DRIL-QUIP INC
Form 10-Q
July 30, 2015

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, 2015

OR

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

Commission file number 001-13439

DRIL-QUIP, INC.

(Exact name of registrant as specified in its charter)

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

6401 N. ELDRIDGE PARKWAY

HOUSTON, TEXAS

77041

(Address of principal executive offices) (Zip Code)

(713) 939-7711

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of July 27, 2015, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 38,705,278.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2015	December 31, 2014
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 382,673	$ 298,705
Trade receivables, net	299,398	373,993
Inventories, net	383,773	392,559
Deferred income taxes	27,028	23,569
Prepaids and other current assets	38,099	38,314
Total current assets	1,130,971	1,127,140
Property, plant and equipment, net	301,635	309,525
Other assets	14,180	12,586
Total assets	$ 1,446,786	$ 1,449,251
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 39,520	$ 53,837
Accrued income taxes	9,515	16,903
Customer prepayments	39,608	71,177
Accrued compensation	19,097	21,527
Other accrued liabilities	18,977	35,198
Total current liabilities	126,717	198,642
Deferred income taxes	4,298	5,417
Total liabilities	131,015	204,059
Commitments and contingencies (Note 7)		
Stockholders equity:		
Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued)		
Common stock:		
100,000,000 shares authorized at $0.01 par value at June 30, 2015 and December 31, 2014, 38,705,278 and 38,932,508 shares issued and outstanding at June 30, 2015 and December 31, 2014	385	388

Additional paid-in capital	4,880	16,480
Retained earnings	1,371,403	1,278,528
Accumulated other comprehensive losses	(60,897)	(50,204)
Total stockholders equity	1,315,771	1,245,192
Total liabilities and stockholders equity	$ 1,446,786	$ 1,449,251

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
	(In thousands, except per share data)			
Revenues:				
Products	$ 176,099	$ 189,914	$ 363,623	$ 361,915
Services	39,177	40,401	77,655	72,473
Total revenues	215,276	230,315	441,278	434,388
Cost and expenses:				
Cost of sales:				
Products	98,349	104,208	204,356	195,539
Services	19,315	20,785	38,446	40,241
Total cost of sales	117,664	124,993	242,802	235,780
Selling, general and administrative	33,633	25,520	50,591	49,455
Engineering and product development	11,400	10,848	23,613	21,632
Total costs and expenses	162,697	161,361	317,006	306,867
Operating income	52,579	68,954	124,272	127,521
Interest income	165	266	214	349
Interest expense	(3)	(5)	(6)	(12)
Income before income taxes	52,741	69,215	124,480	127,858
Income tax provision	13,528	17,891	31,603	33,916
Net income	$ 39,213	$ 51,324	$ 92,877	$ 93,942
Earnings per common share:				
Basic	$ 1.01	$ 1.27	$ 2.40	$ 2.32
Diluted	$ 1.01	$ 1.27	$ 2.39	$ 2.31
Weighted average common shares outstanding:				
Basic	38,686	40,327	38,729	40,501
Diluted	38,888	40,562	38,912	40,723

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

	Three months ended June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
	(In thousands)			
Net income	$ 39,213	$ 51,324	$ 92,877	$ 93,942
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	21,841	10,699	(10,693)	16,428
Total comprehensive income	$ 61,054	$ 62,023	$ 82,184	$ 110,370

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six months ended June 30, 2015	Six months ended June 30, 2014
	(In thousands)	
Operating activities		
Net income	$ 92,877	$ 93,942
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	15,139	15,126
Stock-based compensation expense	6,482	5,660
Loss (gain) on sale of equipment	75	(149)
Deferred income taxes	(4,935)	(2,507)
Changes in operating assets and liabilities:		
Trade receivables, net	70,508	(33,272)
Inventories, net	3,348	(32,708)
Prepaids and other assets	(2,958)	3,194
Excess tax benefits of stock options and awards	(57)	(251)
Accounts payable and accrued expenses	(67,468)	17,637
Net cash provided by operating activities	113,011	66,672
Investing activities		
Purchase of property, plant and equipment	(11,204)	(23,218)
Proceeds from sale of equipment	136	470
Net cash used in investing activities	(11,068)	(22,748)
Financing activities		
Repurchase of common stock	(19,943)	(90,022)
Proceeds from exercise of stock options	1,952	1,386
Excess tax benefits of stock options and awards	57	251
Net cash used in financing activities	(17,934)	(88,385)
Effect of exchange rate changes on cash activities	(41)	2,726
Increase (decrease) in cash and cash equivalents	83,968	(41,735)
Cash and cash equivalents at beginning of period	298,705	384,356
Cash and cash equivalents at end of period	$ 382,673	$ 342,621

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

DRIL-QUIP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Organization and Principles of Consolidation

Dril-Quip, Inc., a Delaware corporation (the Company or Dril-Quip), designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. The Company s principal products consist of subsea and surface wellheads, subsea and surface production trees, subsea control systems and manifolds, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, liner hangers, wellhead connectors and diverters. Dril-Quip s products are used by major integrated, large independent and foreign national oil and gas companies in offshore areas throughout the world. Dril-Quip also provides technical advisory assistance on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products. In addition, Dril-Quip s customers may rent or purchase running tools from the Company for use in the installation and retrieval of the Company s products.

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

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2014, 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, 2015 and the results of operations and comprehensive income for the three- and six-month periods ended June 30, 2015 and 2014 and the cash flows for the six-month periods ended June 30, 2015 and 2014. Certain information and footnote disclosures normally included in the 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. Management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate. The results of operations, comprehensive income and the cash flows for the six-month period ended June 30, 2015 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2014.

2. Significant Accounting Policies

Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated.

Revisions

The Company has corrected its Condensed Consolidated Statements of Cash Flow for the six-month period ended June 30, 2014, to reflect a $6.7 million reclassification adjustment from changes in prepaids and other assets to changes in accounts payable and accrued expenses related to the 2014 beginning balances. There was no impact on the net cash provided by operating activities or any other reported cash flow amounts as a result of the reclassifications. The Company has evaluated the impact of this revision and determined that it was not material.

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.

Revenue Recognition

Product Revenue

The Company earns product revenues from two methods:

- product revenues recognized under the percentage-of-completion method; and
- product revenues from the sale of products that do not qualify for the percentage-of-completion method.

Revenues recognized under the percentage-of-completion method

The Company uses the percentage-of-completion method on long-term project contracts that have the following characteristics:

- The contracts call for products which are designed to customer specifications;
- The structural designs are unique and require significant engineering and manufacturing efforts generally requiring more than one year in duration;
- The contracts contain specific terms as to milestones, progress billings and delivery dates; and
- Product requirements cannot be filled directly from the Company s standard inventory.

For each project, the Company prepares a detailed analysis of estimated costs, profit margin, completion date and risk factors which include availability of material, production efficiencies and other factors that may impact the project. On a quarterly basis, management reviews the progress of each project, which may result in revisions of previous estimates, including revenue recognition. The Company calculates the percent complete and applies the percentage to determine the revenues earned and the appropriate portion of total estimated costs. Losses, if any, are recorded in full in the period they become known. Historically, the Company s estimates of total costs and costs to complete have approximated actual costs incurred to complete the project.

Under the percentage-of-completion method, billings may not correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the Condensed Consolidated Balance Sheets. Likewise, revenue recognized may exceed customer billings in which case the amounts are reported in trade receivables. Unbilled revenues are expected to be billed and collected within one year. At June 30, 2015 and December 31, 2014, receivables included $77.6 million and $68.0 million of unbilled receivables, respectively. For the quarter ended June 30, 2015, there were 10 projects representing approximately 17% of the Company s total revenue and approximately 21% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 12 projects during the second quarter of 2014, which represented approximately 5% of the Company s total revenues and approximately 6% of its product revenues. For the six months ended June 30, 2015, there were 13 projects representing approximately 16% of the Company s total revenues and approximately 19% of its product revenues, compared to 16 projects that represented approximately 8% of the Company s total revenues and approximately 10% of its product revenues for the six months ended June 30, 2014, all of which were accounted for using percentage-of-completion accounting.

Revenues not recognized under the percentage-of-completion method

Revenues from the sale of inventory products, not accounted for under the percentage-of-completion method, are recorded at the time the manufacturing processes are complete and ownership is transferred to the customer.

Service revenue

The Company earns service revenues from three sources:

- technical advisory assistance;
- rental of running tools; and
- rework and reconditioning of customer-owned Dril-Quip products.

The Company does not install products for its customers, but it does provide technical advisory assistance. At the time of delivery of the product, the customer is not obligated to buy or rent the Company s running tools and the Company is not obligated to perform any subsequent services relating to installation. Technical advisory assistance service revenue is recorded at the time the service is rendered. Service revenues associated with the rental of running and installation tools are recorded as earned. Rework and reconditioning service revenues are recorded when the refurbishment process is complete.

The Company normally negotiates contracts for products, including those accounted for under the percentage-of-completion method, and services separately. For all product sales, it is the customer s decision as to the timing of the product installation as well as whether Dril-Quip running tools will be purchased or rented. Furthermore, the customer is under no obligation to utilize the Company s technical advisory assistance services. The customer may use a third party or their own personnel.

Fair Value of Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, receivables and payables. The carrying values of these financial instruments approximate their respective fair values as they are short-term in nature.

Earnings Per Share

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

In each relevant period, the net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the weighted average basic number of common shares outstanding and the weighted average diluted number of common shares outstanding for the purpose of calculating basic and diluted earnings per share:

	Three months ended June 30,		**Six months ended June 30,**	
	2015	**2014**	**2015**	**2014**
	(In thousands)			
Weighted average common shares outstanding basic	38,686	40,327	38,729	40,501
Dilutive effect of common stock options and awards	202	235	183	222
Weighted average common shares outstanding diluted	38,888	40,562	38,912	40,723

3. New Accounting Standards

In May 2014, the FASB issued ASU 2014-09 Revenue from Contracts with Customers (Topic 606). The amendment applies a new five-step revenue recognition model to be used in recognizing revenues associated with customer contracts. The amendment requires disclosure sufficient to enable readers of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill the contract. The standard s effective date was originally for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. On April 1, 2015, the FASB voted to defer the effective date by one year to December 15, 2017 and interim periods within annual reporting periods beginning after December 15, 2017. The Company is currently evaluating the new guidance to determine the impact on its consolidated financial statements.

4. Stock-Based Compensation and Stock Awards

During the three months ended June 30, 2015 and 2014, the Company recognized approximately $3.1 million and $2.8 million, respectively, of stock-based compensation expense, which is included in the selling, general and administrative expense line on the Condensed Consolidated Statements of Income. For the six months ended June 30, 2015 and 2014, stock-based compensation expense totaled $6.5 million and $5.7 million, respectively. No stock-based compensation expense was capitalized during the three or six months ended June 30, 2015 or 2014.

5. Inventories, net

Inventories consist of the following:

	June 30, 2015	December 31, 2014
	(In thousands)	
Raw materials	$ 111,587	$ 107,357
Work in progress	108,110	112,514
Finished goods	200,646	207,295
	420,343	427,166
Less: allowance for obsolete and excess inventory	(36,570)	(34,607)
Total inventory	$ 383,773	$ 392,559

6. Geographic Areas

	Three months ended June 30,		Six months ended June 30,	
	2015	2014	2015	2014
	(In thousands)			
Revenues:				
Western Hemisphere				
Products	$ 82,560	$ 115,953	$ 174,375	$ 210,342
Services	21,498	18,381	43,807	