DRIL-QUIP INC
Form 10-Q
July 28, 2017

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

FORM 10-Q

(MARK ONE)

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

For the Quarterly Period Ended June 30, 2017

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 ý 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 ý No ¨

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

As of July 27, 2017, the number of shares outstanding of the registrant’s common stock, par value $0.01 per share, was 37,838,090.

TABLE OF CONTENTS

Table of Contents

PART I—FINANCIAL INFORMATION
Item 1. Financial Statements
DRIL-QUIP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2017	December 31, 2016
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$436,987	$423,497
Trade receivables, net	221,567	213,513
Inventories, net	330,510	355,413
Deferred income taxes	—	24,497
Prepaids and other current assets	35,831	39,791
Total current assets	1,024,895	1,056,711
Property, plant and equipment, net	314,610	323,149
Deferred income taxes	23,618	1,699
Goodwill	47,882	34,371
Intangible assets	39,484	29,594
Other assets	16,424	15,880
Total assets	$1,466,913	$1,461,404
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,356	$36,108
Accrued income taxes	21,498	24,543
Customer prepayments	5,391	11,884
Accrued compensation	17,720	10,829
Other accrued liabilities	17,285	18,116
Total current liabilities	86,250	101,480
Deferred income taxes	2,345	3,500
Total liabilities	88,595	104,980
Commitments and contingencies (Note 10)		
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, 37,835,792 and 37,797,317 shares issued and outstanding at June 30, 2017 and December 31, 2016	375	375
Additional paid-in capital	12,654	5,468
Retained earnings	1,501,097	1,500,988
Accumulated other comprehensive losses	(135,808)	(150,407)
Total stockholders' equity	1,378,318	1,356,424
Total liabilities and stockholders' equity	$1,466,913	$1,461,404

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

Table of Contents

DRIL-QUIP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	(In thousands, except per share data)			
Revenues:				
Products	$102,092	$116,048	$193,684	$251,242
Services	25,830	26,391	53,466	57,758
Total revenues	127,922	142,439	247,150	309,000
Cost and expenses:				
Cost of sales:				
Products	74,991	65,407	141,453	142,329
Services	12,558	14,474	28,536	30,648
Total cost of sales	87,549	79,881	169,989	172,977
Selling, general and administrative	31,179	5,762	56,987	18,983
Engineering and product development	10,308	11,579	22,158	22,480
Total costs and expenses	129,036	97,222	249,134	214,440
Operating income (loss)	(1,114)	45,217	(1,984)	94,560
Interest income	1,070	541	2,007	1,023
Interest expense	(18)	(10)	(33)	(14)
Income before income taxes	(62)	45,748	(10)	95,569
Income tax provision (benefit)	(77)	9,611	(120)	22,663
Net income	$15	$36,137	$110	$72,906
Earnings per common share:				
Basic	$—	$0.96	$—	$1.94
Diluted	$—	$0.96	$—	$1.93
Weighted average common shares outstanding:				
Basic	37,528	37,564	37,526	37,658
Diluted	37,718	37,713	37,706	37,779

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

Table of Contents

DRIL-QUIP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	(In thousands)			
Net income	$15	$36,137	$110	$72,906
Other comprehensive loss, net of tax:				
Foreign currency translation adjustments	6,740	(20,087)	14,599	(21,352)
Total comprehensive income	$6,755	$16,050	$14,709	$51,554

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, 2017 (In thousands)			2016		
Operating activities						
Net income	$	110		$	72,906	
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Depreciation and amortization	22,713			15,500		
Stock-based compensation expense	6,783			6,254		
Loss (gain) on sale of equipment	(88		)	(29		)
Deferred income taxes	(1,486		)	(3,828		)
Changes in operating assets and liabilities:						
Trade receivables, net	(4,823		)	64,200		
Inventories	29,246			763		
Prepaids and other assets	4,471			20,658		
Excess tax benefits of stock options and awards	—			(26		)
Accounts payable and accrued expenses	(18,226		)	(13,537		)
Net cash provided by operating activities	38,700			162,861		
Investing activities						
Purchase of property, plant and equipment	(12,936		)	(15,276		)
Proceeds from sale of equipment	610			139		
Acquisition of business, net of cash acquired	(21,289		)	—		
Net cash used in investing activities	(33,615		)	(15,137		)
Financing activities						
Repurchase of common stock	—			(24,238		)
Proceeds from exercise of stock options	403			508		
	—			26		

Excess tax benefits of stock options and awards					
Net cash used in financing activities	403		(23,704		)
Effect of exchange rate changes on cash activities	8,002		(13,627		)
Increase (decrease) in cash and cash equivalents	13,490		110,393		
Cash and cash equivalents at beginning of period	423,497		381,336		
Cash and cash equivalents at end of period	$	436,987	$	491,729	

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

6

Table of Contents

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 drilling and production equipment that is well suited primarily 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, diverters and safety valves. Dril-Quip’s products are used by major integrated, large independent and foreign national oil and gas companies and drilling contractors 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 at TIW Corporation (TIW) in Houston, Texas and in Macae, Brazil. The Company maintains additional facilities for fabrication and/or reconditioning and rework in Australia, Canada, China, Denmark, Ecuador, Egypt, Ghana, Hungary, Indonesia, Mexico, Nigeria, Norway, Qatar and Venezuela. The Company’s manufacturing operations are vertically integrated, allowing it to perform substantially all of its forging, heat treating, machining, fabrication, inspection, assembly and testing at its own facilities. The Company’s major subsidiaries are Dril-Quip (Europe) Limited, located in Aberdeen with branches in Denmark, Norway and Holland; Dril-Quip Asia Pacific PTE Ltd., located in Singapore; TIW, located in Houston, Texas; Dril-Quip do Brasil LTDA, located in Macae, Brazil; and DQ Holdings Pty. Ltd., located in Perth, Australia. Other subsidiaries include TIW Canada Ltd., located in Alberta, Canada; Dril-Quip Oilfield Services (Tianjin) Co. Ltd., located in Tianjin, China with branches in Shenzhen and Beijing, China; Dril-Quip Egypt for Petroleum Services S.A.E., located in Alexandria, Egypt; Dril-Quip (Ghana) Ltd., located in Takoradi, Ghana; TIW Hungary LLC, located in Szolnok, Hungary; PT DQ Oilfield Services Indonesia, located in Jakarta, Indonesia; TIW de Mexico S.A. de C.V., located in Villahermosa, Mexico; Dril-Quip (Nigeria) Ltd., located in Port Harcourt, Nigeria; Dril-Quip Qatar LLC, located in Doha, Qatar; TIW (UK) Limited, located in Aberdeen, Scotland; TIW de Venezuela S.A., located in Anaco, Venezuela and with a registered branch located in Shushufindi, Ecuador; and TIW International, Inc., with a registered branch located in Singapore.

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2016 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 statement of the financial position as of June 30, 2017 and the results of operations, comprehensive income for the three and six months ended June 30, 2017 and 2016 and cash flows for the six-month periods ended June 30, 2017 and 2016. 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. Management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate. The results of operations, comprehensive income and cash flows for the six-month period ended June 30, 2017 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, 2016.

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.

Table of Contents

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 revenues

The Company recognizes 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, using the efforts-expended method, calculates the percentage complete and applies the percentage to determine the revenues earned and the appropriate portion of total estimated costs to be recognized. 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, 2017 and December 31, 2016, receivables included $52.4 million and $56.8 million of unbilled receivables, respectively. For the three months ended June 30, 2017, there were six projects representing approximately 16% of the Company's total revenues and approximately 20% of the Company's product revenues that were accounted for using percentage-of-completion accounting, compared to six projects for the three months ended June 30, 2016, which represented approximately 16% of the Company's total revenues and approximately 19% of its product revenues. For the six months ended June 30, 2017, there were seven projects representing approximately 14% of the Company's total revenues and approximately 18% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 10 projects for the six months ended June 30, 2016, which represented approximately 15% of the Company's total revenues and approximately 19% of its product revenues.

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 revenues

The Company recognizes service revenues from three sources:

- technical advisory assistance;

8

Table of Contents

- 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,	
	2017	2016	2017	2016
	(In thousands)			
Weighted average common shares outstanding—basic	37,528	37,564	37,526	37,658
Dilutive effect of common stock options and awards	190	149	180	121
Weighted average common shares outstanding—diluted	37,718	37,713	37,706	37,779

3. New Accounting Standards

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-09, "Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting." This update clarifies which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not anticipate any modifications to its existing awards and therefore has concluded that there is no impact to its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350)." The standard simplifies the subsequent measurement of goodwill by removing the second step of the two-step impairment test. The amendment requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The amendment should be applied on a prospective basis. The standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is evaluating the impact of the new standard on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, “Business Combinations: Clarifying the Definition of a Business (Topic 805).” This update clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. For public business entities,

Table of Contents

the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of the new standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09 “Improvements to Employee Share-Based Payment Accounting (Topic 718).” The standard simplifies several aspects of accounting for share-based payment transactions, including the accounting for income taxes, forfeitures and statutory withholding requirements, as well as classification in the statement of cash flows. The standard is effective for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. The Company adopted this standard as of January 1, 2017. The primary impact of this standard is the income tax effects of awards recognized when the awards are vested or settled is now reflected in the statement of cash flows as part of net income from operating activities.

In February 2016, the FASB issued ASU 2016-02 “Leases (Topic 842).” The new standard requires lessees to recognize lease assets (right of use) and lease obligations (lease liability) for leases previously classified as operating leases under generally accepted accounting principles on the balance sheet for leases with terms in excess of 12 months. The standard is effective for annual periods beginning after December 15, 2018, including interim periods within those fiscal years. The Company is in the process of assessing its contractual commitments and arrangements with respect to the required presentation and disclosure under the new lease standard and its impact. Remaining implementation matters include completing the gap analysis between current requirements and the new leasing standard, establishing new policies, procedures and controls and quantifying any adjustments upon adoption.

In November 2015, the FASB issued ASU 2015-17 “Income Taxes (Topic 740)." The new standard requires that deferred tax assets and liabilities be classified as noncurrent on a classified balance sheet. The Company adopted this standard in the first quarter of 2017 on a prospective basis.

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 new revenue standard permits companies to either apply the requirements retrospectively to all prior periods presented or apply the requirements in the year of adoption through a cumulative adjustment. The Company is in the process of assessing its contractual commitments and arrangements with respect to the required presentation and disclosure under the new revenue standard and its impact. Remaining implementation matters include completing the gap analysis between current requirements and the new revenue standard, establishing new policies, procedures and controls, and quantifying any adjustments upon adoption. The Company has not yet determined if it will apply the full retrospective or the modified retrospective method.

4. Business Acquisitions

On October 14, 2016, the Company entered into an agreement with Pearce Industries, Inc. to acquire all the outstanding common stock, par value $100.00 per share, of TIW for a cash purchase price of $142.7 million, which is subject to customary adjustments for cash and working capital. The acquisition closed on November 10, 2016 and is expected to strengthen the Company's liner hanger sales and increase market share. Additionally, the acquisition of TIW gives Dril-Quip a presence in the onshore oil and gas market.

Total acquisition costs since inception through June 30, 2017 in connection with the purchase of TIW were $2.5 million. These costs were expensed in general and administrative costs as of December 31, 2016.