and Asia-Pacific of \$9.3 million, \$9.7 million and \$2.4 million, respectively. Service revenues increased by approximately \$6.4 million from increased service revenues in the Western Hemisphere, Eastern Hemisphere and Asia-Pacific of \$2.8 million, \$1.0 million and \$2.6 million, respectively. In general, the increase in revenues resulted from increased demand for the Company's products and services realized on a worldwide basis as oil and gas companies have increased their levels of capital expenditures on exploration, drilling and production operations offshore. The increase in service revenues is normally a result of the increase in product sales. As product revenues increase, the demand for installation services is greater and the rental of running tools also increases.

*Cost of Sales.* Cost of sales increased by \$19.2 million, or approximately 29.8%, to \$83.7 million for the three months ended June 30, 2008 from \$64.5 million for the same period in 2007. As a percentage of revenues, cost of sales were approximately 58.7% and 56.2% for each of the three-month periods ended June 30, 2008 and 2007, respectively. The increase in cost of sales as a percentage of revenues resulted primarily from changes in product mix.

*Selling, General and Administrative Expenses.* For the three months ended June 30, 2008, selling, general and administrative expenses increased by approximately \$2.1 million, or 17.4%, to \$14.2 million from \$12.1 million in the 2007 period. The increase in selling, general and administrative expenses was primarily due to increased labor and overhead expenses resulting from increased staffing levels in the areas of sales, administration and finance. The Company experienced approximately \$1.1 million and \$600,000 in foreign currency transaction gains in the second quarter of 2008 and 2007, respectively. Stock option expense for the second quarter of 2008 totaled \$740,000 compared to \$509,000 in the second quarter of 2007. Selling, general and administrative expenses as a percentage of revenues decreased from 10.5% in 2007 to 10% in 2008.

*Engineering and Product Development Expenses.* For the three months ended June 30, 2008, engineering and product development expenses increased by approximately \$1.6 million, or 30.2%, to \$6.9 million from \$5.3 million in the same period of 2007. This increase was primarily due to an increase in personnel and associated operating expenses. Engineering and product development expenses as a percentage of revenues increased from 4.6% in 2007 to 4.8% in 2008.

*Interest Income.* Interest income for the three months ended June 30, 2008 was approximately \$929,000 as compared to \$2.0 million for the three-month period ended June 30, 2007. This decrease was due to a reduction in interest earned on short-term investments resulting from lower interest rates and reduced balances in short-term investments. Short-term investment balances declined primarily as a result of expenditures of \$67.9 million related to the Company's share repurchase program.

*Interest expense.* Interest expense for the three months ended June 30, 2008 was \$44,000 compared to \$61,000 for the same period in 2007.

*Income tax provision.* Income tax expense for the three months ended June 30, 2008 was \$10.9 million on income before taxes of \$38.6 million, resulting in an effective tax rate of approximately 28%. Income tax expense for the three months ended June 30, 2007 was \$10.7 million on income before taxes of \$34.8 million, resulting in an effective tax rate of approximately 31%. This decrease in the effective tax rate reflects a reduction in foreign tax rates resulting from a foreign development tax incentive.

*Net Income.* Net income was approximately \$27.7 million for the three months ended June 30, 2008 and \$24.1 million for the same period in 2007, for the reasons set forth above.

*Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007.*

*Revenues.* Revenues increased by \$42.6 million, or approximately 18.3%, to \$275.0 million in the six months ended June 30, 2008 from \$232.4 million in the six months ended June 30, 2007. The net increase resulted primarily from increased product revenues in the Western Hemisphere, Eastern Hemisphere and Asia-Pacific of \$25.1 million, \$7.2 million and \$1.4 million, respectively. Service revenues increased by approximately \$8.9 million from increased service revenues in the Western Hemisphere, Eastern Hemisphere and Asia Pacific of \$1.9 million, \$3.7 million and \$3.3 million, respectively. In general, the increase in revenues resulted from increased demand for the Company's products and services realized on a worldwide basis as oil and gas companies have increased their levels of capital expenditures on exploration, drilling and production operations offshore. The increase in service revenues is normally a result of the increase in product sales.

*Cost of Sales.* Cost of sales increased by \$29.3 million, or approximately 22.2%, to \$161.5 million for the six months ended June 30, 2008 from \$132.2 million for the same period in 2007. As a percentage of revenues,

cost of sales were approximately 58.7% and 56.9% for the six-month periods ended June 30, 2008 and 2007, respectively. The increase in cost of sales as a percentage of revenues resulted primarily from changes in product mix.

*Selling, General and Administrative Expenses.* For the six months ended June 30, 2008, selling, general and administrative expenses increased by approximately \$3.7 million, or 15.4%, to \$27.8 million from \$24.1 million in the 2007 period. The increase in selling, general and administrative expenses was primarily due to increased labor and overhead expenses resulting from increased staffing levels in the areas of sales, administration and finance. The Company experienced approximately \$1.6 million and \$600,000 in foreign currency transaction gains in the first six months of 2008 and 2007, respectively. Stock option expense for the first six months of 2008 totaled \$1.5 million compared to \$1.0 million in the first six months of 2007. Selling, general and administrative expenses as a percentage of revenues decreased from 10.4% in 2007 to 10.1% in 2008.

*Engineering and Product Development Expenses.* For the six months ended June 30, 2008, engineering and product development expenses increased by \$2.6 million, or approximately 24.8%, to \$13.1 million from \$10.5 million in the same period of 2007. This increase was due primarily to an increase in personnel and associated operating expenses. Engineering and product development expenses as a percentage of revenues increased from 4.5% in 2007 to 4.8% in 2008.

*Interest Income.* Interest income for the six months ended June 30, 2008 was \$2.6 million as compared to \$3.7 million for the six-month period ended June 30, 2007. This decrease was due to a reduction in interest earned on short-term investments resulting from lower interest rates and reduced balances in short-term investments. Short-term investment balances declined primarily as a result of expenditures of \$67.9 million related to the Company's share repurchase program.

*Interest Expense.* Interest expense for the six months ended June 30, 2008 was \$102,000 compared to \$158,000 for the same period in 2007.

*Income tax provision.* Income tax expense for the six months ended June 30, 2008 was \$21.9 million on income before taxes of \$75.0 million, resulting in an effective tax rate of approximately 29%. Income tax expense for the six months ended June 30, 2007 was \$21.0 million on income before taxes of \$69.2 million, resulting in an effective tax rate of approximately 30%.

*Net Income.* Net income was approximately \$53.1 million for the six months ended June 30, 2008 and \$48.2 million for the same period in 2007, for the reasons set forth above.

## **Liquidity and Capital Resources**

The primary liquidity needs of the Company are (i) to fund capital expenditures to improve and expand facilities and manufacture additional running tools and (ii) to fund working capital. Recently, the Company's principal source of funds has been cash flows from operations.

Net cash provided by operating activities was approximately \$6.4 million and \$41.2 million for the six months ended June 30, 2008 and 2007, respectively. The decrease in cash flow provided by operations was principally due to increases in trade receivables and inventory in the Western Hemisphere.

Capital expenditures by the Company were \$30.2 million and \$9.6 million for the six months ended June 30, 2008 and 2007, respectively. The capital expenditures for the six months ended June 30, 2008 were primarily \$14.3 million for machinery and equipment, \$7.6 million for facilities and \$7.0 million for running tools and other expenditures of \$1.3 million. The capital expenditures for the six months ended June 30, 2007 were primarily \$3.3 million for machinery and equipment, \$1.4 million for facilities, \$2.9 million for running tools

and other expenditures of \$2.0 million. Principal payments on long term debt were \$439,000 for the six-month period ended June 30, 2008 and \$425,000 for the same period in 2007. There were no new long-term borrowings during the six months ended June 30, 2008 and 2007.

In May 2008 the Company announced that its Board of Directors had authorized a share repurchase program under which the Company can repurchase up to \$100 million of its common stock. As of June 30, 2008, the Company had repurchased 1,167,225 shares at an average price of \$58.14 per share (including commissions) for a total of approximately \$67.9 million. All repurchased shares were retired prior to the end of the second quarter.

The Company has a credit facility with Guaranty Bank, FSB providing an unsecured revolving line of credit of up to \$10 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 June 1, 2009. The facility also contains certain covenants including maintaining minimum tangible net worth levels, not exceeding specified funded debt amounts and required interest coverage ratios. As of June 30, 2008, the Company had no borrowings under this facility and was in compliance with all loan covenants.

Dril-Quip (Europe) Limited has a credit agreement with the Bank of Scotland dated March 21, 2001 in the original amount of U.K. Pounds Sterling 4.0 million (approximately U.S. \$8.0 million). Borrowing under this facility bears interest at the Bank of Scotland base rate, which was 5.0% at June 30, 2008, 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. The outstanding balance of this facility at June 30, 2008 was approximately U.S. \$2.3 million. The facility is secured by land and buildings in Aberdeen, Scotland and contains no restrictive financial covenants.

The Company believes that cash generated from operations plus cash on hand and its current line of credit will be sufficient to fund operations, working capital needs and anticipated capital expenditure requirements in 2008. 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.

#### **Critical Accounting Policies**

Refer to our Annual Report on Form 10-K for the year ended December 31, 2007 for a discussion of our critical accounting policies. During the six months ended June 30, 2008 there were no material changes in our judgments and assumptions associated with the development of our critical accounting policies.

#### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

The Company is currently exposed to certain market risks related to interest rate changes and fluctuations in foreign exchange rates. The Company does not engage in any material hedging transactions, forward contracts or currency trading which could be subject to market risks inherent to such transactions.

#### **Foreign Exchange Rate Risk**

Through its subsidiaries, the Company conducts a portion of its business in currencies other than the United States dollar, principally the British pound sterling and to a lesser extent, the Brazilian real. The Company experienced a foreign currency pre-tax gain of approximately \$1.1 million and \$1.6 million during the three and six-month periods ended June 30, 2008, respectively, compared to approximately \$600,000 for each of the three and six-month periods ended June 30, 2007. Historically, the Company's foreign currency gains and losses have not been significant. However, when significant disparities between the British pound sterling and the U.S. dollar or the Brazilian real and the U.S. dollar occur, there can be no assurance that the Company will be able to protect itself against such currency fluctuations.

### **Interest Rate Risk**

As described in Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, the Company has entered into two credit facilities or loans that require the Company to pay interest at a floating rate. These floating-rate obligations expose the Company to the risk of increased interest expense in the event of increases in the short-term interest rates. Based upon the June 30, 2008 balance of approximately \$2.3 million related to these floating rate obligations, each 1.0% rise in interest rates would result in additional annual interest expense to the Company of approximately \$23,000 or \$5,750 per quarter.

### **Item 4. Controls and Procedures**

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including the Company's Co-Chief Executive Officers and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's Co-Chief Executive Officers and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2008 to provide reasonable assurance that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and such information is accumulated and communicated to management, including the Company's Co-Chief Executive Officers and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

Management's Annual Reports on Internal Control over Financial Reporting appears on page 30 of the 2007 annual report on Form 10-K.

There has been no change in the Company's internal controls over financial reporting that occurred during the six months ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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**PART II OTHER INFORMATION**
**Item 1. Legal Proceedings.**

See Legal Proceedings in Item 3 of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2007. The Company also 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 1A. Risk Factors.**

There have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

In May 2008, the Company announced that its Board of Directors had authorized a share repurchase program under which the Company can repurchase up to \$100 million of its common stock. The following table summarizes the purchases of our common stock during the three months ended June 30, 2008.

**Issuer Purchase of Equity Securities**

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan or Program
April 1-30, 2008				
May 1-31, 2008	270,469	\$ 58.17	270,469	
June 1-30, 2008	896,756	58.13	896,756	
Total	1,167,225	\$ 58.14	1,167,225	\$ 32,139,671

**Item 3. Defaults Upon Senior Securities.**

None.

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

Dril-Quip's annual meeting of stockholders was held on May 15, 2008 for the purpose of electing two directors to serve for three-year terms and approving the appointment of BDO Seidman, LLP as independent registered public accountants of the Company for 2008.

*1. Election of Directors*

Stockholders elected J. Mike Walker and John V. Lovoi, each for a three-year term expiring at the 2011 annual meeting. The vote tabulation was as follows:

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<b>Director</b>	<b>Votes Cast For</b>	<b>Votes Cast Against Or Withhold</b>
J. Mike Walker	38,179,843	1,102,248
John V. Lovoi	37,758,123	1,523,968

Directors continuing in office were Larry E. Reimert, Gary D. Smith, Gary L. Stone, Alexander P. Shukis and L.H. Dick Robertson.

2. Proposal approving the appointment of BDO Seidman, LLP as independent registered public accountants of the Company for 2008.

For	39,262,584
Against	10,595
Abstain	8,912

**Item 5. Other Information.**

**FORWARD LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q includes certain statements that may be 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 the control of Dril-Quip, Inc. (the Company or Dril-Quip). You can identify the Company's forward-looking statements by the words anticipate, estimate, expect, may, project, believe and similar expressions, or by the Company's discussion of strategies or trends. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, no assurance can be given that these expectations will prove to be correct. These forward-looking statements include the following types of information and statements as they relate to the Company:

future operating results and cash flow;

scheduled, budgeted and other future capital expenditures;

working capital requirements;

the availability of expected sources of liquidity;

the introduction into the market of the Company's future products;

the market for the Company's existing and future products;

the Company's ability to develop new applications for its technologies;

the exploration, development and production activities of the Company's customers;

compliance with present and future environmental regulations and costs associated with environmentally related penalties, capital expenditures, remedial actions and proceedings;

effects of pending legal proceedings; and

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future operations, financial results, business plans and cash needs.

These statements are based on assumptions and analyses in light of the Company's experience and perception of historical trends, current conditions, expected future developments and other factors the Company believes were appropriate in the circumstances when the statements were made. Forward-looking statements by their nature involve substantial risks and uncertainties that could significantly impact expected results, and actual future results could differ materially from those described in such statements. While it is not possible to identify all factors, the Company continues to face many risks and uncertainties. Among the factors that could cause actual future results to differ materially are the risks and uncertainties discussed under Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 and the following:

the volatility of oil and natural gas prices;

the cyclical nature of the oil and gas industry;

uncertainties associated with the United States and worldwide economies, including those due to political tensions in the Middle East and elsewhere;

current and potential governmental regulatory actions in the United States and regulatory actions and political unrest in other countries;

operating interruptions (including explosions, fires, weather-related incidents, mechanical failure, unscheduled downtime, labor difficulties, transportation interruptions, spills and releases and other environmental risks);

the Company's reliance on product development;

technological developments;

the Company's dependence on key employees and skilled machinists, fabricators and technical personnel;

the Company's reliance on sources of raw materials;

control by certain stockholders;

impact of environmental matters;

competitive products and pricing pressures;

fluctuations in foreign currency;

the Company's reliance on significant customers;

creditworthiness of the Company's customers;

access to capital markets; and

war and terrorist acts.

Many of such factors are beyond the Company's ability to control or predict. Any of the factors, or a combination of these factors, could materially affect the Company's future results of operations and the ultimate accuracy of the forward-looking statements. Management cautions against putting undue reliance on forward-looking statements or projecting any further results based on such statements or present or prior earnings levels. Every forward-looking statement speaks only as of the date of the particular statement, and the Company undertakes no obligation to publicly update or revise any forward-looking statement.



**Item 6.**

The following exhibits are filed herewith:

Articles 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)).

Amended and Restated Bylaws of the Company (Incorporated herein by reference to Exhibit 3.1 to the Company's report on Form 8-K dated December 21, 2007.)

Amended and Restated Charter of the Company's Independent Non-Director Members of the Board of Directors (Incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).

Share Purchase 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(a) Certification of Larry E. Reimert.

4(a) Certification of Gary D. Smith.

4(a) Certification of J. Mike Walker.

4(a) Certification of Jerry M. Brooks.

4(a) Certification of Larry E. Reimert.

4(a) Certification of Gary D. Smith.

4(a) Certification of J. Mike Walker.

4(a) Certification of Jerry M. Brooks.

\* Incorporated herein by reference as indicated.

**SIGNATURE**

Pursuant to the requirements 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.

**DRIL-QUIP, INC.**

By: /s/ JERRY M. BROOKS  
**Jerry M. Brooks,**

**Chief Financial Officer  
(Principal Accounting Officer and**

**Duly Authorized Signatory)**

Date: August 7, 2008