DRIL-QUIP INC
Form 10-Q
August 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(MARK ONE)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

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 ¨ Accelerated filer x Non-accelerated filer ¨

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

As of August 7, 2006, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 19,561,425.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2005	June 30, 2006
	(In thousands)	
ASSETS		(Unaudited)
Current assets:		
Cash and cash equivalents	$ 32,762	$ 62,768
Trade receivables, net	108,330	126,973
Inventories, net	155,157	159,975
Deferred income taxes	9,333	12,325
Prepaids and other current assets	5,634	4,660
Total current assets	311,216	366,701
Property, plant and equipment, net	116,583	123,943
Other assets	463	396
Total assets	$ 428,262	$ 491,040
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 48,111	$ 31,828
Current maturities of long-term debt	734	776
Accrued income taxes	6,401	10,940
Customer prepayments	11,634	31,241
Accrued compensation	8,782	7,229
Other accrued liabilities	14,662	15,628
Total current liabilities	90,324	97,642
Long-term debt	3,113	2,983
Deferred income taxes	5,363	5,315
Total liabilities	98,800	105,940
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, 19,271,973 and 19,560,550 shares issued and outstanding at December 31, 2005 and June 30, 2006, respectively	193	196
Additional paid-in capital	152,571	164,551
Retained earnings	177,729	216,321
Foreign currency translation adjustment	(1,031)	4,032
Total stockholders equity	329,462	385,100
Total liabilities and stockholders equity	$ 428,262	$ 491,040

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended June 30, 2005	Three months ended June 30, 2006	Six months ended June 30, 2005	Six months ended June 30, 2006
	(In thousands except share data)			
Revenues	$ 80,616	$ 108,476	$ 150,620	$ 206,674
Cost and expenses:				
Cost of sales	55,783	63,892	104,727	121,055
Selling, general and administrative	9,459	9,210	18,952	20,387
Engineering and product development	5,689	4,821	10,698	9,716
	70,931	77,923	134,377	151,158
Operating income	9,685	30,553	16,243	55,516
Interest expense (income)	410	(352)	774	(461)
Income before income taxes	9,275	30,905	15,469	55,977
Income tax provision	2,615	9,632	4,460	17,385
Net income	$ 6,660	$ 21,273	$ 11,009	$ 38,592
Earnings per common share:				
Basic	$ 0.38	$ 1.09	$ 0.63	$ 1.98
Diluted	$ 0.37	$ 1.06	$ 0.62	$ 1.92
Weighted average common shares:				
Basic	17,466,052	19,546,976	17,458,021	19,459,434
Diluted	17,817,188	20,131,399	17,817,498	20,053,834

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, 2005	Six months ended June 30, 2006
	(In thousands)	
Operating activities		
Net income	$ 11,009	$ 38,592
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	6,710	7,165
Stock-based compensation expense		853
Gain on sale of equipment	(54)	(52)
Deferred income taxes	(519)	(2,979)
Changes in operating assets and liabilities:		
Trade receivables, net	(8,091)	(14,381)
Inventories, net	(23,127)	(51)
Prepaids and other assets	217	1,233
Trade accounts payable and accrued expenses	13,127	4,771
Net cash provided by (used in) operating activities	(728)	35,151
Investing activities		
Purchase of property, plant and equipment	(8,845)	(12,264)
Proceeds from sale of equipment	511	142
Net cash used in investing activities	(8,334)	(12,122)
Financing activities		
Proceeds from revolving line of credit and long-term borrowings	8,600	35
Principal payments on revolving line of credit and long-term debt	(482)	(391)
Proceeds from exercise of stock options	3,600	6,628
Excess tax benefit-stock options	514	4,502
Net cash provided by financing activities	12,232	10,774
Effect of exchange rate changes on cash activities	140	(3,797)
Increase in cash and cash equivalents	3,310	30,006
Cash and cash equivalents at beginning of period	5,159	32,762
Cash and cash equivalents at end of period .	$ 8,469	$ 62,768

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, 2005, 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, 2006, the results of operations for each of the three and six-month periods ended June 30, 2006 and 2005, and the cash flows for each of the six-month periods ended June 30, 2006 and 2005. 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 six-month period ended June 30, 2006 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, 2005.

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 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, 2005.

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Cash and cash equivalents

Investments that have a maturity of three months or less from the date of purchase are classified as cash equivalents.

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. Inventory is valued principally using standard costs that 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 \$17.8 million and \$10.0 million were recorded as of June 30, 2006 and 2005, 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. 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 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. Losses, if any, on contracts are fully 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 current 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 condensed consolidated statements of income.

Stock-Based Compensation

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.

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

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. On May 13, 2004, the Company s stockholders approved the 2004 Incentive Plan of Dril-Quip, Inc. (the 2004 Plan), which reserved up to 1,348,147 shares of Common Stock to be used in connection with the 2004 Plan. Options under both plans are granted at the fair market value of the common stock at the grant date. No options have been granted under the 2004 Plan and no additional options will be awarded under the 1997 Plan. No options were issued during the first six months of 2005 and 2006.

Effective January 1, 2006, the Company adopted SFAS No. 123 - Revised 2004, Stock-Based Payment (SFAS 123(R)) using the modified prospective application and accordingly, no prior periods have been restated. The Company is recognizing compensation expense for the unvested portion of awards outstanding at January 1, 2006 ratably over the remaining vesting period based on the fair value at the date of the grant. The fair value of the options was estimated using the Black-Scholes option pricing model.

Prior to adopting SFAS 123(R), the Company accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and complied with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation . Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company s stock and the exercise price of the option. No stock-based employee compensation cost was recognized in the Company s financial statements for the period ended June 30, 2005, as all options previously granted had an exercise price equal to the market value of the underlying common stock on the date of the grant.

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 customers financial condition and generally does not require collateral. The Company maintains reserves for potential losses and such losses have historically been within management s expectations.

Comprehensive Income

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

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following table provides comprehensive income for the periods indicated:

	Three months ended June 30, 2005	Three months ended June 30, 2006	Six months ended June 30, 2005	Six months ended June 30, 2006
	(In thousands)			
Net income	$ 6,660	$ 21,273	$ 11,009	$ 38,592
Foreign currency translation adjustment	(3,570)	4,135	(4,654)	5,063
Comprehensive income	$ 3,090	$ 25,408	$ 6,355	$ 43,655

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.

The net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the number of common shares outstanding at June 30 of each year to the weighted average 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, 2005	Three months ended June 30, 2006	Six months ended June 30, 2005	Six months ended June 30, 2006
	(In thousands)		(In thousands)	
Number of common shares outstanding at end of period	17,466	19,561	17,466	19,561
Effect of using weighted average common shares outstanding		(14)	(8)	(102)
Weighted average basic common shares outstanding	17,466	19,547	17,458	19,459
Dilutive effect of common stock options	351	584	359	595
Weighted average diluted common shares outstanding	17,817	20,131	17,817	20,054

New Accounting Standard

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109 (FIN 48), which clarifies the accounting for uncertainty in income tax positions. This interpretation 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. The provisions of FIN 48 are effective for fiscal years beginning after December 31, 2006. The Company is evaluating the impact of adopting FIN 48 on its consolidated financial statements.

3. Stock-Based Compensation and Stock Option Awards

As a result of adopting SFAS No. 123(R), stock-based compensation expense recognized during the three and six months ended June 30, 2006 totaled $429,000 and $853,000, respectively, related to unvested outstanding stock option grants and no stock-based compensation expenses were capitalized. The Company s income net of income taxes for the three and six months ended June 30, 2006 was $285,000 and $567,000 lower, respectively, than if the Company had continued to account for stock-based compensation under APB Opinion No. 25.

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Had stock-based compensation expense for the Company s plans been determined based on the fair value at the grant dates for awards consistent with the method available under SFAS No. 123, the Company s net income and earnings per share for the three and six months ended June 30, 2005 would have been reduced to the pro forma amounts listed below.

	Three months ended June 30, 2005	Six months ended June 30, 2005
	(In thousands,	