DRIL-QUIP INC
Form 10-Q
November 09, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(MARK ONE)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number 001-13439

DRIL-QUIP, INC.

(Exact name of registrant as specified in its charter)

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

13550 HEMPSTEAD HIGHWAY

HOUSTON, TEXAS

77040

(Address of principal executive offices)

(Zip Code)

(713) 939-7711

(Registrant s telephone number, including area code)

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

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

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

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

As of November 6, 2007, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 40,451,035.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	December 31, 2006	September 30, 2007
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 135,429	$ 173,819
Trade receivables, net	144,820	160,316
Inventories, net	162,503	175,940
Deferred income taxes	15,424	15,738
Prepaids and other current assets	6,879	6,205
Total current assets	465,055	532,018
Property, plant and equipment, net	129,340	138,456
Other assets	540	404
Total assets	$ 594,935	$ 670,878
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 38,572	$ 29,861
Current maturities of long-term debt	844	878
Accrued income taxes	15,760	8,884
Customer prepayments	39,387	46,210
Accrued compensation	9,916	9,792
Other accrued liabilities	13,326	13,089
Total current liabilities	117,805	108,714
Long-term debt	2,876	2,324
Deferred income taxes	6,757	6,804
Total liabilities	127,438	117,842
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued)		
Common stock:		
50,000,000 shares authorized at $0.01 par value, 40,357,656 and 40,438,785 shares issued and outstanding at December 31, 2006 and September 30, 2007, respectively	404	404
Additional paid-in capital	192,086	195,387
Retained earnings	264,620	340,404
Foreign currency translation adjustment	10,387	16,841
Total stockholders equity	467,497	553,036

Total liabilities and stockholders equity	$ 594,395	$ 670,878

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
	(In thousands, except per share data)			
Revenues	$ 117,767	$ 130,423	$ 324,441	$ 362,806
Cost and expenses:				
Cost of sales	67,596	75,895	188,651	208,137
Selling, general and administrative	12,320	11,772	32,707	35,856
Engineering and product development	4,759	6,009	14,475	16,495
	84,675	93,676	235,833	260,488
Operating income	33,092	36,747	88,608	102,318
Interest income	1,140	2,273	2,044	6,022
Interest expense	(131)	(98)	(574)	(256)
Income before income taxes	34,101	38,922	90,078	108,084
Income tax provision	10,689	11,298	28,074	32,300
Net income	$ 23,412	$ 27,624	$ 62,004	$ 75,784
Earnings per common share:				
Basic	$ 0.59	$ 0.68	$ 1.58	$ 1.87
Diluted	$ 0.58	$ 0.67	$ 1.55	$ 1.85
Weighted average common shares:				
Basic	39,528	40,438	39,124	40,417
Diluted	40,382	41,004	39,948	40,983

The accompanying notes are an integral part of these statements.

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine months ended September 30, 2006	Nine months ended September 30, 2007
	(In thousands)	
Operating activities		
Net income	$ 62,004	$ 75,784
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	10,935	11,560
Stock-based compensation expense	1,287	1,580
Gain on sale of equipment	(114)	(226)
Deferred income taxes	(4,590)	(173)
Changes in operating assets and liabilities:		
Trade receivables, net	(7,514)	(11,868)
Inventories, net	4,542	(9,316)
Prepaids and other assets	(2,630)	979
Excess tax benefits of stock option exercises	(11,937)	(827)
Trade accounts payable and accrued expenses	12,775	(11,293)
Net cash provided by operating activities	64,758	56,200
Investing activities		
Purchase of property, plant and equipment	(18,610)	(17,706)
Proceeds from sale of equipment	294	277
Net cash used in investing activities	(18,316)	(17,429)
Financing activities		
Proceeds from long-term borrowings	206	
Principal payments on long-term debt	(599)	(635)
Proceeds from exercise of stock options	13,214	894
Excess tax benefit-stock options	11,937	827
Net cash provided by financing activities	24,758	1,086
Effect of exchange rate changes on cash activities	(4,211)	(1,467)
Increase in cash and cash equivalents	66,989	38,390
Cash and cash equivalents at beginning of period	32,762	135,429
Cash and cash equivalents at end of period	$ 99,751	$ 173,819

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, 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.

The condensed consolidated financial statements included herein have been prepared by Dril-Quip and are unaudited, except for the balance sheet at December 31, 2006, which has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of September 30, 2007, the results of operations for each of the three and nine-month periods ended September 30, 2007 and 2006, and the cash flows for each of the nine-month periods ended September 30, 2007 and 2006. 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 nine-month period ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the consolidated audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

2. Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

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

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

Cash and cash equivalents

Short-term investments that have a maturity of three months or less from the date of purchase are classified as cash equivalents. The Company invests excess cash in 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 $19.0 million and $17.7 million were recorded as of September 30, 2007 and 2006, respectively. If market conditions are less favorable than those projected by management, additional inventory reserves may be required.

Property, Plant and Equipment

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

Income Taxes

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

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 project contracts which generally require more than one year to fulfill. Revenues and profits on long-term project contracts are recognized under the percentage-of-completion method based on the ratio of costs incurred to total estimated costs. Price and cost estimates are reviewed periodically as the work progresses, and adjustments proportionate to the percentage complete are reflected in the period when such estimates are revised. Losses, if any, on contracts are recognized when they become known. Contracts for long-term projects contain provisions for customer progress payments. Payments in excess of revenues recognized are included as a customer prepayment liability.

Foreign Currency

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

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

Stock-Based Compensation

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

Fair Value of Financial Instruments

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

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.

The following table provides comprehensive income for the periods indicated:

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2007**	**2006**	**2007**
	(In thousands)			
Net income	$ 23,412	$ 27,624	$ 62,004	$ 75,784
Foreign currency translation adjustment	764	1,855	5,827	6,453
Comprehensive income	$ 24,176	$ 29,479	$ 67,831	$ 82,237

Earnings Per Share

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

The net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the number of common shares outstanding at September 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 September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
	(In thousands)		(In thousands)	
Number of common shares outstanding at end of period	39,771	40,439	39,771	40,439
Effect of using weighted average common shares outstanding	(243)	(1)	(647)	(22)
Weighted average basic common shares outstanding	39,528	40,438	39,124	40,417
Dilutive effect of common stock options	854	566	824	566
Weighted average diluted common shares outstanding	40,382	41,004	39,948	40,983

New Accounting Standards

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

Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition in our financial statements. Our evaluation was performed for the tax years which remain subject to examination by major tax jurisdictions as of September 30, 2007, which are the years ended December 31, 2001, through 2006.

We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results.

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

3. Stock-Based Compensation and Stock Option Awards

During the three and nine months ended September 30, 2007, the Company recognized $534,000 and $1,580,000, respectively, of compensation expense compared to $434,000 and $1,287,000, respectively, for the three and nine months ended September 30, 2006. Compensation expense is reported as selling, general and administrative expense, in the accompanying condensed consolidated statements of income. During the three and nine months ended September 30, 2007 and 2006, there were no stock options granted. On October 26, 2007, the Nominating, Governance and Compensation Committee of the board of directors of the Company granted options to purchase an aggregate of 256,284 shares of Common Stock pursuant to the 2004 Plan to certain officers and employees of the Company. Refer to Note 12 of the Company s 2006 Form 10-K for additional information regarding stock-based compensation plans.

4. Inventories

Inventories consist of the following:

	December 31, 2006	September 30, 2007
	(In thousands)	
Raw materials and supplies	$ 40,861	$ 40,379
Work in progress	35,624	46,783
Finished goods	102,891	107,800
	179,376	194,962
Less: allowance for obsolete and excess inventory	(16,873)	(19,022)
	$ 162,503	$ 175,940

5. Geographic Areas

	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
	(In thousands)		(In thousands)	
Revenues:				
Western Hemisphere:				
Products	$ 54,245	$ 49,786	$ 137,624	$ 144,903
Services	9,387	9,994	25,434	29,297
Intercompany	18,193	13,315	54,242	49,522
Total	$ 81,825	$ 73,095	$ 217,300	$ 223,722
Eastern Hemisphere				
Products	$ 31,371	$ 40,308	$ 96,769	$ 110,988
Services	9,158	9,891	23,174	23,685
Intercompany	545	683	2,822	1,965
Total	$ 41,074	$ 50,882	$ 122,765	$ 136,638
Asia Pacific				
Products	$ 12,215	$ 18,893	$ 35,922	$ 49,278
Services	1,391	1,551	5,518	4,655
Intercompany	2,138	904	4,297	5,420
Total	$ 15,744	$ 21,348	$ 45,737	$ 59,353
Summary				
Products	$ 97,831	$ 108,987	$ 270,315	$ 305,169
Services	19,936	21,436	54,126	57,637
Intercompany	20,876	14,902	61,361	56,907
Eliminations	(20,876)	(14,902)	(61,361)	(56,907)
Total	$ 117,767	$ 130,423	$ 324,441	$ 362,806

Income before income taxes:				
Western Hemisphere	$ 25,631	$ 18,382	$ 58,411	$ 59,705
Eastern Hemisphere	8,132	8,661	24,702	22,201
Asia Pacific	5,329	8,226	17,197	22,452
Eliminations	(4,991)	3,653	(10,232)	3,726
Total	$ 34,101	$ 38,922	$ 90,078	$ 108,084

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	December 31, 2006	September 30, 2007
	(In thousands)	
Total Long-Lived Assets:		
Western Hemisphere	$ 110,452	$ 121,303
Eastern Hemisphere	30,782	29,824
Asia Pacific	10,557	11,035
Eliminations	(21,911)	(23,302)
Total	$ 129,880	$ 138,860

	December 31, 2006	September 30, 2007
	(In thousands)	
Total Assets:		
Western Hemisphere	$ 368,709	$ 446,826
Eastern Hemisphere	181,146	170,407
Asia Pacific	57,760	63,841
Eliminations	(12,680)	(10,196)
Total	$ 594,935	$ 670,878

6. Common Stock

In September 2006, the board of directors of the Company approved a two-for-one common stock split in the form of a stock dividend. As a result, the split was paid in the form of a stock dividend on October 5, 2006 to stockholders of record as of the close of business on September 21, 2006. The Company issued 19.9 million shares of common stock as a result of the stock split. In addition, the number of shares of common stock issuable upon the exercise of outstanding stock options and the number of shares of common stock reserved for issuance under the Company s employee benefit plans were proportionately increased in accordance with the terms of those respective agreements and plans.

7. Stockholders Equity

The Rights Agreement between the Company and ChaseMellon Shareholder Services, L.L.C. dated as of October 17, 1997 (the Rights Plan) included one Right to purchase one one-hundredth of a share of Series A Junior Participating Preferred Stock for each share of common stock. On October 17, 2007, the Rights Plan and the rights issued thereunder expired by their terms. No shares of the Series A Preferred Stock were issued or outstanding.

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 is not determinable and therefore, it is not possible to accurately 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 financial position.

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

The following is management s discussion and analysis of certain aspects of the Company s financial position and results of operations 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, 2006.

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 the nine months ended September 30, 2007 and 2006, the Company derived 84% and 83%, respectively, of its revenues from the sale of its products and 16% and 17%, respectively, 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 nine months of 2007, 14 projects representing approximately 17% 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 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 67% and 64% of its revenues derived from foreign sales for each of the three-month periods ended September 30, 2007 and 2006, respectively, and 66% and 63% for the nine months ended September 30, 2007 and 2006, 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 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 September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
Revenues:				
Product Group	83.1%	83.6%	83.3%	84.1%
Service Group	16.9	16.4	16.7	15.9
Total	100.0	100.0	100.0	100.0
Cost of sales	57.4	58.2	58.1	57.4
Selling, general and administrative expenses	10.5	9.0	10.1	9.9
Engineering and product development expenses	4.0	4.6	4.5	4.5
Operating income	28.1	28.2	27.3	28.2
Interest income	1.0	1.7	0.6	1.7
Interest expense	(0.1)	(0.1)	(0.1)	(0.1)
Income before income taxes	29.0	29.8	27.8	29.8
Income tax provision	9.1	8.6	8.7	8.9
Net income	19.9%	21.2%	19.1%	20.9%

Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006.

Revenues. Revenues increased by $12.6 million, or approximately 10.7%, to $130.4 million in the three months ended September 30, 2007 from $117.8 million in the three months ended September 30, 2006. The net increase resulted primarily from increased product revenues in the Eastern Hemisphere and Asia-Pacific of $8.9 million, and $6.7 million, respectively which was slightly offset by a decrease in the Western Hemisphere of $4.5 million. The Western Hemisphere decrease was primarily due to lower sales in the Gulf of Mexico. Service revenues increased by approximately $1.5 million. 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.

Cost of Sales. Cost of sales increased by $8.3 million, or approximately 12.3%, to $75.9 million for the three months ended September 30, 2007 from $67.6 million for the same period in 2006. As a percentage of revenues, cost of sales were approximately 58.2% and 57.4% for the three-month period ended September 30, 2007 and 2006, 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 September 30, 2007, selling, general and administrative expenses decreased by approximately $500,000, or approximately 4.1%, to $11.8 million from $12.3 million in the 2006 period. This decrease was primarily due to foreign currency transaction gains which totaled $1.4 million for the three months ended September 30, 2007 compared to losses of approximately $240,000 for the same period in 2006. These gains were offset by increased labor and overhead expenses resulting from increased staffing levels in the areas of sales, administration and finance, and increased legal and professional fees. Selling, general and administrative expenses as a percentage of revenues decreased from 10.5% in 2006 to 9.0% in 2007.

Engineering and Product Development Expenses. For the three months ended September 30, 2007, engineering and product development expenses increased by approximately $1.2 million, or 25%, to $6.0 million from $4.8 million in the same period of 2006. This increase was primarily due to an increase in personnel and associated operating expenses needed to meet the engineering requirements of an increased number of larger and more complex projects that have relatively longer engineering and manufacturing time frames. Engineering and product development expenses as a percentage of revenues increased from 4.0% in 2006 to 4.6% in 2007.

Interest Income. Interest income for the three months ended September 30, 2007 was approximately $2.3 million as compared to $1.1 million for the three-month period ended September 30, 2006. This increase was due to interest earned on short-term investments resulting from cash flows generated.

Interest expense. Interest expense for the three months ended September 30, 2007 was $98,000 compared to approximately $131,000 for the same period in 2006.

Income tax provision. Income tax expense for the three months ended September 30, 2007 was $11.3 million on income before taxes of $38.9 million, resulting in an effective income tax rate of approximately 29%. Income tax expense for the three months ended September 30, 2006 was $10.7 million on income before taxes of $34.1 million, resulting in an effective tax rate of approximately 31%. The decrease in the effective tax rate was due to increased tax benefits for manufacturing companies located in the United States.

Net Income. Net income was approximately $27.6 million for the three months ended September 30, 2007 and $23.4 million for the same period in 2006, for the reasons set forth above.

Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006.

Revenues. Revenues increased by $38.4 million, or approximately 11.8%, to $362.8 million in the nine months ended September 30, 2007 from $324.4 million in the nine months ended September 30, 2006. The net increase resulted primarily from increased product revenues in the Western Hemisphere, Eastern Hemisphere and Asia-Pacific of $7.3 million, $14.2 million and $13.4 million, respectively. Service revenues increased by approximately $3.5 million from increased service revenues in the Western Hemisphere and Eastern Hemisphere of $3.9 million and $500,000, respectively, which was partially offset by a decrease in Asia-Pacific of $900,000. In general, the increase in revenues resulted from increased demand for the Company s products 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 essentially a result of the increase in product sales.

Cost of Sales. Cost of sales increased by $19.4 million, or approximately 10.3%, to $208.1 million for the nine months ended September 30, 2007 from $188.7 million for the same period in 2006. As a percentage of revenues, cost of sales were approximately 57.4% and 58.1% for the nine-month periods ending September 30, 2007 and 2006, respectively. The reduction in cost of sales as a percentage of revenues resulted primarily from changes in product mix.

Selling, General and Administrative Expenses. For the nine months ended September 30, 2007, selling, general and administrative expenses increased by approximately $3.2 million, or 9.8%, to $35.9 million from $32.7 million in the 2006 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 and increases in legal and professional fees. In addition, the Company experienced approximately $2.0 million in pre-tax foreign currency transaction gains for the nine months ended September 30, 2007 and 2006. Selling, general and administrative expenses as a percentage of revenues decreased from 10.1% in 2006 to 9.9% in 2007.

Engineering and Product Development Expenses. For the nine months ended September 30, 2007, engineering and product development expenses increased by $2.0 million, or approximately 13.8%, to approximately $16.5 million from $14.5 million in the same period of 2006. This increase was due primarily to an increase in personnel and associated operating expenses. Engineering and product development expenses as a percentage of revenues remained constant at 4.5% in the nine months ended September 30, 2007 and 2006.

Interest Income. Interest income for the nine months ended September 30, 2007 was $6.0 million as compared to $2.0 million for the nine-month period ended September 30, 2006. This increase is due to interest earned on short-term investments resulting from cash flows generated.

Interest Expense. Interest expense for the nine months ended September 30, 2007 was $256,000 compared to $574,000 for the same period in 2006.

Income tax provision. Income tax expense for the nine months ended September 30, 2007 was $32.3 million on income before taxes of $108.1 million, resulting in an effective income tax rate of approximately 30%. Income tax expense for the nine months ended September 30, 2006 was $28.1 million on income before taxes of $90.1 million, resulting in an effective income tax rate of approximately 31%. This decrease in the effective tax rate reflects a reduction in tax rates in the Asia-Pacific region and increased tax benefits for manufacturing companies located in the United States of America.

Net Income. Net income was approximately $75.8 million for the nine months ended September 30, 2007 and $62.0 million for the same period in 2006, 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 rental of running tools and (ii) to fund working capital. Historically, the Company s principal sources of funds have been cash flows from operations and bank indebtedness.

Net cash provided by operating activities was approximately $56.2 million and $64.8 million for the nine months ended September 30, 2007 and 2006, respectively. The decrease in cash flow from operating activities is principally due to increases in inventory levels partially offset by higher net income.

Capital expenditures by the Company were $17.7 million and $18.6 million for the nine months ended September 30, 2007 and 2006, respectively. The expenditures in each period were primarily for facilities, machinery and costs associated with running tools. Principal payments on long term debt were $635,000 for the nine month period ended September 30, 2007 versus principal payments of $599,000 on long-term debt and for the same period in 2006. There were no additional long-term borrowings during the nine months ended September 30, 2007 compared to $206,000 for the same period in 2006.

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 September 30, 2007, 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. $8.2 million). Borrowing under this facility bears interest at the Bank of Scotland base rate, which was 5.75% at September 30, 2007, 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 September 30, 2007 was approximately U.S. $2.9 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 2007. 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 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, 2006 for a discussion of our critical accounting policies. During the nine months ended September 30, 2007 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 pre-tax foreign currency gains of approximately $1.4 million and $2.0 million during the three and nine month periods ended September 30, 2007, respectively, compared to $242,000 pre-tax foreign currency loss and $2.0 million pre-tax foreign currency gain for the three and nine month periods ended September 30, 2006, respectively. 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 September 30, 2007 balance of approximately $2.9 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 $29,000, or $7,250 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 September 30, 2007 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 2006 Annual Report on Form 10-K.

There has been no change in the Company s internal controls over financial reporting that occurred during the nine months ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

PART II OTHER INFORMATION

Item 1. ***Legal Proceedings.***

See Note 8 to the condensed consolidated financial statements included in Item 1 of Part I above, as well as Legal Proceedings in Item 3 of Part I of the Company s Annual Report on Form 10-K for the year ended December 31, 2006. 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, 2006.

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

None.

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

None.

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

None.

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 Dril-Quip s control. 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. Althou 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 and administrative proceedings; and
- 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, 2006 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 future 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:

n 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)).
ted herein by reference to Exhibit 3.3 to the Company s Registration Statement on Form S-1 (Registration No. 333-33447)).
mmon Stock (Incorporated herein by reference to Exhibit 4.1 the Company s Registration Statement on Form S-1 (Registration No. 333-33447)).
ng 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. 3
npany and ChaseMellon Shareholders Services, L.L.C., as rights agent (Incorporated herein by reference to Exhibit 4.3 to the Company s registration Statement on F
ion of Larry E. Reimert.
ion of Gary D. Smith.
ion of J. Mike Walker.
ion of Jerry M. Brooks.
E. Reimert.
D. Smith.
e Walker.
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: November 8, 2007